

# Study on the Role of Auditing in Managing Financial Crises in the Business Practices

Mr. Prasad Naik<sup>1</sup>, Mr. Anish Pawar<sup>2</sup>, Mr. Sudeep Dett<sup>3</sup>

Assistant Professor, Lilavati Lalji Dayal Night College of Commerce, Charni Road, Mumbai<sup>1</sup>

FYBCOM, Lilavati Lalji Dayal Night College of Commerce, Charni Road, Mumbai<sup>3</sup>

FYBAF, Lilavati Lalji Dayal Night College of Commerce, Charni Road, Mumbai<sup>4</sup>

**Abstract:** *The financial crisis that occurred in the past decade did not occur suddenly. Scholars must analyze the fundamental factors that led to the financial catastrophe. Regarding corporate governance, our focus will be on enhancing internal control and internal audit. Studies have identified specific warning signs that indicate the impending financial crisis. However, the main problem stems from inadequate financial detection and a lack of comprehension of the importance of the internal audit role in the internal control system. Internal audit is a fundamental pillar of corporate governance. The purpose of our study is to investigate the perception of financial auditors regarding the impact of their understanding of internal controls on the production of accurate financial reports and the enhancement of the audit procedure. In this study, we evaluate the importance of internal audit in the internal control system using data from 70 auditors who are members of the Romanian Financial Auditors Chamber, out of a total of 1178 members from all regions of Romania. To underscore the research, our focus has been on doing an empirical study in Romania*

**Keywords:** ACFE (Association of Certified Fraud Examiners), financial crisis, fraud, internal audit, and internal control

## I. INTRODUCTION

The significance of internal controls and internal audit has significantly escalated during the previous decade. This study seeks to provide survey data demonstrating the indispensability of internal controls, their effectiveness in preventing fraud, and their capacity to enhance the quality of financial reports. The IFRS 2011 manual states that the aim of financial reporting is as follows: Universal The objective of financial reporting is to provide financial information about the reporting organization that can be used to assess whether to allocate resources to it and to evaluate the effectiveness and efficiency of its management and governing board (Bruce, Danie, Tapiwa, & Raymond, 2011). Accurate financial reporting has been emphasized by numerous experts and standard-setters due to its importance. The function of the audit intern is crucial in the prevention of errors and fraud. The financial reports must precisely depict the organization, as previously stated, to optimize the utilization of available resources. Companies that provide precise financial reporting should take into account the function of auditors.

Accounting scandals, such as the ones that occurred with Enron in 2001, WorldCom in 2002, Qwest Communications, Adelphia, Global Crossing, Nortel, and Parmalat at the beginning of the twenty-first century, added complexity to the financial world and highlighted its ambiguous character. Following this particular financial crisis, external auditors have faced criticism, while experts have recognized the significance of internal audit and its indispensability.

The Institute of Internal Auditors (IIA, 2011) defines internal auditing as an unbiased and objective activity that provides assurance and advisory services to enhance an organization's operations and add value. By implementing a methodical and rigorous strategy to evaluate and improve the effectiveness of risk management, control, and governance processes, it assists an organization in attaining its objectives. Studies indicate that there has been a 10% increase in the allocation of staffing and resources towards internal audit following the occurrence of accounting scandals. The frequency of conversations and information sharing between the audit committee and internal audit department has increased by 25% compared to previous crises. The year 2009 (Atanasiu & A).

The internal audit function plays a crucial role in corporate governance by monitoring organizational risks and ensuring that organizational procedures are efficient and properly controlled (IIA, 2003). Internal audit and internal control are integral elements of corporate governance, serving as the foundation of the financial system to ensure its effective operation. Undoubtedly, it is logical for the senior management to verify and review the internal audit reports. Otherwise, the organization's performance deteriorates if the senior management fails to allocate time to evaluate reports and disregards them. This study aims to illustrate the significance of internal audit within the internal control framework of financial markets, based on the aforementioned assertion. An effective internal control function facilitates the creation of accurate financial reports and mitigates the occurrence of any abnormalities.

## **II. LITERATURE REVIEW**

An efficient internal control system (ICS) is widely recognized as the primary means of preventing, detecting, and rectifying fraud and errors, as supported by various sources (e.g., AICPA 2007; Beck 1986; Bierstaker et al. 2006; Heier et al. 2005; Hooks et al. 1994; Mautz and Mini 1966; PCAOB 2008; Rae and Subramaniam 2008; Wales 1965; Wells 2008). However, the precise definition of a successful Incident Command System (ICS) is primarily based on assumptions derived from retrospective analysis, a form of inductive reasoning conducted by professionals. The source cited is Barra (2010).

Recent academic study has proven that a well-designed internal audit system can effectively prevent financial statement fraud. Management may attempt to utilize fraudulent accounting practices in order to present the company as financially prosperous. When analyzing financial figures, auditors should maintain a certain level of skepticism. In order to identify common fraudulent methods, taxonomies of financial statement fraud have been created (Rezaee, 2009).

The Association of Certified Fraud Examiners (ACFE) has undertaken a comprehensive study on the impacts of internal control vulnerabilities. This study identifies the main factor that facilitated fraudulent activities. According to the data, in 38% of the instances, the primary deficiency identified was a deficiency in internal controls, specifically the absence of job segregation. Internal controls were detected in over 19% of the instances, however, the perpetrator or perpetrators managed to bypass them in order to carry out and conceal the fraud. The control deficiency of lacking a reporting mechanism was the least frequently mentioned by the CFEs who participated in our study. This is intriguing considering that hotlines are consistently the most effective detective control mechanism, and less than half of the victim organizations had one in place during the occurrence of the fraud. The source cited is ACFE (2010).

Prawitt et al. (2009) suggest that the Internal Audit Function (IAF) has the ability to improve the quality of reporting by minimizing potential errors in the design of incentive systems. A separate investigation carried out in Romania on a nationwide scale by Dumitru Matis and Cristina Bota in 2010. The study authors endeavored to evaluate the significance of creating an internal audit report as a means to ensure robust corporate governance. One of the survey questions inquired whether the respondents perceived the internal audit report as necessary or advantageous in promoting transparency for effective company governance. According to 58.70% of respondents, generating the internal audit report can enhance transparency. Nevertheless, a significant proportion of respondents, specifically 39.13%, answered in the negative.

Holt and DeZoort released a significant study on internal audit in 2006. The study conducted by Holt and DeZoort in 2006 examined the impact of disclosing internal audit reports on the perception of financial reporting reliability. This empirical study sought to illustrate the impact of the internal audit report on investors' confidence in the precision and dependability of financial reporting. Investors assert that they have greater confidence in the accuracy of the financial reporting of companies that generate internal audit reports compared to those who do not.

Subsequently, the writers further developed their previous research. Their research centers around enhancing the transparency of internal audit reports for external stakeholders with regards to governance. The researchers examine the literature and the results of 18 semi-structured interviews with analysts, audit committee members, internal auditors, and policymakers to evaluate the possible advantages and disadvantages of disclosing IAR (Integrated Annual Report), such as enhanced transparency and accountability, but also increased information burden, legal risks, and reporting expenses. Their conclusion is that an Integrated Assurance and Reporting (IAR) system has the capacity to improve existing governance disclosures, strengthen stakeholder confidence in the efficacy of governance, and promote internal

audit vigilance. An internal auditor report is necessary to enhance transparency in governance and provide information to external stakeholders. (Holt, DeZoort, & Deborah, 2008)

#### **An analysis of financial auditors' perceptions of internal control mechanisms**

The section under "Knowledge and Assessing of Internal Control" contains information about the second study issue, which pertains to the accurate comprehension and recognition of the internal control mechanism.

The initial inquiry in this section prompts participants to evaluate the importance of different risks that can be reduced by employing internal control mechanisms. The independent audit committee's aim is to monitor the financial reporting process, ensuring the production of precise and reliable financial information. It is not necessary for the audit committee to spend the entire day overseeing the accounting records of the organization as part of the monitoring procedure. Deficiencies in the internal control system are considered a significant cause of financial data fabrication. Inadequate internal controls over financial reporting and accounting operations may have a detrimental effect on the ability to guarantee prompt and accurate financial reporting. However, it is essential for every publicly traded company to establish a suitable internal control department that aligns with its size. This department should consist of experienced professionals who can effectively validate the accuracy and reliability of the financial reports.

### **III. CONCLUSION**

AFCE has identified three main types of occupational fraud:

Embezzlement

Corruption

Inaccurate financial statement.

As per the Association of Certified Fraud Examiners (ACFE), the category of professional frauds encompasses the following: Asset misappropriations are instances of fraud where the perpetrator unlawfully obtains or misuses an organization's resources. Corruption schemes involve an employee leveraging their power in business transactions in a manner that violates their obligation to the employer, with the intention of benefiting either themselves or another party. Financial statement fraud refers to schemes where critical information is intentionally falsified or omitted from an organization's financial reporting. Common fraudulent financial statement manipulation strategies include falsely recording income, concealing commitments or expenses, and fraudulently inflating reported assets (ACFE, 2010).

The above described definitions of fraud emphasize the essential role of the internal control function in the financial markets. We assert that internal control plays a pivotal role in the financial markets. The internal control reports require prioritization by executive management and the company's administration to ensure their effective functioning. Alternatively, if the applicants for internal control are not given attention, their efforts may be disregarded, potentially resulting in insolvency, especially for businesses.

Significant financial losses have been suffered, namely in the past decade after to the 1929 financial crisis in the United States. Every financial action worldwide can potentially influence other global financial markets due to the interconnectedness of our globalized society. Producing dependable and precise financial reports is the initial measure in averting any financial concerns. Failure to address this issue would undoubtedly lead to financial crises in the financial markets, which could trigger a detrimental chain of events that impacts the global financial system. Given the worldwide nature of financial markets, several professionals and auditors have examined the consequences of internal control by developing mathematical models. For an internal control to be effective, it is crucial to consolidate all the components. Otherwise, senior executives would face difficulties in making sound decisions, and such bad decision-making might potentially destabilize the company's financial framework.

Internal audit can improve the transparency and quality of the financial position through thorough investigation and in compliance with research findings. In order to prevent any adverse impact on the decision-making process, individuals who utilize financial information should accurately analyze the financial reports. Furthermore, research indicates that the internal audit report holds significant importance and serves as an opportunity for the top management of firms. The findings of the aforementioned studies may vary across different countries. This text aims to form an opinion regarding the transition of a new European nation from communism to democracy in 1989. Romania outperformed all other Balkan nations in attracting international investment. Romania is arguably the ex-communist nation in the region that has most effectively assimilated with eastern neighbours.

**REFERENCES**

- [1]. ACFE. (2016). Report to the Nations on Occupational Fraud and Abuse. Austin. ACFE. (2010). Report to the Nations on Occupational Fraud and Abuse. Austin.
- [2]. Atanasiu, P., & A, C. B. (2009). Criza Economica Globala: Activitatea de Audit Intern Ar Fi Putut Preveni Aceasta Criza? Audit Financiar, 7, 14-21.
- [3]. Bruce, M., Danie, C. T., Tapiwa, N., & Raymond, C. (2011). IFRS "International Financial Report Standards". New Jersey: John Willey & Sons.
- [4]. DiNapoli, T. P. (2007). Standards for Internal Control in New York State Government. New York: State Comptroller.
- [5]. Dragan, C. (2005). Auditul Financiar-Contabil în Contextul European. Craiova: Editura Universitaria.
- [6]. Dumitru, M., & Cristina, B. (2010). Studiu Privind Relevanta Publicarii Raportului de Audit Intern in Contextul Asigurarii Unei Bune Guvernante Corporative. Audit Financiar, 8(10), 26-33.
- [6]. George, C., & Traian, I. (2009). Risk Analysis - Specific Procedure of the Internal Audit . Annals of the University of Petroșani, 9(1), 93-100.
- [7]. Holt, T. P., DeZoort, T. F., & Deborah, A. S. (2008). The Need for an Internal Auditor Report to External Stakeholders To Improve Governance Transparency. Accounting Horizons, 22(4), 275-288