

THE ROLE OF THE FORENSIC AUDIT IN PREVENTION AND DETECTION OF THE FINANCIAL REPORTS MANIPULATION

ULOGE FORENZIČNE REVIZIJE U SPRIJEČAVANJU I OTKRIVANJU MANIPULACIJA U FINANCIJSKIM IZVIJEŠĆIMA

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Abstract: *This paper aims to clarify the role of the forensic audit in the prevention and detection of the criminal acts in the financial reporting, as well as to determine the division of responsibilities between the accountants/auditors, management and internal control systems to detect and prevent financial fraud.*

The subject of this research work are the procedures and techniques of the forensic audit in prevention and detection of the financial reports manipulation as well as analysis of available empirical data on their use in the Federation of Bosnia and Herzegovina, where this discipline is relatively new and unknown.

Keywords: *forensic audit, prevention, manipulation, financial reports.*

Sažetak: *Ovim radom se nastoji pojasniti uloga forenzične revizije u prevenciji i otkrivanju kriminalnih radnji vezanih uz financijsko izvještavanje, kao i utvrditi podjela odgovornosti između računovođa/revizora, menadžmenta i sustava internih kontrola u otkrivanju i spriječavanju financijskih prijevara.*

Predmet istraživanja rada su procedure i tehnike forenzične revizije, te analiza empirijski prikupljenih podataka o njihovoj zastupljenosti i potrebi za istim u Federaciji Bosne i Hercegovine, u kojoj je ova disciplina relativno nova i nepoznata.

Ključne riječi: *forenzična revizija, prevencija, manipulacije, financijska izvješća.*

1. INTRODUCTION

The growing trend of financial fraud in the corporate world requires the development of financial forensics in a focused discipline that integrates application of tools by fraud investigators in order to detect the existence of criminal activities, collection of financial

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records for the purpose of instituting legal proceedings, evaluation of internal controls and fraud risk assessment, and ensuring control over the entities.

All organizations can be at risk of suffering criminal activities and frauds. The definitions "prevention of criminal acts" and "detection of criminal acts" are related, but definitely not the same concepts. Prevention or preemption involves the policies, procedures, trainings and communication aimed at avoiding the occurrence of fraud, while detection means the activities and techniques focused on quickly identifying any criminal activities during or after their occurrence. These activities certainly complement each other. Despite the fact that preventive actions do not ensure prevention of fraud, they are the first line of defense in reducing the risk of fraud.

Although many users of financial statements believe that auditors, when providing their judgments, are responsible for the accuracy of them, as well as detection of any errors, frauds or illegal acts, the initial role of an auditor is to state an opinion on the credibility of the state of business as presented through the drafted financial reports. While auditors have significant responsibilities too, still it is the managers who are primarily responsible for fair financial reporting.

The primary concern of this research is to identify the role of auditing in preventing and detecting criminal acts and, based on empirical research, to get a clearer picture of the attitudes of experts in the FBiH on forensic auditing, its development and presence, as well as its role and tools in detecting and preventing manipulations.

2. THE ROLE OF THE FORENSIC AUDIT IN PREVENTION AND DETECTION OF THE FINANCIAL REPORTS MANIPULATION

In order to suppress illegal activities in the world, in addition to conventional audits of financial reports performed by independent auditors or authorized public accountants, there is a specialized forensic audit or audit of illegal activities carried out by financial detectives specially trained for that. There is a special title that is acquired by training, experience and successfully passed examination, and that is the title of certified fraud examiner (*CFE – Certified Fraud Examiner*). ACFE (Association of Certified Fraud Examiners) operates in the USA as the largest global financial fraud combating organization and the primary body for certification and granting of titles based on training and education.

Auditing of illegal activities, embezzlement auditing or forensic auditing (*fraud auditing, forensic auditing*) is an active approach in the field of financial manipulation detection, using in this matter accounting records and information, analytical interdependence and full knowledge of guilt and schemes for their concealment.

Independent forensic auditing of financial statements is essentially a new specialized service within independent auditing of financial reports and, according to Professor Thomas Buckhoff, it "involves contracting a special engagement with auditing firms and requires services of an auditor with special training and experience in the prevention and detection of criminal activities"[2].

According to Paul Thangam [2], forensic auditing is "the application of accounting methods in monitoring and collecting forensic evidence, usually for investigation and criminal prosecution of criminal acts such as embezzlement and fraud." The same author points out that forensic auditing is the "concentrated auditing of all transactions of a legal person aimed to verify their validity in terms of whether an unrealistic image is represented and unlawful benefit acquired by these transactions" [2].

Bearing in mind the above positions, it follows that forensic auditing is a special service of the financial report auditing based on the application of accounting and auditing skills in the form of targeted, focused and detailed auditing procedures conducted with the purpose of discovering incriminating acts in the financial statements and presenting them in a manner acceptable for court proceedings. The main goal of forensic auditing is to detect an incriminating act in client's financial reports regardless of the magnitude of its significance, or the degree of its influence on the accuracy and objectivity of financial statements.

A forensic audit can be carried out as part of a regular audit, or it can be focused on detecting embezzlement. It is conducted because of allegations or a wish to reveal a fraudulent activity in the business system. In fact, audit of an embezzlement is actually the application of auditing procedures designed to increase the chances of detecting frauds in the foundation of business systems. It is of an exceptional importance for a forensic audit to establish the methods or techniques used to commit the incriminating act. In this manner, the client of the forensic audit identifies weaknesses in the system of internal controls and mechanisms by which they are bypassed by the perpetrator.

According to ISA 240, the primary responsibility for prevention and detection of fraud is on those who are in charge of governance of the entity and the management. It is important that management place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to occur, and fraud deterrence, and persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior.

When creating forensic auditing procedures, it is not the existence of internal control that is tested, but the authenticity of what a document present. This may seem like playing with semantics, but the difference is the key to understanding relative to traditional auditing. The auditor does not rely on the assumption that fraud of the management occurs in transactions, statements or representations. Embezzlement auditing procedures are targeted against coverup strategies. By its nature, embezzlement involves cheating and concealment. The perpetrator uses concealment strategies to create the illusion that the transaction is justified and approved. The procedures are aimed to collect the evidence that perpetrators cannot destroy by their actions. A forensic auditing procedure must be created for the scenario of embezzlement, focusing both on the structure of the economic entity and the embezzlement scenario action component, which is performed through the red flag (indicator) testing procedures related to the embezzlement scenarios and through the testing procedures concerning embezzlement schemes in the base of the business system.

3. RESEARCH METHODOLOGY

Empirical research was conducted in January and February 2015 in the territory of the Federation of BiH. The sample consisted of certified auditors, members of the Association of Accountants, Auditors and Financial Workers of FBiH. The questionnaire was sent to 60 addresses, and the response was received from 23 auditors, the response rate is 38.3%.

The questionnaire consisted of 6 closed questions and 12 statements. The closed questions were aimed to examine the auditor's past experience with manipulations in financial statements. Respondents were offered a five-point Likert scale accompanying the statements designed with the aim to identify the standpoints of certified auditors in the FBiH on auditing analytical procedures, importance of internal control systems, regulatory provisions and auditor's responsibilities when performing forensic auditing.

After logical and technical control of the collected data, the results are presented by descriptive statistics - absolute and relative frequencies, mean (M), standard deviation (SD), range [min, max], mode (D).

4. RESULTS AND DISCUSSION

As stated in the survey methodology, the sample consists of 23 certified accountants. More than $\frac{3}{4}$ of them reported having performed or having participated in audits that revealed manipulations through financial statements (18; 78.3%). All 23 of the surveyed certified auditors reported being aware of the analytical procedures that can reveal manipulations made in financial statements when carrying out audits. Slightly more than half of the respondents reported having acquired the knowledge of processes and procedures of preventing and detecting manipulations in financial statements during their professional training (14; 60.9%). As for an established internal control system and its help in revealing irregularities in financial reports, only 39.1% (9) of the auditors stated that the companies in which they carried out audits had these systems established. On the other hand, 14 auditors (60.9%) did not come across these. Almost $\frac{3}{4}$ of the surveyed auditors (17; 73.9%) deem that the audits aimed to detect and prevent manipulations should be entrusted to specially accredited professionals, while others disagree.

The standpoints of certified auditors in the FBiH on auditing analytical procedures, importance of internal control systems, regulatory provisions and responsibilities of auditors in carrying out forensic audits are examined through a set of 12 statements shown in Table 1.

Code	Statement
T1	Companies that have an organized internal control system have a greater ability to detect and prevent illegal activities than those that do not have one.
T2	Manipulations made in financial statements can be revealed by analytical procedures during audits.
T3	Introduction of analytical procedures in business practice when performing audits would reduce the number of cases of manipulations through financial statements.
T4	Adequately assessing the risk of manipulations being present in financial statements to be audited is a requirement to finding these manipulations.
T5	It is the responsibility of the auditor to reveal manipulations in financial reports.
T6	The auditor is responsible to report the revealed manipulations to relevant government bodies.
T7	The issue of mandatory auditing that will investigate and reveal manipulations in financial statements should be regulated by law.
T8	The issue of auditor's responsibility in case of revealing manipulations in financial statements should be regulated by law.
T9	The issue of responsibilities and duties of auditors in the regulatory acts of BiH is appropriately defined.
T10	In the case when it is required by law for a certified auditor to investigate manipulative actions in financial statements when performing the audit, his/her responsibility increases.
T11	It is in the interest of the state to incorporate in legislation mandatory auditing of companies in order to detect illegal activities.
T12	The subjectivity factor - effort to provide the client with a suitable auditing result - can be completely eliminated when carrying out the audit.

Table 1: Statements from the questionnaire (Source: made by authors)

Descriptive statistics of the above statements is shown in Table 2.

Statement	M±SD	Range	D	Rates – % responses					Total (100%)
				1	2	3	4	5	
T1	4.000±1.128	[2, 5]	5	0	4 (17.4)	2 (8.7)	7 (30.4)	10 (43.5)	23
T2	4.130±0.920	[3, 5]	5	0	0	8 (34.8)	4 (17.4)	11 (47.8)	23
T3	4.217±0.795	[3, 5]	5	0	0	5 (21.7)	8 (34.8)	10 (43.5)	23
T4	3.522±0.790	[2, 5]	3	0	1 (4.3)	12 (52.2)	7 (30.4)	3 (13.0)	23
T5	2.826±1.302	[1, 5]	2	4 (17.4)	6 (26.1)	6 (26.1)	4 (17.4)	3 (13.0)	23
T6	2.957±1.637	[1, 5]	1	8 (34.8)	0	6 (26.1)	3 (13.0)	6 (26.1)	23
T7	4.174±1.267	[1, 5]	5	1 (4.3)	3 (13.0)	1 (4.3)	4 (17.4)	14 (60.9)	23
T8	3.652±1.526	[1, 5]	5	3 (13.0)	4 (17.4)	1 (4.3)	5 (21.7)	10 (43.5)	23
T9	2.957±1.186	[1, 5]	3	3 (13.0)	5 (21.7)	7 (30.4)	6 (26.1)	2 (8.7)	23
T10	4.130±1.325	[1, 5]	5	3 (13.0)	0	0	8 (34.8)	12 (52.2)	23
T11	4.130±1.058	[1, 5]	5	1 (4.3)	0	5 (21.7)	6 (26.1)	11 (47.8)	23
T12	3.696±0.876	[2, 5]	4	0	2 (8.7)	7 (30.4)	10 (43.5)	4 (17.4)	23

M – mean, SD – standard deviation; Range - [min, max]; D – mode

Table 2: Descriptive statistics of statements (Source: Author's calculation)

Thirteen positive responses were received on the question whether the internal control system was helpful in detecting irregularities, and even 20 auditors reported having found irregularities in the companies that did not have this system established, which means that its absence facilitated the incidence of irregularities. According to responses to the statement that an adequate assessment of risks of manipulations being present is a requirement to revealing these manipulations, it can be concluded that this is possible, but not always the case.

The surveyed auditors limit their responsibilities in terms of finding and processing manipulations in financial statements. What the surveyed auditors almost completely agree on is that execution of audits aimed at detecting and preventing manipulations, as well as the degree of responsibility of auditors in this case, must be regulated by law. If it is so, most of them agree that their responsibility then increases. Another standpoint that this survey has confirmed is that it is in the interest of the state as an institution to regulate by law the mandatory enforcement of audits in order to prevent and reveal manipulations. This is another indicator that the overall branch of auditing in the FBiH requires a reform with an emphasis on treatment of fraudulent actions.

According to the information resulting from this survey on the view of auditors in the FBiH that indicators of irregularities in financial reports may be obtained by specific analytical procedures, another statement reflecting the positive attitude of auditors is "the issue of

mandatory execution of audits with which to investigate and reveal manipulations in financial statements should be a part of legislation" (14 ratings of 5). On the other hand, the opinion of auditors on their responsibility to report manipulations to competent state bodies is divided (8 ratings of 1).

Differences in standpoints of the certified auditors who have acquired knowledge of the processes and procedures for preventing and detecting manipulations in financial statements during professional education, and those who did not acquire the knowledge in this manner, are shown in Table 3.

Code	Yes – 14 (60.87%)		No – 9 (39.13%)	
	M±SD	Range	M±SD	Range
T1	4.071±1.141	[2, 5]	3.889±1.167	[2, 5]
T2	4.071±0.917	[3, 5]	4.222±0.972	[3, 5]
T3	4.071±0.917	[3, 5]	4.444±0.527	[4, 5]
T4	3.643±0.842	[3, 5]	3.333±0.707	[2, 5]
T5	3.143±1.292	[1, 5]	2.333±1.225	[1, 5]
T6	3.286±1.684	[1, 5]	2.444±1.509	[1, 5]
T7	4.571±0.852	[2, 5]	3.556±1.590	[1, 5]
T8	3.857±1.512	[1, 5]	3.333±1.581	[1, 5]
T9	2.667±1.225	[1, 5]	3.143±1.167	[1, 5]
T10	4.071±1.385	[1, 5]	4.222±1.302	[1, 5]
T11	4.357±0.842	[3, 5]	3.778±1.302	[1, 5]
T12	3.857±0.864	[2, 5]	3.444±0.882	[2, 5]

M – mean, SD – standard deviation; Range – [min, max]

Table 3: Views of the auditors with respect to acquisition of knowledge
(Source: Author's calculation)

The difference in attitudes of auditors with respect to acquisition of knowledge occurs in the standpoint on responsibility of auditors and legal provisions of their trade. Auditors who have acquired professional education on the procedures and processes of detecting and preventing manipulations in financial statements agree to a higher extent that there is a responsibility for detection and reporting of illegal activities to the competent authorities, and that mandatory enforcement of this specific-purpose audit should be incorporated in legislation.

After the survey conducted among the auditors, the general picture can be summed up in the word "heterogeneous," because positions of auditors vary significantly. The auditors were thinking in the ways they act at various stages and with respect to different conditions of conducting audits, through their own experiences and views on how the studied elements should look like, rather than only through theoretical knowledge in the field.

Certainly, one should refrain from making general conclusions because the number of collected surveys represents a significant limitation.

The topicality and magnitude of influence of financial frauds give opportunities to further research and find elements that can prevent losses and other negative implications for the economy. The element suggesting itself as the first is the role of regulators and the applicability of forensic auditing approaches in the regulatory frameworks.

5. CONCLUSION

Forensic auditing is a special service of the financial report auditing based on the application of accounting and auditing skills in the form of targeted, focused and detailed auditing procedures conducted with the purpose of discovering criminal acts in financial statements. The conducted survey has fulfilled the primary objective of the paper, i.e. the role and application of techniques and procedures of forensic auditing is explored within the auditing profession in the Federation of Bosnia and Herzegovina.

In the foreseeable future, corporate fraud will be a major challenge for the accounting and auditing profession. Traditional auditing cannot prevent frauds in financial statements or illegal activities of employees. It may deter some or detect others, but it is unlikely that the auditor will always identify a material misstatement caused by fraud by using traditional auditing concepts of selective testing (sampling).

The increase in accounting manipulations, evident in the number of detected cases and in the monetary value of the damages caused, raises the question of applicability and practical utility of the side of the accounting and auditing standards and the profession that is committed to identifying and preventing such acts. The diversity of national legislations, different interpretations of International Accounting Standards, constant changes in the environment in which business events take place and quality of training of the perpetrator of criminal acts cause the techniques of false financial reporting to keep becoming more complex, to change and adapt to new conditions. In such business circumstances and indications of future trends, it is to be expected that the importance of forensic auditing in detecting and preventing manipulations of financial statements will be increasing.

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