The Importance of the Internal Control in Detecting Errors and Frauds on Corporate Governance: Case Study "IAS 16"

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Abstract

Disregarding internal control is the first step of losing governance power over any entity. Part of the internal control regarding IAS 16 "Property, Plant and Equipment" is rather important for any financial controller. In this paper we try to identify the errors committed while recognizing the property and equipment according to the IAS 16 "Property, Plant and Equipment" in the financial situation. We considered that fixed assets entered the entity by purchase; own production, leases, government grants or other credit institutions on which the internal control was conducted. Our study also aims to analyze how errors and frauds affect the financial information users in the capital markets. The results of the case study will be detailed and compared in the present paper.

Keywords: *internal control, corporate governance, errors, frauds, fixed assets, IAS 16*

JEL Classification: M10

Introduction

The design and operation of the internal control are handled by the management/governance. As such, the management recognizes and understands the fact that it is responsible for the preparation of the financial statements in conformity with the applicable financial regulations, this fact including also the precise presentation of the financial statements. Also, the management is responsible for the execution of the internal control in such a way that the presentation of the financial statements should not contain significant misrepresentations, expressed either by fraud or mistakes.

In the same context we would like to point out the fact that the management of the company is accountable for maintaining the internal control, considered necessary for the preparation of financial statements that do not contain significant misrepresentations, but taking into account that no matter how effective the internal control is, it can offer but a reasonable degree of certainty concerning the accomplishment of the financial objectives of the entity, because of certain inherent limitations of the internal control.

The type of internal control that is to be used for the preparation of the financial statements is up to the management of the entity, because a series of factors are involved, such as: the control environment, the risk evaluation process used in the entity; the informational system (including the relevant business processes for the financial report process and communication); the control and control monitoring activities.

The internal control of an entity, including the accountancy books and the entries or the accountancy system, reflect the requirements of the management, the complexity of the business, the laws or relevant regulations, as well as the type of risks the entity is subject to.

The objective of the control is to determine the degree to which internal control mechanisms are working, in such a way that the presentation of the financial reports should not contain significant misrepresentations, and as such, the users of the financial reports are not misled in the elaboration of the economic decisions based on the financial reports presented by the company.

1. Methodology

Our objective is to identify the significant information misrepresentation risks, because of fraud or errors pertaining to financial reports, by understanding the company and its environment, including the internal control. As such, we shall evaluate a basis for the elaboration and implementations of answers to the significant misrepresentation risks.

Method: In this case study our objective is to use the following risk evaluation procedures and other related activities:

- Questioning the management and other personnel categories, that according to the reasoning of the appointed person for the internal control can help identify risks of significant misrepresentation, because of fraud or error;
- Analytical procedures;
- Observation and inspection;
- Other used control techniques.

Concerning the evaluation process of the risks for the entity, the persons responsible for the internal control must understand the extent to which the entity needs the process in order to:

- Identify risks for the business that are relevant for its financial reporting objectives;
- Assessing the significance of the risks;
- Evaluating the probability of their occurrence;
- Decision concerning the actions in order to tackle those risks.

Another element we want to approach in this case study is the identification and evaluation of the risks of significant misrepresentation, situation in which the internal controller must identify and evaluate the risks of significant misrepresentation:

- At the financial report level;
- At the level of the affirmations as to the classes of transactions, balance accounts and presentations.

In the same context, we want to take the following steps:

- identify the risks involved in the process of understanding the enterprise and its environment, including control of the classes of transactions, balance accounts, entries in the financial reports;
- evaluate the identified risks and the degree to which they affect the financial situations overall;
- bring together the identified risks with the relevant controls that we intend to test;

- take into consideration the risk of significant misrepresentation, including the possibility that multiple misrepresentations occur leading to a significant misrepresentation of the financial reports.

In applying professional reasoning in regards to the completeness of the assets, their evaluation on entry or exit, and balance, the accuracy, existence, independence of the exercise, rights and obligations, the prevalence of the economic over the juridical, the reasonable assessment for depreciation, presentation and report, we aim to take into account at least the following aspects:

- The extent to which the risk is a fraud risk;
- The extent to which the risk is connected with recent economical, accounting or other developments and requires special attention;
- The complexity of the transactions;
- The extent to which the risk involves transactions with affiliated parties;
- The degree of partiality in the evaluation of financial information pertaining to the risk, in the evaluations that involve a broad range of uncertainty;
- The degree to which the risk involves significant transactions outside the regular activity of the company, or that seem unusual from other viewpoints.

2. IAS 16 "Property, Plant and Equipment"

Concerning the internal control of the assets, we took into account the provisions of the *International Accounting Standard 16 "Property, Plant and Equipment*" and we set as main objective of the internal control for this section of the financial reports that of describing and testing the way in which the accounting treatment applied to the tangible assets which have an effect on the reasoning of the users of the financial reports concerning an enterprise investing in its tangible assets, as well as the modifications such an investment suffers. Hence, we took into account the main aspects in the book-keeping of tangible assets such as: the recognition of the assets, determining the book value, expenses for losses and from the depreciation that must be recognised as connected with the assets. It is essential that we test the appropriate accounting policies, consistent from one period to another, concerning the criteria used to define and recognise tangible assets.

We took into account the fact that tangible assets entered the records of the entity only by the following means, representing the chronological track of the control of tangible assets: acquisition; own production; leasing contracts; government subsidies or other credit entities.

2.1. Recognising the Fixed Assets Entering by Acquisition

Concerning the *tangible assets that enter the entity records by acquisition*, we would like to mention the cost of a piece of equipment imported by the entity that was determined without considering the provisions of paragraph 16, letter a. (Provisions, Contingent Liabilities and Contingent Assets) according to which any costs can be attributed directly in order for it to function is a constitutive element of the cost of an asset.

In this way, it was discovered by using the control technique by sampling an invoice for services of assembly of the aforementioned equipment that was not included in the cost of the asset, together with the purchase cost, but was registered as expenses under the column "Other third party services", in the debit of the account. The accounting reasoning that was applied was erroneous and did not comply with the provisions of The International Financial Reporting Standards, and the purchase invoice no. 2876/15.07.2012 in the amount of 490,980 lei (€ 112.870) should have been included in the cost of the asset, and then immobilised and subjected to depreciation of the asset, not attributed directly to the "Profit and Loss Statement".

This error has led to the incorrect calculation of the initial cost of the equipment and modified the financial reports in the amount of 49,980 lei (€ 11.480) at the tangible assets element.

2.2. Recognising the Fixed Assets Entering by Own Production

The second option for the *registration in the patrimony of the fixed assets is own production*. Thus, it was discovered that a manufacturing plant built with the entity's own resources during the financial year 2012 in order to expand its production, was not evaluated in accordance with The International Financial Reporting Standards. More precisely, the production cost is represented by the equivalent of cash of the price at the date of recognition and is determined in accordance with the International Accountancy Standard 16 "Property, Plant and Equipment" according the following formula:

(1) Production cost = Direct production expenses
+ Quota indirect expenses
+ Capitalisation of the interest resulting from the loan taken for the execution of the tangible assets with a long production process, during construction
+ Differences of exchange rate for the loans in foreign currency if they are regarded as a compensation of the interests expenses

The elements of the production costs were all well-kept, with the exception of the direct production expenses that according standard no. 16 "Property, Plant and Equipment" are determined by the formula:

(2) Direct production expenses = expense of raw stock and consumables
+ Direct manual labour
+ The cost of the loan corresponding to the interest up to the date of entry of the manufacturing plant in the balance sheet.

In the above described formula, direct expenses did not include the cost of the debt corresponding to the interest up to the date the production hall is recognised in the balance sheet, more precisely the costs corresponding to a medium-term bank loan in foreign currency (euro).

Thus, according to The International Accounting Standard no.23, "Borrowing Costs" ,*interest and other costs incurred by an entity to borrow funds represent borrowing costs*. In this context, we emphasis that the total borrowing costs include the total interest expense calculated by using the effective interest method and foreign exchange differences on foreign currency loans.

At a second determination, we found that the entity has included interest expenses in foreign currency (euro) worth 69,489.78 lei (€ 15.975) and exchange differences corresponding to the bank loan in foreign currency, on a 5 year term worth 35,978.45 (€ 8.270), in the profit and loss account, specifically entered these costs in BCR accounts, "Interest expense" and BCR, "Foreign exchange expenses". Formula 1 and 2 were calculated by the entity as follows:

Direct production expenses = consumption of raw materials and consumables
+ Direct labour

+ Cost of borrowing corresponding to interest until the manufacturing plant is recognised in the balance sheet =
= 1,979,538.98 + 1,124,789.9 + 0 =
= 3,104,328.88 lei (€ 713.638)

The accounting judgment was erroneous because interest expenses and exchange differences were not included, and the proper way to determine direct production costs is:

Direct production expenses = direct production expenses as entity
+ Interest expenses
+ Expenses from foreign exchange differences
= 3,104,328.88 + 69,489.78 + 35,978.45
= 3,209,797.11 lei (€ 737.884)

The production cost determined by the entity in the financial statements was of 5,583,879.65lei (€ 1,283,650), taking into account the cost of borrowing for the interest until the balance sheet recognition of the production hall are:

Production cost = Production cost
- Direct production expenses
+ Direct production expenses
= 5,583,879,65 – 3,104,328,88 + 3,209,797,11 5,689,347,88 lei (€ 1,307,896)

This error affected the presentation in the financial statements, thus distorting the production cost of the hall in the financial position worth 105,468.23lei (€ 24,245) within tangible assets and within the profit and loss account led to a decreased global result with the same amount.

2.3. Recognising the Fixed Assets Entering by Leasing Contract

The third modality encountered as to *the entry of the tangible assets in the patrimony is represented by tangible assets based on a leasing contract*. The entity has applied the professional reasoning corresponding to an operational leasing for equipment with useful life of 3 years from a foreign supplier, specifically from the U.S. The International Financial Reporting Standards state that the *operational leasing is a leasing that does not fall under financial leasing*. In order to separate the operational leasing from the financial leasing we referred to the provisions of the International Accounting Standard no.17, "Leases" which state that a *lease by which all risks and rewards incidental to the ownership right of the equipment are transferred is a financial leasing.*

Although in an annex to the contract it was stipulated that all the significant risks and awards incidental to the ownership right are transferred, the entity registered and presented the equipment throughout the 3 years of functioning of the production equipment as an operational leasing.

Considering the provisions of the International Financial Reporting Standards which classify leasing contracts according to:

- Risk transfer: losses generated as a result of a reduced usage degree of the equipment, technological obsolescence and variations of the revenues due to the modifications of economic conditions; and
- Awards transfer: profitable activity during the economic life of the equipment, the gains resulting from the increase of the economic value or from the realization of the residual value

We underline that this contract is not an operational leasing one, but on the contrary, a financial leasing one, all the risks and awards incidental to the ownership right were significantly transferred, in contradistinction to the operational leasing where these rest with the locator.

The entity should have registered in its accountancy the following *operations related to a financial leasing and not an operational one as it was highlighted and presented.*

This error affected the reasoning of financial statement users for it did not record and present correctly, on the one hand, the equipment as active, mainly at the beginning of the financial leasing period, in the statement of the financial position in the debit account "Technological equipment", and on the other hand, the debt in the credit account "Other assimilated loans and debts", at a value equal to the fair value or with the updated value of the minimal leasing payments, more precisely the value of539,208 lei (€ 123,955).

Secondly, the "income statement" was affected by non-mentioning, on the one hand, the expenses with the interest in the debit account "Expenses with interests", and, on the other hand, it affected the statement of the financial position, by non-mentioning in the credit account "Expenses recorded in advance", of the monthly value of 2,890 lei (€ 664); the cumulative value which had to be recognized is of 17,340 lei (2,890 lei x 6 months) (€ 3,986).

Thirdly, in the "Income Statement" the amortization expenses corresponding to the equipment were not recorded in the debit account "Depreciation expenses", on the one hand, and in the credit account "Equipment depreciation", with a monthly value of 14,978 lei (€ 3,443), the cumulative value being of 89,868 lei (14,978 lei x 6 months) (€ 20,659).

We conclude by underlining that the aggregate value of the error we observed mainly in the financial position is of 539,208 lei (€ 123,955) (input value of the equipment) to which are added the expenses recorded in advance with a cumulated value of 17,340 lei (€ 3,986), therefore a total of 556,548 lei (€ 127,942); secondly, the "Income Statement" was affected with a cumulated value of17,340 lei (€ 3,986), non-recorded leasing interests and of 89,868 lei (€ 20,659), corresponding to non-recorded depreciation expenses, of a total of 107,208 lei (€ 24,645).

2.4. Recognising the Fixed Assets Entering by Government Subventions or Credit Institutions

The fourth method encountered in the registration in accountancy of *the tangible assets is the tangible assets on the basis of government subventions or of other credit institutions.* In this respect we mention that the entity received a subvention through an EU grant programme worth 455.000 lei (€ 104,597) to finance complex equipment for manufacturing furniture for public nurseries, kindergartens, secondary schools and high schools. The conditions for receiving the subvention had to meet the following mandatory criteria:

- putting the equipment into operation within 4 months since the reception of the subvention;
- the equipment had to function at the capacity specified in the handbook;
- the equipment had to provide at least 10 jobs to persons enlisted as unemployed at NAE.

The equipment was acquired from a purveyor member of the European Union, more precisely from Hungary, the contract signed with the respective partner including also the shipping, the equipment installation, the training of the personnel, installation and assembly.

The initial costs are as follows:

Table 1.

Initial Costs

Costs	Sum (LEI)
Price per unit of the equipment	400,000
Delivery cost of the equipment	20,000
Installation and assembly	8,500
Training of the personnel	7,500
Other expenses occasioned by the putting into operation of the equipment by the domestic purveyor "EnelMuntenia S.A."	20,000
Total costs	**455,000**

The equipment has an estimated useful life of 5 years and was amortised according to the method of linear amortisation.

According to the International Financial Reporting Standards, this is an input through government subventions, and government subventions concerning the assets should be presented in the statement of the financial position either by recording the subvention as deferred revenue, or by deducting the grant to arrive at the carrying value of the asset.

The ledgers of the entity display the following records corresponding to the input of the equipment in the patrimony of the society under a government grant.

We wish to underline that the entity observed the provisions of the International Financial Reporting Standards as regards the recognition of government subventions, i.e.:

- The entity respected the conditions required in order to receive a government grant:
  - It put into operation the equipment within 3 months since it received the grant;
  - The equipment worked at the production capacity specified in the handbook; and
  - It hired 10 employees who were enlisted as unemployed at the NAE before being hired.
- The entity received the grant of 455,000 lei in the bank account specified in the documentation for the awarding of a subvention according to a EU grants programme.

However, as regards the presentation of government grants, the *entity did not meet the recommendations of the International Financial Reporting Standards, due to an unintentional error of professional reasoning.* More precisely it did not present (according to one of the two methods required by the standards)the subvention as a deferred revenue, recognised in the profit and losses, on a systematic basis during the useful lifetime of the tangible asset or the "deduction of the value of the received government grant from the calculation of the book value of the asset". According to the last mentioned method, the subvention is recognised in the profit or loss during the lifetime of the depreciable asset as a reduction in the depreciation charge, in order to evince the effort of the entity to increase the economic benefits by acquiring new tangible assets.

The entity should have recorded in its accounting records the following *operations incidental to the entry of a tangible asset through government grants.*

We conclude by underlining the effects of the detected errors on the reasoning of the users of financial statements. Firstly, the entity omitted to record the operation no. 1, grant to be received recognised as deferred revenue, more precisely the sum of 445,000 lei on the financial position, in the credit account "Government Subventions for investments".

Secondly, according to the operation no. 4, the registration of the expenses generated by the putting into operation of the equipment by the domestic purveyor "EnelMuntenia S.A." worth 20,000 lei (€ 4,597) was not immobilised, included in direct costs in the debit account "Technological Equipment", but, on the contrary, it was directly registered in the profit and loss account, through the debit of the account "Expenses with energy and water". Thus, the reasoning of the users of financial statements was affected from the viewpoint of the financial position, the input value of the equipment being of 455,000 lei, and not of 435,000 lei (€ 100,000) as the entity recorded.

Thirdly, the monthly expenses with the depreciation with fixed assets were not registered for 9 months since the equipment was put into operation, therefore the book value of the asset was presented erroneously; according to the entity, the presentation was of 435,000 lei (€ 100,000), instead of 386,750 lei (€ 88,908), calculated by the following formula:

(3) Net book value = Acquisition costs – Accumulated amortisation – losses from depreciation

= 455,000 lei – 68,250 lei – 0 lei =386,750 lei (€ 88,908)

Fourthly, the registrationno.6 was not operated, namely the systematic allocation of the subsidy over the revenues from subventions (for the period of the 5 years when the benefits will have been consumed according to the management's estimations) worth7,584 lei (€ 1,743). The omission of the registrations no. 5and 6 affected the turnover of the "Income Statements" with the amount of 68,250 lei (€ 15,689), corresponding to both debit and credit of the profit and loss account.

Fifthly, we wish to underline that by omitting the registration no.1, the registration of the subvention to be received recognised as deferred revenue, the account "Government Subventions", which is a receivables account, presented a creditor sold of 455,000 lei, which, in fact, was evinced in the financial statements, affecting once more the honesty of the image.

And finally, as regards the presentation of the information, we mention that the explanatory notes exhibited no information regarding the accounting policy adopted for "government grants", including the presentation models adopted in the financial statements, such as the nature and especially the volume of the government grants was presented erroneously, still we did not detect any embezzlement intent.

According to the International Financial Reporting Standards, "*the book value is the value at which an asset is recognised after having deducted the accumulated depreciation and the cumulative losses from depreciation*". *According to the calculation technique,* it was discovered in the balance sheet, under the chapter "Tangible assets", the fact that the equipment was not registered at its book value, more precisely, due to a calculation error, the deduction of the cumulative depreciation was omitted. The acquisition cost of the equipment was of 270,840 lei (€ 62,262), displayed in the analytical debit account, the cumulative depreciation being of 110,090 lei (€ 25,308), presented in the trial balance in the analytical credit account. The presentation error ensuing from this omission was of 160,750 lei (€ 36,954), calculated according to the following formula:

(4) Acquisition cost – Cumulated depreciation – losses from depreciation = Book value, So, applying the calculation formula:

270,840 – 110,090 – 0 = 160,750 lei

According to the International Financial Reporting Standards, *amortisation is the systematic allocation of the amortisable value of an asset during its entire useful life*. Also in this context, the standard specifies that the *useful life is the period during which an asset is expected to be used by the entity or the number of production units the entity expects to obtain from the asset.* Using the documentary control technique, and the reconciliation, the control team noticed that one of the means of transportation was not correctly presented in the financial statements, due to an error in determining the amortisable value which affected directly the book value. More specifically, the amortisation plan was improperly drawn up, which affected the presentation of the analytical patrimonial element and of the analytical irreversible depreciation element corresponding to the means of transportation.

The acquisition cost of the means of transportation was of 2,200,980 lei (€ 505,972), included in the analytical debit account, and the expenses with the amortisation were determined by the control team with the linear amortisation formula:

(5) Depreciation value = Acquisition cost / Useful life

Thus, by applying the formula:

Monthly amortisation value = 2,200,980 / 48 months = 45, 853. 8 lei (€ 10,541)

By using the comparison technique, between the creditor turnover of the analytical account corresponding to the means of transportation from the trial balance (taken from the Irreversible depreciation plan) and the value determined according to the calculation formula no. 2, it was observed that the monthly irreversible depreciation was diminished by 15,000 lei (€ 3,448). This fact led to the corruption of the financial statements with the amount of 210,000 lei (15,000 lei x 14 months, the period since the means of transportation was put into operation) (€ 48,275). This error also affected the registration in the financial statements corrupting the book value of the means of transportation.

Another error resulting from the erroneous application of the provisions of the International Financial Reporting Standards, which specify that "*the losses from depreciation represent the value by which the book value of an asset exceeds its recoverable value". The recoverable value is the biggest value between the fair value of an asset minus the costs generated by the sale and its utilisation value.* Thus, the book value of the manufacturing plant, evinced by the analytical debit account was in the accounting year 2012, July, of 1,259,937 lei (€ 289,640), and the recoverable value (fair value) was determined by an expert evaluator member of the National Association of Romanian Evaluators to the amount of 1,010,658 lei (€ 232,335). This fact was not taken into consideration and it was thus omitted to record the loss from depreciation, worth 249,279 lei (€ 57,305), which generated an incorrect representation of the financial statements by distorting the value of the manufacturing plant which was presented without taking into consideration the evaluation made by the expert evaluator, and hence of the reversible depreciation which should have been taken into account.

According to the International Accounting Standard 36 the "Assets depreciation" was:

(6) Loss from depreciation = book value – Recoverable value

By applying the calculation formula 3, the amount of 249,279 lei was obtained:

Loss from depreciation = 1,259,937 – 1,010,658 lei

Another particularly important aspect consists in the derecognition of tangible assets. According to the documentation technique and physical inspection the financial statements revealed that the registration of an element, more precisely of an equipment which would no longer bring subsequent economic benefits through its utilisation. *According to the International Financial Reporting Standards, the book value of an element of tangible assets has to be derecognised on disposal or when subsequent economic benefits are no longer expected through the usage or disposal of the certain asset.* Thus, this equipment recorded with a book value of 250.897 lei (€ 57,677) in the financial period subject to review should no longer have been recorded in the entity's financial statements, affecting thereby once more the honest image and the possible future decisions of the users. Moreover, the loss resulting from the derecognition of the equipment should have been recorded in the profit and loss account, according to the International Accounting Standard 16 "*Tangible assets" – Derecognition, point 68.*

As far as the presentation errors are concerned, we mention a deviation from the provisions of the International Financial Reporting Standards, more precisely for each class of tangible assets, financial statements must record the useful life or the used depreciation rates, and these provisions were not registered and presented in the Explanatory notes which accompany the financial statements.

Also related to the presentation in the financial statements, we underline the fact that the gross carrying amount and the accumulated depreciation (aggregated with the accumulated losses from depreciation) were presented inappropriately at the beginning and at the end of the period due to the errors observed during the subchapter of the internal control of tangible assets.

Conclusion

The conclusion ensuing from this section of the internal control is that the aggregated effect of the errors discovered during the internal control of the tangible assets on the users of financial statements is of *2,607,040,23 lei (€ 599,319), out of a total of 18,952,400 lei (€ 4,356,873), representing the total tangible assets at the end of the 2012 accounting year*. This represents *16.42% of the total tangible assets significant error active and 13.16% of the total assets.* In conclusion, the aggregated effect of the errors as to tangible assets is one that affects thoroughly the decision of the users of the information presented in the financial statements for the future provisions of investments or disinvestments.

References

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