

Preliminary Paper

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## **FRAUDS FROM THE PERSPECTIVE OF INTERNAL AUDITORS – CROATIAN EXPERIENCES**

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### **SUMMARY**

Financial frauds and manipulations of financial statements occur frequently and represent a major problem for the organizations and society as a whole. According to fact that they can result in huge financial losses, frauds damage the reputation of the company and thus represent a problem for current and potential investors. For successful economic development and society as a whole, it is crucial to reduce the occurrence of frauds to a minimum level. Various factors, such as the increasing globalization of the market, the rapid development of modern technology, crises, recessions and even pandemics, complicate this process and frauds are becoming more frequent. Tools and techniques used by fraud perpetrators are rapidly developing, so that persons responsible for the prevention and detection of frauds are required to accelerate and train employees, improve the system of internal controls and use more intensively sophisticated technologies for fraud prevention and detection. Research results show that almost every second fraud perpetrator is a member of the organization's management so the tone at the top is highlighted as a key challenge in frauds detection. The authors therefore believe that establishing a quality corporate governance system is essential to reduce the likelihood of frauds occurrence and to increase the likelihood of frauds detection. In doing so, the engagement of independent and competent members of supervisory and audit boards and ensuring the independence of internal

audit through direct selection of its employees, or at least its person in charge, and direct responsibility to the supervisory board is one of the tools that would significantly contribute to reducing the incidence of fraud.

**Key words:** *financial frauds, audit, internal controls, corporate governance system*

## 1. INTRODUCTION

Fraud represents any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage [International Standards for the Professional Practice of Internal Auditing – Glossary]. Estimates of multi-year research show that fraud damages range at the level of 5% of the annual revenues of organizations [Association of Certified Fraud Examiners, 2022, 4]. It is important to note that fraud damages are not compensated at all in as many as 52% of cases, while on the other hand, depending on the regions, full compensation ranges from 9 to 17%, which imposes the need to establish appropriate preventive and detective mechanisms. Pandemic has significantly increased organizations' vulnerability to frauds. In particular, the incidence of cybercrime has increased, while employee changes within organisations and remote work are highlighted as key factors influencing frauds. The pandemic has also affected the violation of the integrity of management structures, which can be considered one of the most important fraud risk factors, since the tone at the top affects the attitude of the organization towards fraud prevention and detection [Zenzerović, R. et.al. 2022, 97].

The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk [International Standards for the Professional Practice of Internal Auditing – Performance standards]. The role and organisational position of internal audit enable it to gain key insights into the occurrence and types of fraud that organizations face. Guided by this, the authors conducted research among internal auditors with the objective of determining the degree of occurrence and types of fraud and the systems for fraud prevention and detection that organizations establish. The purpose of the paper is to deepen the existing knowledge about frauds and the ways in which organizations respond to them from the perspective of employees who make up a significant segment of the internal surveillance system i.e. from the perspective of internal auditors. Consequently, the following research questions were asked:

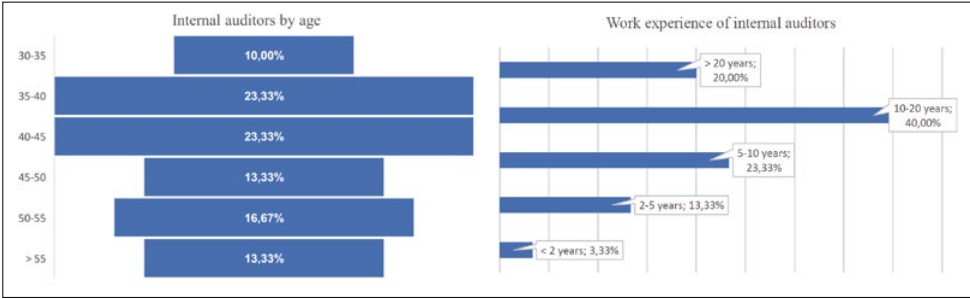
1. How do organizations respond to fraud prevention and detection, and what are the key challenges in this area?
2. What are the types of frauds faced by the organizations?
3. Who are the main frauds perpetrators?
4. Which positions of financial statements are most susceptible to fraudulent financial reporting?

## **2. RESEARCH METHODOLOGY**

The scientific approach to find answers to the research questions included the application of various scientific research methods. The descriptive method was used for the purpose of theoretical elaboration of the topic and the design of questionnaire. Through structured survey questionnaires sent to the addresses of 96 internal auditors employed in banks, insurance companies, companies from the pharmaceutical industry, tourism, telecommunications and other activities, data were collected on the basis of which appropriate conclusions were drawn. The survey was conducted in the period from May to August 2022. The 31% response return was realized, i.e. 30 internal auditors answered the questionnaire. The survey questionnaires contained a total of 15 questions, of which three questions covered the characteristics of internal auditors, five questions described the relationship of the organization in which the internal auditor is employed against fraud, while the rest of them collected various information on frauds. For the purpose of data processing and drawing appropriate conclusions, statistical analysis methods as well as methods of analysis and synthesis were used.

The average age of respondents included in the sample was 45 years and they had on average 14 years of work experience in performing internal audits. Figure 1 shows the structure of respondents by age group and work experience in performing internal audit activities. This sample structure indicates the appropriate experience of the respondents, since 60% of them have over 10 years of work experience. We therefore consider the findings collected by the questionnaire to be relevant for drawing appropriate conclusions.

**Figure 1. Characteristics of respondents according to selected characteristics**

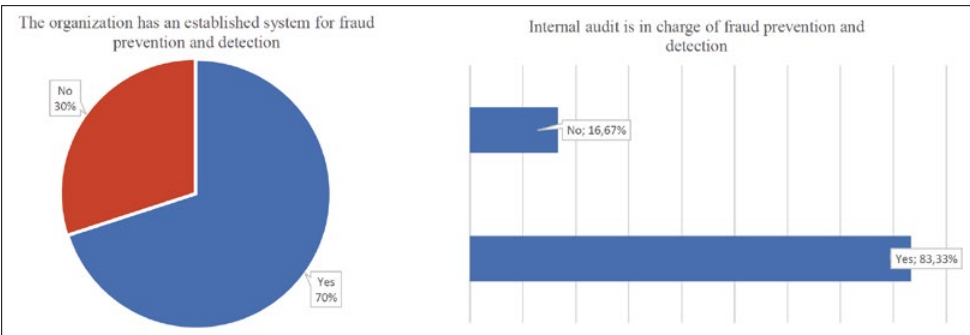


Source: Research results

**3. RESEARCH RESULTS**

In 70% of cases, organisations included in the survey had a system for fraud prevention and detection in place, while in 83% of them an internal audit represented the body in charge of fraud prevention and detection (Figure 2). In only two organizations that had this system in place, internal audit was not in charge of fraud prevention and detection. In those cases, these activities were carried out by the fraud prevention department and the department for processes and control system improvement. Organizations where systematic mechanisms for fraud detection and prevention were not in place in most cases (78%) assigned the task of carrying out these activities to internal audit, while other organizations use some other ways of reporting non-compliances, but did not have preventive mechanisms in place.

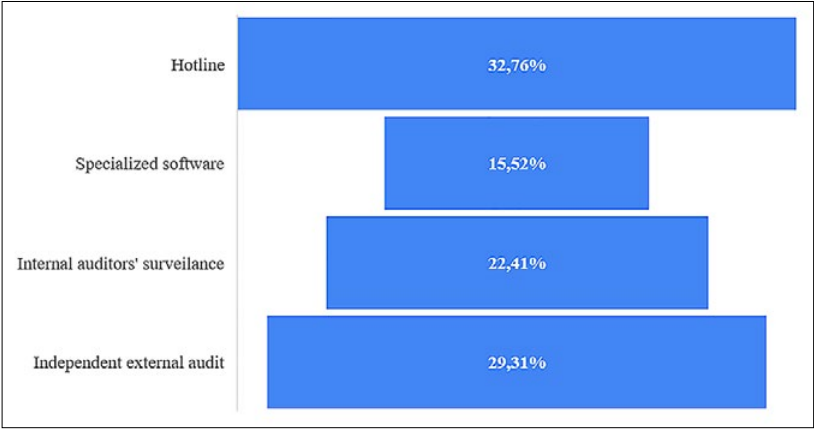
**Figure 2. Prevention and detection of fraud in organizations where internal auditors are employed**



Source: Research results

Figure 3 shows established mechanisms for the prevention and detection of fraud in organizations that have confirmed the existence of a systematic approach to fraud. The respondents also had the ability to choose multiple answers at the same time, so the Figure 3 shows the share of a particular mechanism in the total number of mechanisms selected by internal auditors. The largest number of organizations has established a reporting system or hotlines as a mechanism which detect the largest number of frauds, as indicated by the global, but also by the results of research conducted in the Republic of Croatia [Association of Certified Fraud Examiners Croatia, 2022, 19]. The hotlines are not established in 21% of surveyed organizations, while in other organizations they represent one of the mechanisms for fraud prevention and detection which is mostly used in combination with other ones. The largest number of organisations (25%) combines all mechanisms, followed by a combination of a hotlines and an independent external audit of financial statements (21%) and a combination of a hotlines, independent external audit of financial statements and independent surveillance performed by internal auditors in the field (13%). Independent surveillance carried out by internal auditors and independent external audit of financial statements represent independent mechanism of detection in 8 and 4% of cases, respectively. Although it is important to have a hotline from the aspect of the quality of the fraud prevention and detection system, relevant research shows that these mechanisms detect fraud in the Republic of Croatia in only 22% of cases, while on a global level this percentage is almost twice as high and reaches 42%. On the global level, after hotlines, the highest number of frauds are detected through internal audit activities (16%), managerial control mechanisms (12%), document review (6%) and by accident (5%) [Association of Certified Fraud Examiners, 2022, 22]. Comparable research shows that the order of detective mechanisms in the Republic of Croatia is different. Thus, as many as 13% of frauds are accidentally detected, as well as by reviewing documents, followed by managerial control mechanisms (9%), automatic data monitoring (7%), while internal audit detects fraud in 6% of cases [Association of Certified Fraud Examiners Croatia, 2022, 16]. Active mechanisms such as internal audit and specialized software are less represented in relation to the hotlines and independent external audit, which represent a form of passive-active prevention and detection mechanisms.

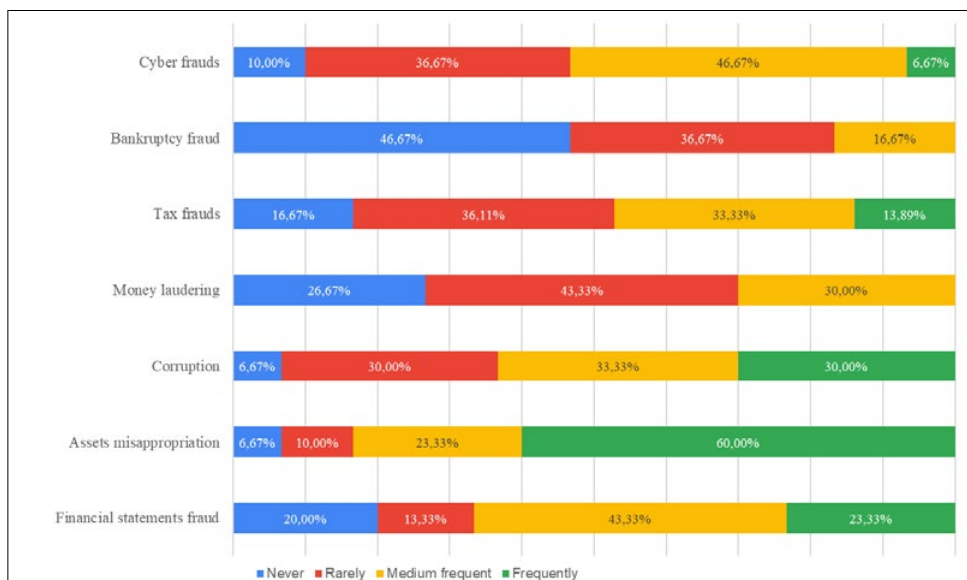
**Figure 3. Established mechanism for fraud prevention and detection**



*Source: Research results*

The frequency of fraud occurring in organizations is shown in Figure 4. Out of a total of seven categories of fraud whose frequency was evaluated by internal auditors, bankruptcy fraud, money laundering and tax and cyber fraud are the least represented. On the other hand, financial statements fraud, corruption and misappropriation of assets as a common category of frauds were highlighted by between 23% and 60% of internal auditors. The results of the research are similar to the findings of the research at the international level, where differences related to the occurrence of financial statements fraud were observed which are more emphasized in this research. This can be attributed to the structure of a sample in which only internal auditors are included and they encounter this category of fraud more often than other respondents in similar studies.

**Figure 4. Frequency of fraud occurring in organizations**

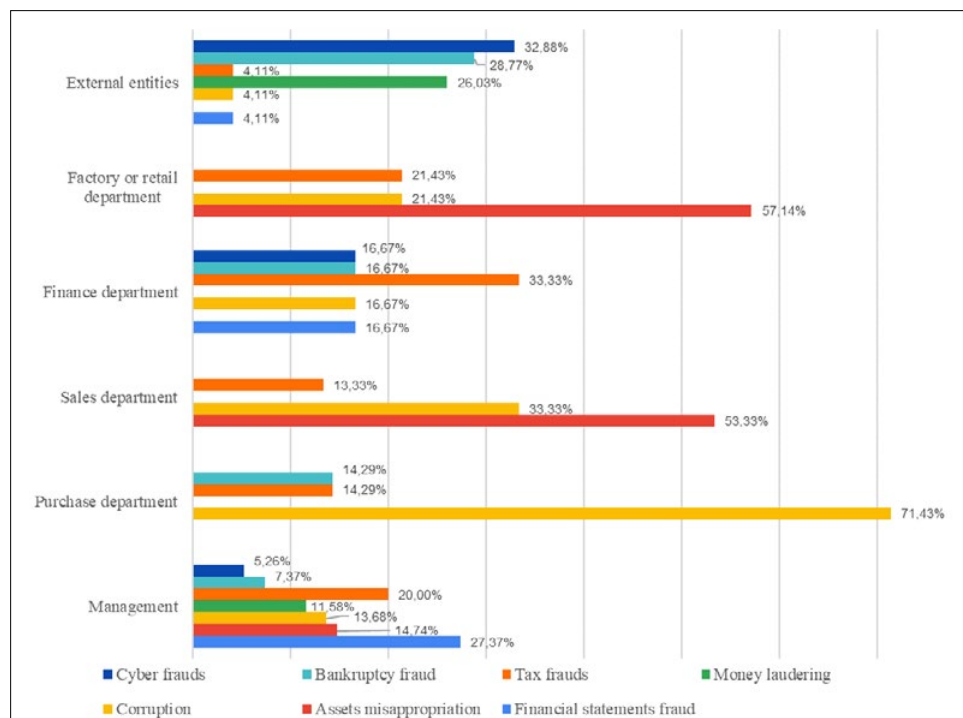


*Source: Research results*

A questionnaire asked internal auditors to identify perpetrators of fraud by category. The main perpetrators of fraud in organisations by category are shown in Figure 5. Perpetrators of misappropriation of assets as the most common category of fraud are employed in production and retail departments as well as sales departments. Also, every seventh fraud committed by the management of the company refers to this fraud category. Corruption is present in all departments that have been under consideration, but is expectedly the most common in purchase and sales departments. Financial statements fraud is the most common category of fraud committed by management and is, next to it, reserved for the finance department. The perpetrators of tax fraud are most often employees of the finance, sales and purchase departments. It is interesting to notice that as much as 20% of the total number of management frauds refers to this category. Cyber fraud is the most common form of fraud committed by external entities which is not surprising. Interesting are the results of research that indicate the cyber fraud is committed by employees of the finance department, which imposes the need to establish appropriate control mechanisms within this organizational department. Money laundering is the least represented category of fraud that is mainly committed by external entities, although in a smaller number of cases, members of management are involved in these fraudulent activities.

Internal auditors pointed out that the highest number of frauds were committed by the management of the organization (45%) followed by external entities (35%), employees in production or retail as well as sales department with 7% each and employees of the purchasing and finance department, each with 3% of the total number of frauds committed.

**Figure 5. The main perpetrators of fraud in organizations**

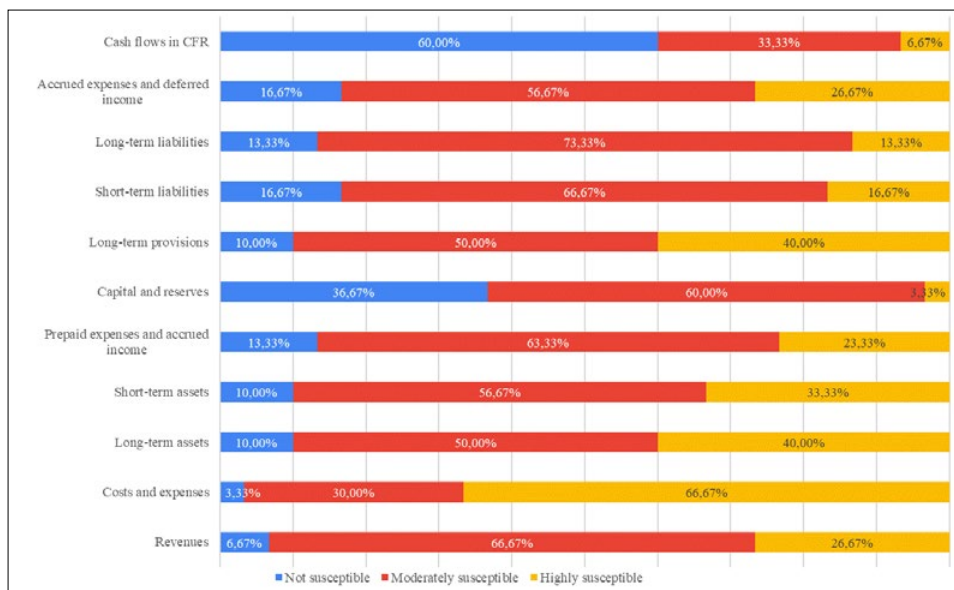


Source: Research results

In the continuation of the research, the authors focused on financial statements fraud, i.e. fraudulent financial reporting. The results of the research highlight the positions of costs and expenses, fixed assets, long-term provisions and current assets as positions of financial statements most susceptible to manipulation (Figure 6). In contrast, internal auditors highlighted cash flows and capital and reserves as positions least susceptible to misrepresentation.



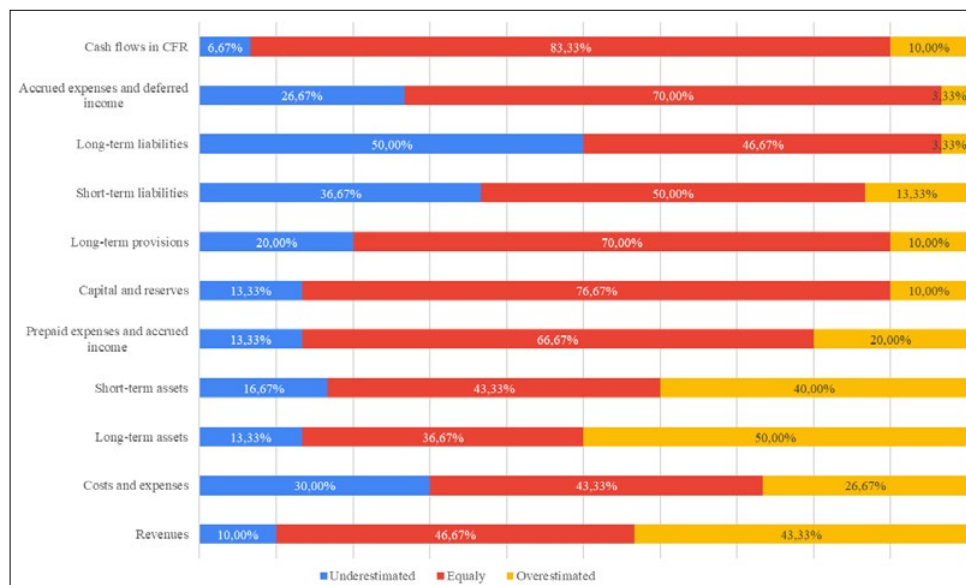
**Figure 6. Susceptibility of financial statements positions to fraudulent financial reporting**



*Source: Research results*

Costs and expenses as positions most susceptible to manipulation are exposed equally to overestimation and underestimation. The findings are similar with capital and reserves, prepaid expenses and accrued income and cash flows in the cash flow statement (Figure 7). Overestimation of positions of financial statements is more emphasized at revenues and current assets, while positions of accrued expenses and deferred income, liabilities and long-term provisions are more susceptible to showing values that are lower than real ones.

**Figure 7. Direction of manipulation of financial statements positions**



*Source: Research results*

Inadequate time recording of revenues, costs and expenses, prepaid expenses and accrued income and accrued expenses and deferred income as well as the recording of fictitious positions are common techniques of manipulation. According to research results revenues were recorded in an inadequate accounting period in as many as 60% of cases, in 25% of cases false revenues were recorded, in 10% the same deliveries were double-invoiced, while in 5% of cases invoices that are issued have been deleted. When falsifying costs and expenses, avoidance of incoming invoices recording dominates as well as their recording into an inappropriate accounting period, followed by the posting of private expenses as costs of the organization and fictitious accounts.

Balance sheet positions are also subject to manipulation. The positions of fixed assets are dominated by manipulation of depreciation rates, records of assets used as assets in preparation, records of assets that are used for personal needs of employees and overvaluation of assets when putting into use as well as during revaluation. Manipulations of current asset positions are dominated by manipulations of the value of inventories and non-write-off of outdated receivables, stocks and loans, while false inventory results are common as well. Internal auditors noticed the least manipulations on the positions of capital and reserves within which they emphasized unreal presentation of business results, as a consequence of manipulation of revenues and expenses, and revaluation reserves. Long-term provisions have also proven to be an

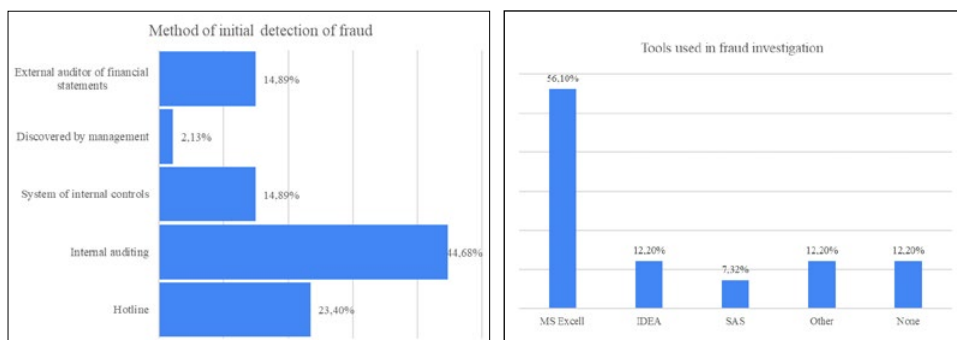
instrument of manipulation which direction depends on the interests of the persons responsible for preparing the financial statements. Manipulations of liability positions mainly include techniques of avoiding the classification of obligations according to their maturity, i.e. classification of long-term liabilities into short-term ones and vice versa. In these positions, there are also cases of underestimating obligations by avoiding the record of incoming invoices, unreal presentation of liabilities towards creditors, non-recording of negative exchange rate differences, but also overestimation through the recording of fictitious loans.

The research shows that the positions of cash flow statements are the least susceptible to manipulation and mainly refer to inadequate classifications among individual cash flow activities.

The research also sought to determine how the frauds has been initially discovered according to the respondents' experience (Figure 8). Nearly half of the frauds were discovered by the internal audit service. The hotlines revealed approximately one in four frauds, while external auditors of financial statements detected 15% of them, approximately the same as the embedded mechanisms that make up the internal control system. The lowest number of frauds was detected by management.

Significant area for improvement is evident from the tools used when investigating fraud. Specifically, more than half of respondents use the MS Excell, while a third use specialized tool. Some respondents combine MS Excell and specialized software tools, while 12% of them do not use any software at all when researching fraud.

**Figure 8. Initial discovery methods and tools used in fraud research**



Source: Research results

At the end of questionnaire, the internal auditors gave information on the challenges they consider essential in the field of fraud detection. The biggest

challenge highlighted by 44% of respondents is the tone from the top, i.e. management's attitude towards fraud as an acceptable form of behaviour. This is followed by an inadequate or non-existent internal control system highlighted by respondents in 32% of cases and a lack of resources for fraud investigation that occurs in every fifth case. The problems with collecting the evidence of frauds are highlighted in 4% of cases.

#### **4. DISCUSSION AND CONCLUSION**

Fraud prevention and detection activities are almost in all organizations included in research under the authority of internal audit department. Significant part of organizations still does not approach frauds systematically, but fit them as a segment of the overall internal audit activities. Lack of material and human resources, unawareness of actual and potential damages from fraud, but also unwillingness and insufficient competence of supervisory authorities within organizations are just some of the most significant reasons that contribute to that condition.

The research results show that fraud prevention and detection systems are dominated by passive-active mechanisms such as hotlines and independent external audit, while the share of active mechanisms such as independent surveillance performed by internal auditors and specialized software is less represented. This results in a large share of accidentally discovered fraud, which in the Republic of Croatia is almost three times higher than the global average [Association of Certified Fraud Examiners Croatia, 2022, 16]. While at the global level internal audit ranks second as a fraud detection mechanism with a 16% share, in the Republic of Croatia this place is occupied by accidentally detected frauds with a share of 13%. These results indicate the need to establish a systematic approach to fraud prevention and detection that will not only be declarative and that will include a significant number of active detection mechanisms. Namely, research shows that active mechanisms result in earlier detection of fraud and less damage compared to other mechanisms [Association of Certified Fraud Examiners, 2022, 23].

A significantly lower degree of fraud detection by hotlines in the Republic of Croatia, as the most effective preventive and detective mechanism, compared to the global average is partly due to the absence of this system in organizations, and partly to its inadequate functioning and its' declarative existence. Research on a global scale shows that legislation and companies provide a higher level of safety to whistleblowers than they did three years ago (EY, 2022). The importance of establishing a hotline is recognized by the legislator who in 2019 adopted the Directive (EU) 2019/1937 of the European Parliament

and of the Council on the protection of persons reporting on breaches of Union law, after which the new Act on the Protection of Whistleblowers entered into force in the Republic of Croatia. United States legislation takes different approach to protecting and motivating whistleblowers under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Based on the above law, the Securities and Exchange Commission formed in 2011 The Office of the Whistleblowers, which manages the program of protection and motivation of whistleblowers. Motivating whistleblowers consists in monetary rewards that result in successful prosecution of fraud for which fines above \$1 million have been imposed. The award is paid in the amount of not less than 10% and not more than 30% of the amount of the settled fine. So far, the Office of the Whistleblowers has paid over US\$1.1 billion in awards to a total of 214 individuals, with \$564 million paid to 108 whistleblowers in the 2021 fiscal year alone. Two record payments were noted: a \$114 million payment to one whistleblower and the same amount paid to two whistleblowers [Zenzerović et.al, 2022, 98].

Misappropriation of assets and corruption, as the most common categories of frauds, impose the need for organizations to establish an appropriate system of internal controls within the entire organizational structure, regardless of the organizational department. The research results show that none of organizational department is immune to fraud although some of them are more prone to a certain fraud category. The establishment of a quality corporate governance system is crucial in the process of reducing the likelihood of fraud occurrence and increasing the likelihood of fraud detection, since almost every second fraud perpetrator is a member of the organization's management – the tone at the top is highlighted as a key challenge in fraud detection. The internal supervisory system as a broader term than the system of internal control should include competent and independent members of supervisory and audit boards, and the role of internal audit, which members or at least it's head should be elected by and directly responsible to the supervisory board, is also crucial. In such a way higher level of independence and availability of resources, which will improve the quality of work of internal auditors, as well as the formation of a fraud prevention and detection team would be enabled. This would, along with the improvement of the quality of financial statements audits, contribute to higher level of credibility of financial statements, in particular profit and loss accounts and statements of financial position, i.e. balance sheets which internal auditors considered to contain the highest number of irregularities.

The research results significantly confirm the findings of similar studies conducted on larger samples of respondents and complement the existing knowledge in the field of fraud by looking at this complex topic from the per-

spective of internal auditors. Research conducted on a sample of internal auditors in the Republic of Croatia can serve as a starting point for gaining new insights through sample enlargement and expanding the focus of research from fraudulent financial reporting to other categories of fraud. What are the types of misappropriation of assets? What are the types of cyber fraud faced by organizations in the Republic of Croatia? Are there differences in categories and forms of fraud depending on the organization's activity, ownership and other characteristics? These are just some of the open questions for future research that should be answered.

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## **PRIJEVARE IZ PERSPEKTIVE INTERNIH REVIZORA – HRVATSKA ISKUSTVA**

### **SAŽETAK RADA**

Financijske prijevare i manipulacije financijskim izvještajima učestale su i predstavljaju veliki problem za organizacije i društvo u cjelini. S obzirom na to da mogu dovesti do velikih financijskih gubitaka, prijevare štete ugledu tvrtke te predstavljaju problem za sadašnje i potencijalne investitore. Za uspješan gospodarski razvoj i društvo u cjelini ključno je pojavu prijevara svesti na najmanju moguću mjeru. Razni čimbenici, poput sve veće globalizacije tržišta, brzog razvoja moderne tehnologije, kriza, recesija pa čak i pandemija, kompliciraju ovaj proces, a prijevare su sve češće. Alati i tehnike koje koriste počinitelji prijevara ubrzano se razvijaju, tako da su osobe odgovorne za prevenciju i otkrivanje prijevara dužne ubrzati i osposobiti zaposlenike, poboljšati sustav internih kontrola i intenzivnije koristiti sofisticirane tehnologije za prevenciju i otkrivanje prijevara. Rezultati istraživanja pokazuju da je gotovo svaki drugi počinitelj prijevare član uprave organizacije pa se ton na vrhu ističe kao ključni izazov u otkrivanju prijevara. Autori stoga smatraju da je uspostava kvalitetnog sustava korporativnog upravljanja ključna za smanjenje vjerojatnosti pojavljivanja prijevara i povećanje vjerojatnosti otkrivanja prijevara. Pri tome je jedan od alata angažiranje neovisnih i kompetentnih članova nadzornih i revizijskih odbora te osiguranje neovisnosti unutarnje revizije neposrednim odabirom njezinih zaposlenika ili barem odgovorne osobe te izravnom odgovornošću nadzornom odboru. što bi značajno pridonijelo smanjenju učestalosti prijevara.

**Ključne riječi:** *financijske prijevare, revizija, interne kontrole, sustav korporativnog upravljanja*

