

EMPIRICAL STUDY ON THE ROLE OF FINANCIAL AUDIT IN ASSESSING THE RISKS OF MONEY LAUNDERING AND TERRORISM FINANCING

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Abstract:

In recent years, the scale of criminal activity has reached alarming levels and the globalisation of the financial services industry and advances in technology have made the financial aspects of crime increasingly complex. Money laundering and terrorist financing are most often carried out by economic entities. Accounting professionals in general and financial auditors in particular occupy positions that enable them to fight criminal acts of this nature. The overall aim of the research is to assess the extent to which the financial auditor can contribute to the prevention or mitigation of money laundering and terrorist financing at the level of audited companies, following the adoption of legislative changes. More specifically, the first direction of this research consists in identifying and analyzing the variables that characterize the susceptibility of the involvement of companies, listed on the BSE on the regulated market, in acts of money laundering and terrorist financing in the period 2019-2020 by sector of activity. The second direction of the research aims to assess the extent to which the financial auditor can contribute to preventing and combating money laundering and terrorist financing by identifying and reporting the factors of occurrence of risks of this nature as key audit issues. Statistical methods of multivariate data analysis are used to test the research hypotheses.

Key words: money laundering, terrorist financing, financial audit, econometric study, audit quality

JEL classification: M41, M42, M48

1. INTRODUCTION

In recent years, the globalization of the financial services industry and rapid advances in technology have meant that criminal activities have grown in scale and the financial aspects of crime have become increasingly complex (McDowell and Novis, 2001). Accounting, as well as being a science, a technique, can also be an art. Given the art of accounting, accounting knowledge can also be used to encourage financial criminality. Our research focuses precisely on the position of the accounting professional as an important factor that could prevent criminal acts in the field of finance and accounting (Bunget et. al., 2009; Montesdeoca et. al., 2019).

Money laundering refers to the process of converting or transferring money to disguise its origin. Actions aimed at financing terrorism use the financial system to erase the source and destination of the money (Parkman, 2019). Most of the time, these actions, classified as economic crime, are characterized by non-disclosure. According to a study by the Association of Certified Fraud Examiners, from January 2018 to September 2019, the global cost created as a result of fraudulent activity amounts to 3.6 billion USD, with asset misappropriation leading the way at an overwhelming 86%, followed by corruption schemes at 43% and fraudulent financial reporting at 10% (Amara et. al., 2020; ACFE, 2020). On top of all this, there are consequences that cannot be

easily quantified, such as a decline in brand image, loss of market position, deterioration in employee morale and loss of future opportunities (Zhang et. al., 2018; PwC, 2020). Given that these crimes are not only the consequence of incorrect application of the law, but also represent an increasingly serious threat to national and international security, the financial auditor is increasingly playing an important role in countering economic criminality. More specifically, as part of the financial audit assignment, an auditor must also assess the risks of money laundering and terrorist financing as fraud risks in which a company may be involved. There are situations where the professional judgment of those responsible within the client entity is more than present and it is then also difficult for financial auditors to determine whether the distortions in these areas are due to error or fraud (Sadaf et. al., 2018).

Legislative changes at European and national level in recent times have put financial auditors in an important position by expressly calling for the introduction of measures to prevent and combat economic criminality in their work. A first direction of this research consists in identifying and analyzing the variables that characterize the susceptibility of the involvement of companies, listed on the BVB on the main market, in acts classified as economic criminality in the period 2019-2020 by sector of activity. The second direction of the research is focused on assessing the extent to which the financial auditor can contribute to preventing and combating economic criminality, by identifying and reporting on the factors leading to the occurrence of such risks as key audit issues.

2. REVIEW OF LITERATURE

2.1. CONCEPTUAL AND REGULATORY FRAMEWORK ON PREVENTING AND COMBATING MONEY LAUNDERING AND TERRORIST FINANCING

As previously mentioned, money laundering (*AML-Anti-Money Laundering*) is about converting or transferring money to disguise its real origin. Countering the Financing of Terrorism (CFT) facilitates the financing of such acts, but without disclosing the source and destination of the money (Parkman, 2019). Although the first money laundering operations appeared in the 14th century, the term money laundering was first formally used in 1972 in the Watergate affair, when the campaign committee for President Nixon's re-election allegedly arranged for illegally obtained campaign finance money to be wired to Mexico and then transferred back through Miami entities (Achim and Borlea, 2019). Terrorism has been talked about since the Old Testament, but as we move into the modern period, terrorist attacks have evolved in technique and strategy. In the 1970s, hijackings of civilian airliners began, in the 1980s the technique of car bomb explosions took off, and since the 1990s suicide bombings have taken off at an astonishing pace, with the frequency of everyday events (Diaconu, 2004). And as there is no successful organisation without successful funding (Koh, 2006), terrorist organisations also need funding. At the international level, in 1989, the Financial Action Task Force (FATF) was established as an international body to develop anti-money laundering (AML) policies and, subsequently, counter-terrorist financing (CFT) measures (Bălăceanu and Porojan, 2012). More specifically, after the 1980s, money laundering became a subject of criminal law, when the relationship between the criminal act generating dirty money and the actual act of money laundering was approached differently, with the tendency for money laundering acts themselves to take the form of a crime (Neacșu, 2019).

At international level, the first act to criminalise money laundering was a Convention adopted for this purpose in November 1990 in Strasbourg. This document attests to the need to follow a mutual criminal policy, whereby the perpetrator is deprived of all gains from criminal activity (Neacșu, 2019). In Europe, Directive 2005/60/EC, designed to regulate action to prevent economic crime (Achim and Borlea, 2019), repealed by Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015, lays down cooperation rules applicable to the Member States of the European Union. In Romania, the crime of money laundering was first criminalised by Law no. 21/1999, and subsequently, the legislative framework was completed by:

Law no. 39/2003 on *the prevention and combating of organised crime* which included the crime of money laundering in the list of serious crimes, Law no. 535 of 25 November 2004 on *preventing and combating terrorism*, still in force today, Law no. 656 of 7 December 2002 on *preventing and punishing money laundering and establishing measures to prevent and combat the financing of terrorism*, with subsequent amendments and additions (Șcheau, 2018), repealed by Law no. 129 of 11 July 2019, found in the list of sources, which transposes into national law Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015. In Romania, the National Office for Preventing and Combating Money Laundering (NOPCML) plays an important role in the implementation of the system to combat economic criminality.

Money laundering involves a whole set of economic, legal and financial techniques and methods by which the proceeds of criminal acts (fraud, embezzlement, tax evasion, etc.), represented by money or other goods, are separated from their (illicit) origin, in order to give them an apparent legally justified origin, with the aim of introducing them into the real economy (Neacșu, 2019). It is noted that, by its nature, money laundering involves activities and operations that are usually secret, complex and with a very wide geographical coverage (Jurj-Tudoran and Drosu Șaguna, 2016). Three stages of the money laundering process are identified, according to the Financial Action Task Force - FATF (Accountancy Europe, 2018), namely: placement, layering and integration of money into the circuit of economic activities. The steps mentioned are also common in terrorist financing actions, except that the integration involves the distribution of funds to terrorist organizations, and in money laundering actions, the dirty money is subsequently integrated into the legal circuit (Schott, 2006).

2.2. OBLIGATIONS OF FINANCIAL AUDITORS IN PREVENTING AND COMBATING MONEY LAUNDERING AND TERRORIST FINANCING

According to Law No. 129/2019 (hereinafter "the Law"), financial auditors fall under the category of reporting entities supervised and controlled by the National Office for the Prevention and Combating of Money Laundering (NOPCML, 2021). With regard to preventing and combating economic criminality, financial auditors have obligations from two perspectives (CFAR, 2016): 1) as a person who undertakes cash transactions on their own behalf, in lei or in foreign currency, the limit of which is the equivalent in lei of 10. 000, even if the transaction is carried out through a single operation or through several operations that appear to be related to each other, and 2) as a reporting entity, from the position of the professional who provides auditing services, tax, business or accounting advice or other services to its clients and who has the obligation to report under the conditions provided for by the Law in the services provided. At the same time, the fundamental principles of integrity and professional conduct contained in the IESBA Code establish responsibilities for accounting professionals ("Non-Compliance with Laws and Regulations" - NOCLAR), with the public interest being a priority (Vasile et. al., 2018; Özşahin et. al., 2017). NOCLAR provides for laws and regulations that also cover economic criminality (IESBA, 2020). In addition, in order to prevent and combat money laundering and terrorist financing risks, financial auditors should develop and establish internal rules and policies, internal control mechanisms and procedures to manage money laundering and terrorist financing risks. These should include at a minimum: internal rules including applicable measures on reporting, prompt provision of information at the request of competent authorities, retention of documents and all records, and applicable measures on know-your-client measures; risk management procedures, procedures setting out internal control, communication and compliance management standards, procedures applicable to their staff and covering measures to protect staff involved in the application of those policies from any hostile or discriminatory threats or actions, specific internal reporting procedures, and periodic training and evaluation procedures (NOPCML, 2021). From a financial audit point of view, four elements associated with customer knowledge in the prevention and combating of money laundering and terrorist financing are considered (Grosu and Mihalciuc, 2020): 1) acceptance of clients according to the degree of risk, as well as monitoring during engagements; 2) establishment

of standard and additional know-your-customer measures for each category; 3) identification of suspicious transactions by examining unusual client transactions; 4) preparation and maintenance of documentation by the auditor and establishment of criteria for accessing reports on preventing and combating money laundering and terrorist financing. As members of the CFAR, financial auditors shall adopt and apply policies and procedures designed to fight economic criminality in their engagements as part of the internal quality control system. According to the Guidance on a Risk-Based Approach for the Accounting Profession, at the AML/CFT due diligence stage, the FATF recommends that accounting professionals apply each of the following steps in a risk-based approach: a) establish and verify the identity of the client; b) taking steps to identify the real beneficiary; c) understanding the nature and purpose of the business; and d) continuously monitor the relationship (FATF, 2019). In a risk-based approach, accounting professionals need to expand their work to reduce risk. The higher the risks, the better preventive controls need to be managed (Yao, 2019; IFAC, 2020).

Financial auditors should select and apply the most appropriate procedures and tests in the course of their engagements in order to gather sufficient and sound audit evidence of the money laundering and terrorist financing risks that clients may be involved in. The most suitable procedures for this purpose are documentation, investigation, analytical procedures and external confirmations (Grosu and Mihalciuc, 2020). It is well known and proven, as a result of major financial scandals, that the risk of not detecting significant misrepresentations caused by fraud is higher than the risk of not detecting misrepresentations caused by errors (Robu, 2014). There may be sophisticated and carefully organised strategies to conceal a fraud, including those involving economic crime offences such as forgery, non-recording or misrecording of transactions or intentional misrepresentation to the auditor (IFAC, 2020). The detection of fraud by financial auditors depends on the scope of the fraud, the skill of the perpetrator(s), the frequency and extent of the manipulation, the extent of complicity and the level of hierarchy of the persons involved and the relative size of the individual amounts manipulated.

Based on previous research, the hypotheses proposed for testing are formulated below.

Hypothesis 1. At the level of the sample analyzed, a decrease in the involvement of companies in economic criminality can be observed as a consequence of changes in legislation.

Hypothesis 2. The financial auditor's identification of risk factors relating to economic criminality in the companies included in the sample analyzed as key audit issues contributes to the prevention of these phenomena over time.

3. RESEARCH METHODOLOGY: POPULATION, SAMPLE, VARIABLES, DATA SOURCE, DATA ANALYSIS METHODS

The statistical approach (Jaba, 2002) followed for testing and validating the proposed research hypotheses takes into account the steps listed in point three: identification of population, sample selection, identification of variables and choice of data analysis methods, processing, obtaining results and their interpretation.

The population analyzed in the study is represented by companies listed on the Bucharest Stock Exchange - BSE, the sample includes only companies on the main market, subject to statutory audit, according to legislation (Law no. 162/2017). As the number of listed companies was not the same at the end of the financial years 2019 and 2020, and some data were not available for a number of companies, a balanced sample of 69 listed companies was reached, for which the data collected relate to financial years 2019 and 2020. Depending on the object of activity, the sample analysed is distributed as shown in Figure no.1.

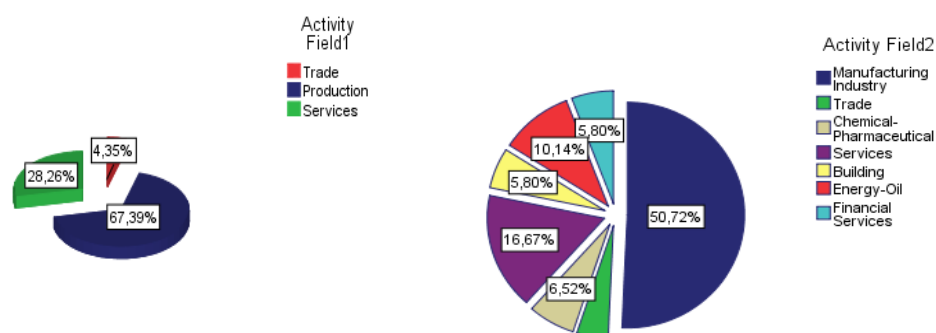


Figure no. 1. Distribution of companies in the sample by business activity

(Source: own processing)

In order to demonstrate the formulated research hypotheses, the study first focuses on the extent to which companies in Romania are involved in money laundering and terrorist financing, depending on the sector of activity, the codes and policies adopted, the management system and the compliance or non-compliance with Law 129/2019 during the period analysed. Secondly, the research is aimed at assessing the extent to which the identification of risk factors relating to economic criminality by the financial auditor as key audit issues contributes to the prevention of these phenomena over time. The identification of associations between the mentioned variables is carried out by using Multiple Correspondence Factor Analysis (FAMC) as a multivariate data analysis method (Pintilescu, 2007), and the classical graphical method is used to group and compare the values of the variables of interest

The table below shows the variables identified and their associated attributes.

Table no. 1. List of identified variables

| <i>Symbol</i> | | <i>Description</i> |
|---------------|-------------------------------------|-------------------------|
| Act_Field2 | Activity Field2 | Manufacturing Industry |
| | | Services |
| | | Energy-Oil |
| | | Chemical-Pharmaceutical |
| | | Financial Services |
| | | Building |
| | | Trade |
| Auditor | Auditor | Big4 |
| | | NonBig4 |
| Code_Ethics | Code of Ethics and Integrity | Non/Yes |
| Anti_Corr_Pol | Anti-Corruption Policies | Non/Yes |
| Decl_NAS | Declaration of Adherence to the NAS | Non/Yes |
| Affil_Trans | Affiliated Parties Transactions | Non/Yes |
| Int_Ctrl | Inefficient Internal Control | Non |
| | | Yes |
| App_Auditor | Appointment of Auditor after Dec 31 | Non |
| | | Yes |
| Reorg_Plan | Reorganization Plan | Non |
| | | Yes |
| Changes_Acc | Changes Accounting Department | Non |
| | | Yes |
| Inf_Access | Information Access Limitation | Non |
| | | Yes |
| Own_Shares | Redemption of own Shares | Non |
| | | Yes |
| CG_BVB | Compliance - Governance Code BVB | Non |

| <i>Symbol</i> | | <i>Description</i> |
|---------------|---|--------------------|
| | | Yes |
| Audit_Comm | Independent Audit Committee | Non |
| | | Yes |
| Remun_Pol | Transparency in the Remuneration Policy | Non |
| | | Yes |

Source: own processing

Data collection was done manually, using the annual financial reports of the sampled companies as a source, and the software used for data processing was SPSS 23.0.

4. RESULTS AND DISCUSSIONS

To test Research Hypothesis 1 - *At the level of the sample analyzed, a decrease in the involvement of companies in economic criminality can be observed as a consequence of changes in legislation*, the variables taken into account concerned the adoption or not of anti-corruption policies, codes of ethics and integrity, adherence or not to the National Anti-Corruption Strategy (NAS), transparency in the remuneration policy of members of the Board of Directors, full or partial compliance with the BSE's Corporate Governance Code, and compliance or not with all the provisions of Law no. 129/2019 associated with the object of activity. The whole approach was aimed at analysing the involvement of companies during the period under review in money laundering and terrorist financing. Figures 2 and 3 depict these associations.

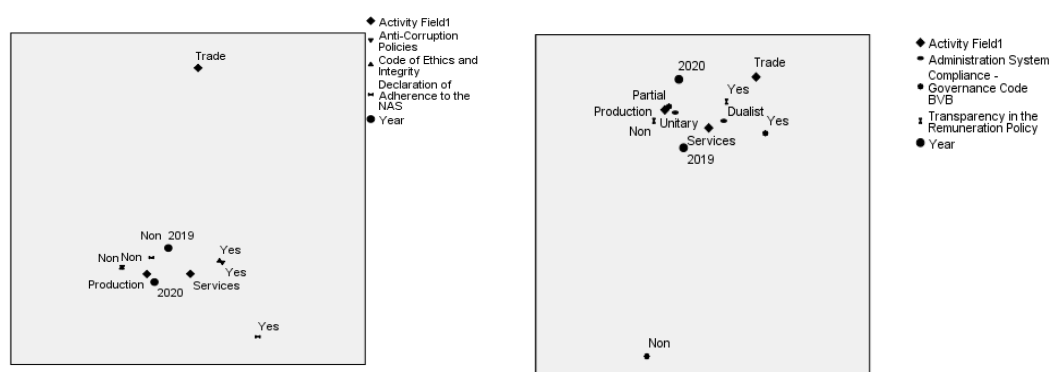


Figure no. 2. Associations between the activity field, codes, management system and policies adopted by companies in 2019-2020

Source: own processing, using FAMC

From Figure no. 2 it can be seen that while in 2019, the sampled entities operating in the manufacturing and services sector did not adopt much in the way of anti-corruption policies and ethical codes, did not adhere to the National Anti-Corruption Strategy (NAS), did not present transparency on directors' remuneration and partially complied with the BSE's Governance Code, in 2020 the situation improved. Entities in the trading sector are somewhat neutral in this direction. Compliance or non-compliance with Law 129/2019 by the sampled companies can be seen in Figure no. 3.

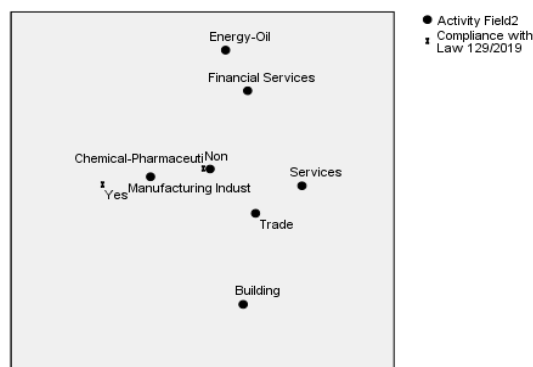


Figure no. 3. Association between the activity field and compliance with Law no. 129/2019

Source: own processing, using FAMC

The association in Figure no. 3 was made between the objects of analytical activity and compliance with the Law no. 129/2019, and it could be seen that the somewhat non-compliant area of activity is chemical-pharmaceutical. Companies operating in the manufacturing, non-construction and energy-oil sectors comply with the provisions of Law no. 129/2019 more than the other entities, which are impartial. In view of the findings from testing the first hypothesis, it can be stated that the sampled firms show a decrease in their involvement in economic crime over time as a result of changes in legislation.

To test Research Hypothesis 2 - *The financial auditor's identification of risk factors relating to economic criminality in the companies included in the sample analyzed as key audit issues contributes to the prevention of these phenomena over time*, the research is based on the identification of associations between the factors of occurrence of money laundering and terrorist financing risk identified by auditors and reported as key audit issues in published reports and the extent to which once these factors are identified over time, such phenomena can be diminished over time. Figures 4 and 5 show these phenomena.

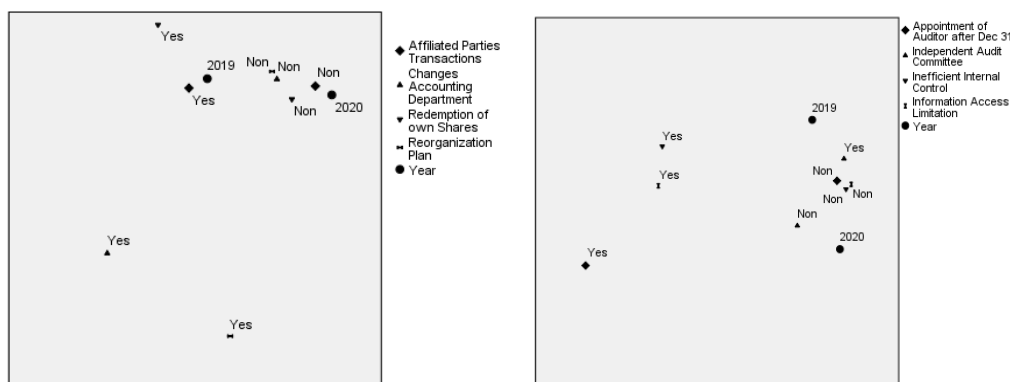


Figure no. 4. Associations between money laundering risk factors and time period

Source: own processing, using FAMC

The factors leading to money laundering and terrorist financing risk were identified by the financial auditors as a key audit issue and reported in the audit reports published in the two periods under review. From the literature review, the following were identified as risk factors of this nature: involvement of entities in transactions with affiliated parties, changes in the financial accounting department, buy-back of own shares, reorganization plans, late auditor appointment, lack of audit committee independence, ineffective internal control (Cascarino, 2013), and limiting auditor access in gathering audit evidence. From the first quadrant of Figure no. 4, it can be observed that compared to 2019, in 2020 the sampled entities were less involved in actions constituting money

laundrying risk factors. An evolution of these characteristics considered as risk factors can be seen in Figure no. 5.

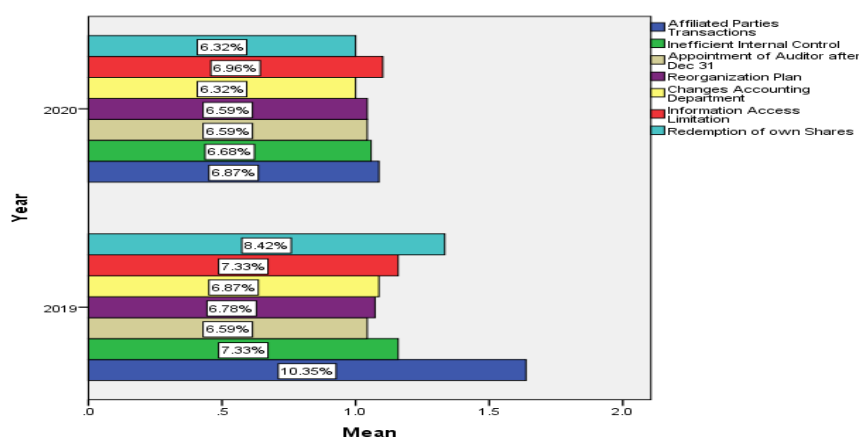


Figure no. 5. Frequency of money laundering risk factors over time

Source: own processing

From Figure no. 5, it can be seen that most money laundering risk factors have decreased and some have maintained their trend. Importantly, the sampled entities engaged less in such activities than in the previous period. This can be explained, on the one hand, by the period of 2020 - the Covid-19 pandemic - characterized by a limitation of some actions for inherent reasons, and on the other hand, legislative changes have also led to compliance with certain rules with a focus on reducing money laundering and terrorist financing.

5. CONCLUSIONS

As we have maintained in the content of the article, financial crime consists of all non-violent criminal acts that result in financial loss. In the alternative, it refers to fraud, corruption, bribery, money laundering, tax evasion, etc. This state of affairs, which is the result of the spread of the scourge of these offences, makes the subject matter topical and is also the basis of the argument of this research. Economic entities should take steps to develop procedures that focus on preventing, combating and reporting fraudulent behaviour. The financial auditor has an important role in assessing the risk of fraud in general and the risks of money laundering and terrorist financing in particular. Recent changes in European and national legislation have specifically addressed the obligations of financial auditors to put in place measures to prevent and combat economic criminality in their work.

In this context, our research aimed, first of all, to identify and analyze the variables that give content to the susceptibility of companies analysed to get involved in money laundering and terrorist financing in the period 2019-2020. After testing the first hypothesis, it was found that the sampled firms show a decrease in their involvement in economic criminality over time as a result of changes in legislation. Secondly, the research sought to assess the extent to which the financial auditor can contribute to preventing and combating economic criminality by identifying and reporting the factors that lead to the occurrence of such risks as key audit matters. By testing the second hypothesis, it was concluded that most money laundering risk factors have decreased over time, which is due to both legislative changes and the role of the financial auditor in preventing and combating money laundering and terrorist financing.

Our study certainly has its limitations, due to the size of the sample and the period analysed, but it may also be useful to the supervisory bodies in assessing the application of the recently amended regulations in this field and in awarding audit quality ratings to financial auditors.

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