

Original scientific paper

UDK: 657.63

Paper received: 01/08/2023

Paper Accepted: 23/08/2023

## FRAUDS FROM THE PERSPECTIVE OF EXTERNAL AUDITORS – CROATIAN EXPERIENCES

**Prof. Robert Zenzerović, PhD**

*Juraj Dobrila University of Pula, Faculty of Economics and Tourism*

*“Dr. Mijo Mirković, Pula, Croatia*

*rzenzo@unipu.hr*

**Dolores Pušar Banović, PhD**

*University of Applied Sciences RRiF, Zagreb, Croatia*

*dolores@rrif.hr*

**Sanja Jolić, MSc**

*Pula, Croatia*

*sanja.jolic01@gmail.com*

### ABSTRACT

Financial frauds and manipulations in financial statements often occur and pose a significant problem for organizations, capital owners, tax authorities, creditors, potential investors, and society. In that sense, the role of external auditing is invaluable, precisely aimed at protecting the interests of all the stakeholders mentioned. External auditing primarily examines the objectivity and accuracy of fundamental financial statements. Timely detection of financial fraud and manipulations in financial statements are among the key tasks of external auditors.

The purpose of this paper is to broaden the existing knowledge about fraud and how organizations respond to them from the perspective of external auditors.

In addition to the research on the role and significance of external auditing in detecting financial frauds and understanding the process of uncovering financial frauds within companies, a comparison of the role and activities of internal auditing in the same process was also conducted.

The primary observation derived from comparing the research outcomes of internal and external auditors reveals notable distinctions in the occurrence of fraud they detected, vulnerability to manipulation of financial statements, the na-

ture of that manipulation, and the specific department where fraud perpetrators are employed.

**Keywords:** *financial fraud, external auditing, internal auditing, tools, activities, and participants in detecting financial frauds, fraud perpetrators*

## 1. INTRODUCTION

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving deception to obtain an unjust or illegal advantage (International auditing standard 240, 161). International auditing standards point out two types of fraud that are relevant to the auditor's consideration – fraudulent financial reporting and misappropriation of assets while some other relevant research includes corruption, cyber frauds, bankruptcy fraud, tax fraud, and money laundering as additional fraud categories.

According to the research of the Association of Certified Fraud Examiners, losses related to fraud are estimated at 5% of the annual revenues of organizations with rather low full fraud compensation ranging from 9 to 17% (Association of Certified Fraud Examiners, 2022). Research performed among Croatian companies indicates that there was about 13% of the total annual income lost due to fraud (Bartulovic et al. 2022). The pandemic has significantly increased organizations' vulnerability to fraud. In particular, the incidence of cybercrime has increased, while employee changes within organizations and remote work are highlighted as key factors influencing fraud. 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 toward fraud prevention and detection (Zenzerović, R. et.al. 2022, 97).

Along with research performed by the Association of Certified Fraud Examiners, there are other relevant researches in the field of fraud performed by Big 4 audit companies. According to the PwC Global Economic Crime and Fraud Survey, fraud prevention measures are working showing a decrease in the organization experiencing economic crime. The number of internal fraud perpetrators decreased which can be attributed to prevention and detection measures, while the number of external perpetrators as well as collusion between internal and external perpetrators is rising (PwC, 2022). The same research has been performed in Croatia in 2016 showing the same ranks of particular fraud types as the ones on the global level. The most important particularity is that Croatia is experiencing more bribery than the global average (PwC, 2016).

The primary responsibility for preventing and detecting fraud rests with those charged with governance of the entity and management (International auditing standard 240, 159). They should put intensive efforts into fraud prevention and fraud deterrence to create a culture of honesty and ethical behaviour. Independent external auditors are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error (International auditing standard 240, 160). Research results indicate that independent external auditors initially detected 4% on an international level, almost the same as in Croatia where they discovered 3% of the total number of frauds (Association of Certified Fraud Examiners Croatia, 2022).

The purpose of the paper is to broaden the existing knowledge about fraud and how organizations respond to them from the perspective of external 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 exposed to fraudulent financial reporting?
5. Are there any differences in types of fraud from the perspectives of internal and external auditors?
6. Are there any differences in financial statements positions' exposure to fraudulent financial reporting between the internal and external auditors' points of view?
7. Are there any differences in the direction of manipulation of financial statements positions between the internal and external auditors' points of view?
8. Are there any differences in the fraud perpetrators between the internal and external auditors' points of view?

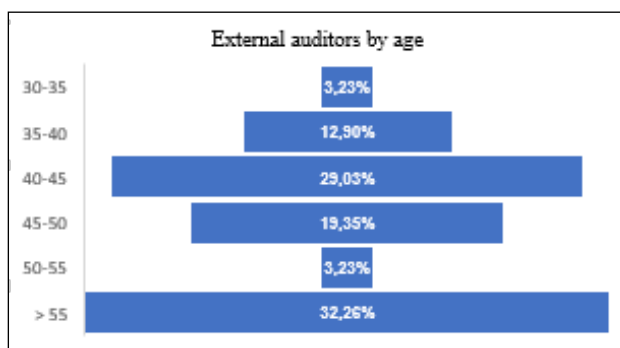
## **2. RESEARCH METHODOLOGY**

Answering the research questions included various scientific methods like methods of description, analysis, and synthesis as well as basic statistical analysis methods. The description method was used for the theoretical elaboration of the topic and the questionnaire design. The questionnaire included 10 questions and was sent to the addresses of 200 audit companies that operated in the Republic of Croatia. Three questions covered the characteristics of external auditors, two questions were related to the characteristics of audit

companies while the rest of the five questions elaborated on the various information on frauds. The survey was conducted in the period from May to August 2022 with a response rate of 15,5%.

The average respondent included in the sample was 49 years old with an average of 20 years of professional experience in performing audits. The structure of respondents by age and professional experience in auditing is shown in Figure 1. According to the appropriate experience of the respondents, the findings collected by the questionnaire could be considered relevant for drawing appropriate conclusions.

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



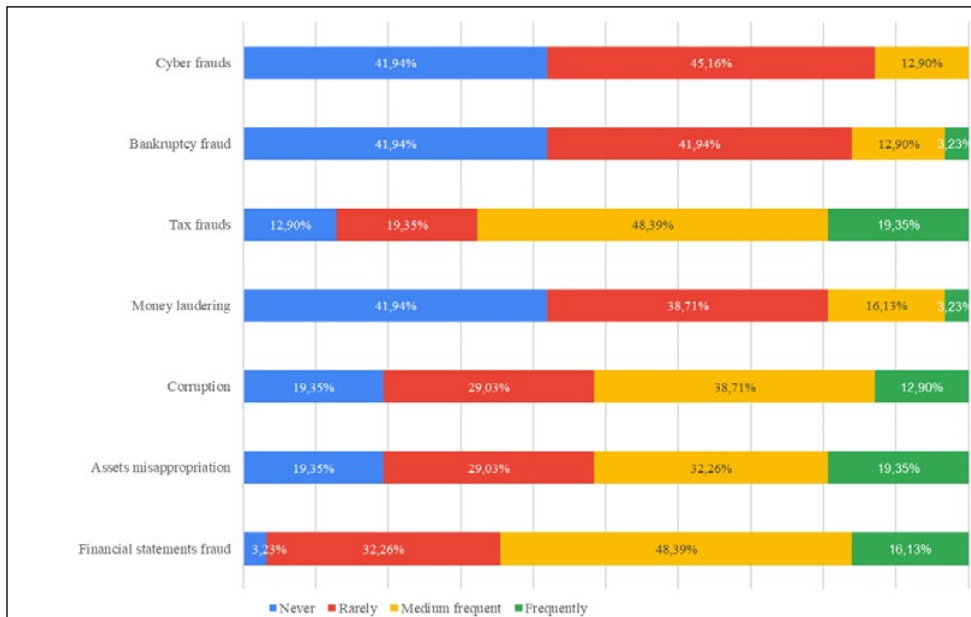
Source: Research results

### 3. RESEARCH RESULTS

The frequency of fraud occurring in organizations is shown in Figure 2. Out of a total of seven categories of fraud whose frequency was evaluated by external auditors, cyber fraud, bankruptcy fraud, and money laundering are the least represented. On the other hand, misappropriation of assets, tax fraud, and financial statements fraud, as a common category of fraud, were highlighted by between 25 and 30 external auditors. According to research conducted by the Association of Certified Fraud Examiners (2022, 4) asset misappropriation schemes are the most common (86%) but least costly (100.000 \$ median loss).

On the other hand, financial statement fraud schemes are the least common (9%) but most costly (593.000 \$ median loss).

**Figure 2.** Frequency of fraud occurring in organizations



Source: Research results

A questionnaire asked external auditors to identify perpetrators of fraud by category. The main perpetrators of fraud in organizations by category are shown in Figure 3. Perpetrators of misappropriation of assets as the most common category of fraud are employed in production or retail and purchase departments. This fraud category is present in all departments that have been under consideration.

Corruption is the most common fraud in the sales department and production department or retail department. At the same time, financial statements fraud is the most common category of fraud committed by management and is, next to it, reserved for finance departments.

The perpetrators of tax fraud are most often employees of the finance, management of the companies, and sales departments. It is interesting to notice that as much as 18% 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 unsurprising. Interesting are the results of research that indicate that cyber fraud is around 11% committed by management.

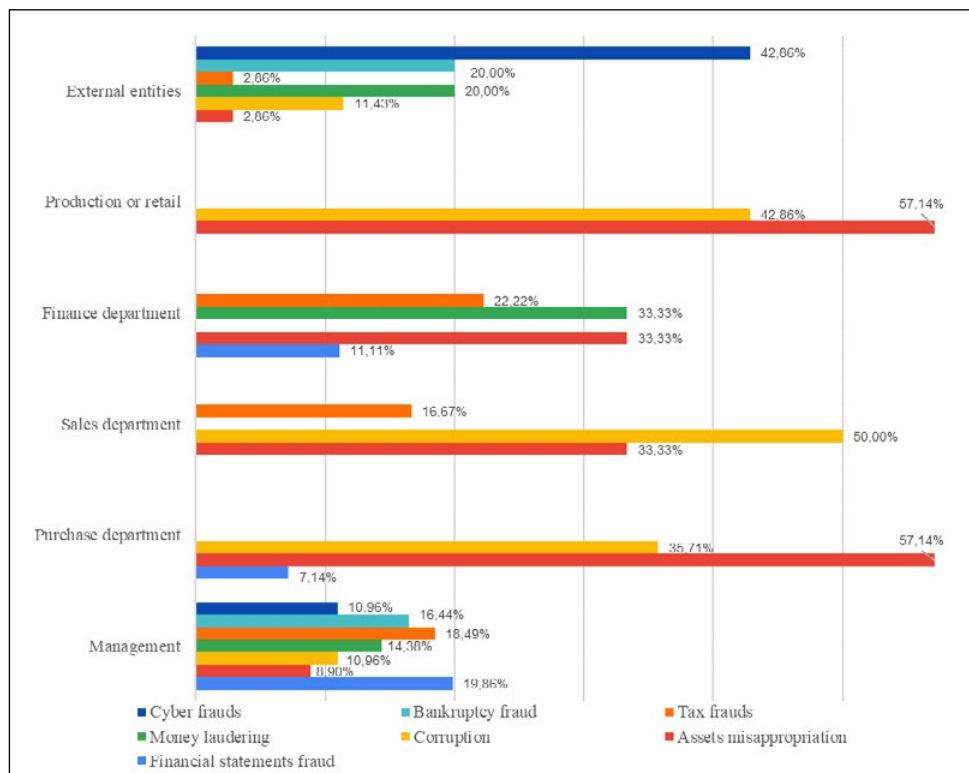
Money laundering is the category of fraud that is mainly committed by employees of finance departments and external entities.

External auditors pointed out that the highest number of frauds were committed by the management of the organization (67%). On the other hand, in the analysis conducted by the Association of Certified Fraud Examiners (2022, 4), the results are a little different; owners/executives committed only 23% of occupational frauds, but they caused the largest losses.

Research results suggest that management of the organization as the largest perpetrators are followed by external entities (16%), employees in the purchasing department (6%), employees of the finance department (4%), and sales department and production departments or retail departments, each with 3% of the total number of frauds committed.

Research by the Association of Certified Fraud Examiners (2022, 5) pointed out that nearly half of all occupational frauds came from four departments: Operations 15%, Accounting 12%, Executive/upper management 11%, and Sales 11%.

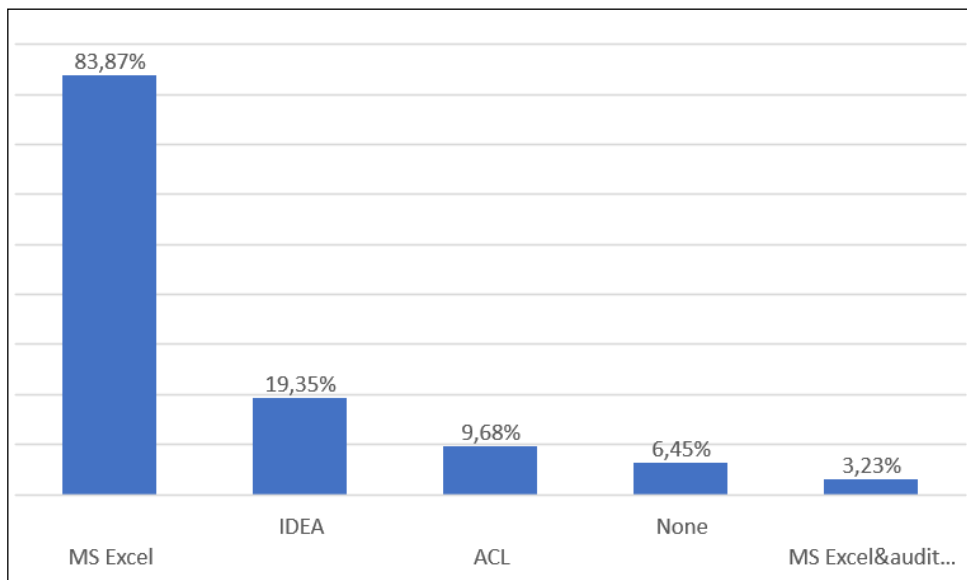
**Figure 3.** The main perpetrators of fraud in organizations



Source: Research results

The research also sought to determine the tools used in fraud investigation (Figure 4). A significant area for improvement is evident from the tools used when investigating fraud. Specifically, more than 83% of respondents use MS Excel, while more than 29% use specialized tools (IDEA, ACL). Some respondents combine MS Excel and specialized auditing software tools, while 6,45% do not use any software when researching fraud.

**Figure 4.** The tools used in fraud investigation



Source: Research results

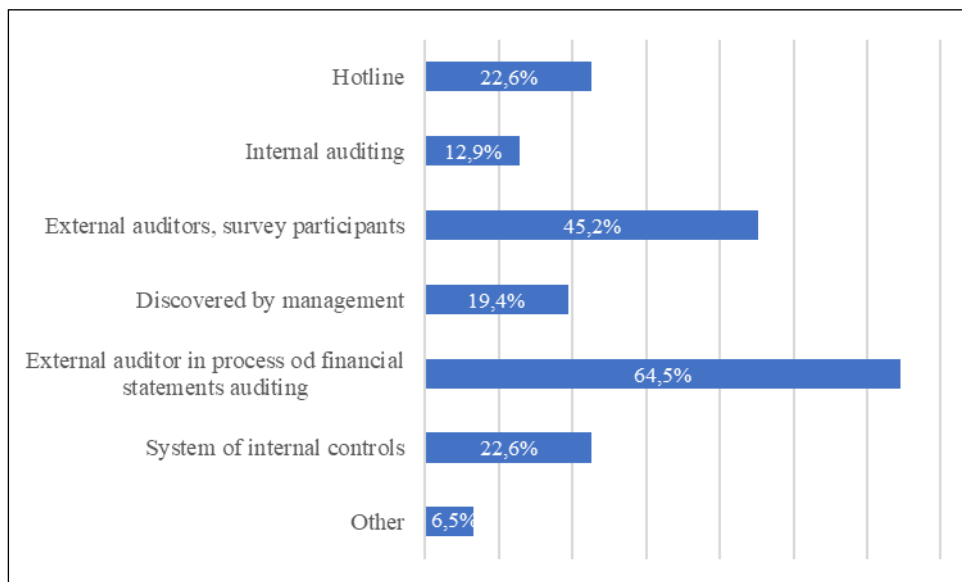
Figure 5 shows established mechanisms for preventing and detecting fraud in organizations that have confirmed the existence of a systematic approach to fraud. The respondents could also choose multiple answers simultaneously, so Figure 5 shows the share of a particular mechanism in the total number of mechanisms selected by internal and external auditors.

According to external auditors, the most common discovery tool used in fraud research is external auditing as part of the financial statement auditing process.

It is interesting to point out that external auditors find external audits made up of survey participants as the second most important discovery method used in fraud research (45,2%), while internal auditing made only 12,9% of discovery tools.



**Figure 5.** Initial discovery methods and tools used in fraud research



Source: Research results

According to research conducted by the Association of Certified Fraud Examiners Croatia in 2022 [16], a significant number of organizations have implemented a reporting system or hotlines as a mechanism to detect fraud, which is consistent with global findings. However, 21% of surveyed organizations do not have hotlines established. In other organizations, hotlines are considered one of the key mechanisms for fraud prevention and detection, often used in conjunction with other methods.

Most organizations (25%) utilize a comprehensive approach by combining all available mechanisms. Additionally, 21% of organizations combine hotlines with an independent external audit of financial statements, while 13% combine hotlines, independent external audits of financial statements, and independent surveillance conducted by internal auditors in the field. Independent surveillance conducted by internal auditors finds in 8% of cases, and independent external audits find in 4% of cases that auditing financial statements is the main mechanism utilized for fraud detection.

Despite the importance of having a hotline for the overall quality of fraud prevention and detection systems, research reveals that in the Republic of Croatia, these mechanisms only detect fraud in 22% of cases. In contrast, this detection rate is nearly twice as high on a global scale, reaching 42%.

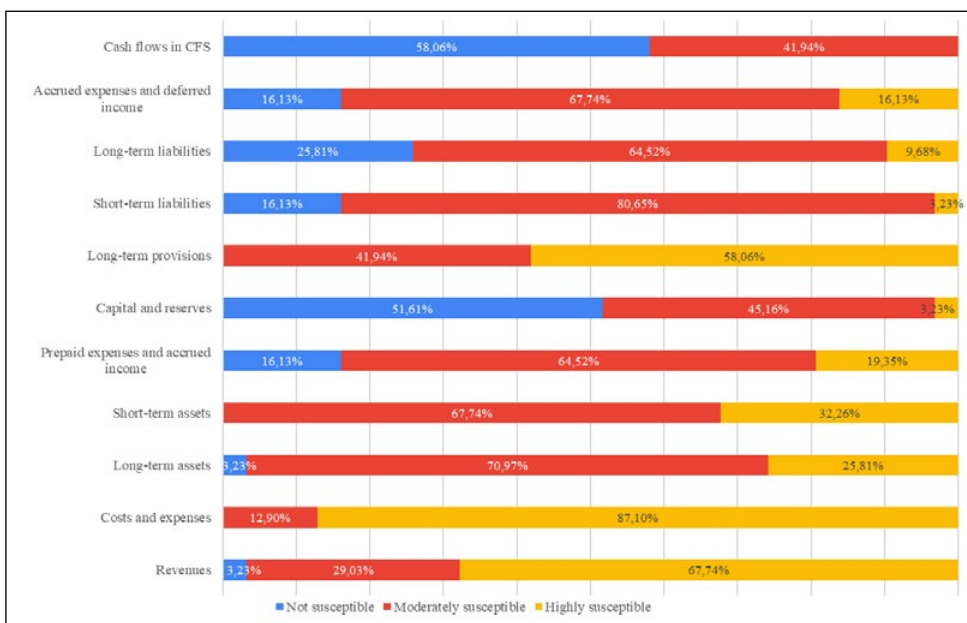
At the global level, hotlines are followed by internal audit activities (16%), managerial control mechanisms (12%), document review (6%), and accidental

discovery (5%) as the most effective means of detecting fraud, according to research conducted by the Association of Certified Fraud Examiners in 2022 [22]. However, the order of detective mechanisms differs in the Republic of Croatia. Comparable research indicates that 13% of fraud cases are accidentally detected or discovered through document review, followed by managerial control mechanisms (9%), and automatic data monitoring (7%), while internal audits detect fraud in 6% of cases (Association of Certified Fraud Examiners Croatia, 2022, 16).

Active mechanisms, such as internal audits and specialized software, are less prevalent than hotlines and independent external audits, representing a combination of passive and active prevention and detection measures.

The authors continued researching financial statement fraud, i.e., fraudulent financial reporting. The research results highlight the positions of costs and expenses, revenues, long-term provisions, and short-term and long-term assets as positions of financial statements most susceptible to manipulation (Figure 6). In contrast, external auditors highlighted cash flows and capital and reserves positions as positions least susceptible to misrepresentation.

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

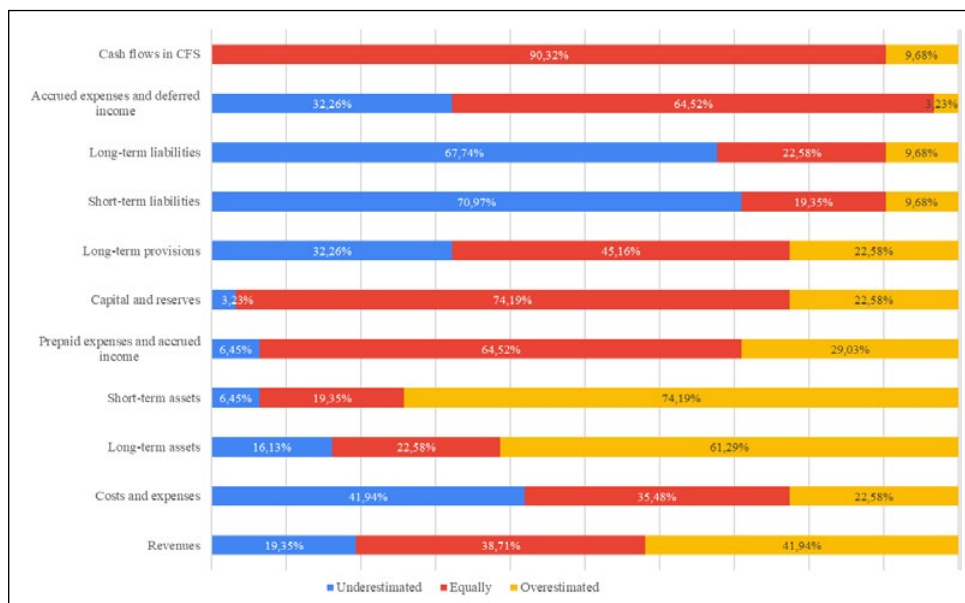


Source: Research results

Costs and expenses, positions most susceptible to manipulation, are exposed much more to underestimation (41,94%) than overestimation (22,58%). At the same time, 35,48% of respondents consider that the mentioned position is equally overestimated and underestimated.

Cash flow in the cash flow statement is the position the most exposed equally to overestimation and underestimation. The findings are similar to capital and reserves, prepaid expenses and accrued income, and accrued expenses and deferred income (Figure 7). Overestimation of positions of financial statements is more emphasized at short-term and long-term assets, while positions of short and long-term liabilities and cost and expenses are more susceptible to showing lower values than real ones.

**Figure 7.** The direction of manipulation of financial statements positions

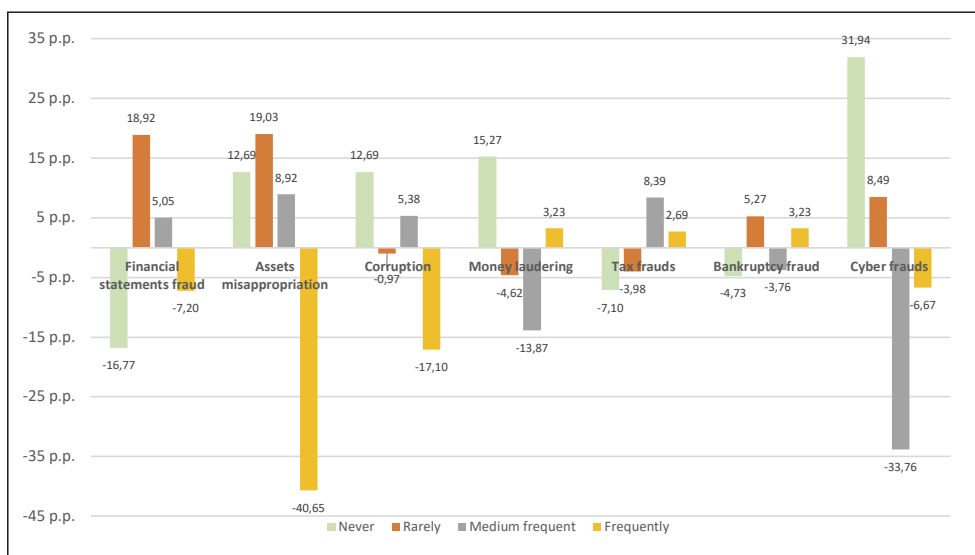


Source: Research results

The second part of the research compared the findings on fraud by external and internal auditors. The research results on fraud from the perspectives of internal auditors are presented in a paper by Zenzerović and Marković (Zenzerović & Marković, 2023). The respondents were asked how often they faced fraud. Figure 8 shows the differences in the frequency of frauds between external and internal auditors by fraud type expressed in percentage points (p.p.). Most of external auditors have faced financial statement fraud during their professional activities. Namely, only 3% of them answered that they have never experienced it, while 20% of internal auditors claimed the same. On the other side, more in-

ternal auditors answered that they experienced frequently financial statement fraud than external auditors which can be attributed to inside information that the internal auditors have and the quality of audits the external auditors perform as well as their willingness to address this challenging problem. Asset misappropriation, corruption, money laundering, and cyber fraud are types of fraud that are more frequently found by internal auditors and are in line with the scope of their activities. On the other side, tax, and bankruptcy fraud are types of fraud that external auditors are more frequently exposed to.

**Figure 8.** Differences in the frequency of fraud between external and internal auditors

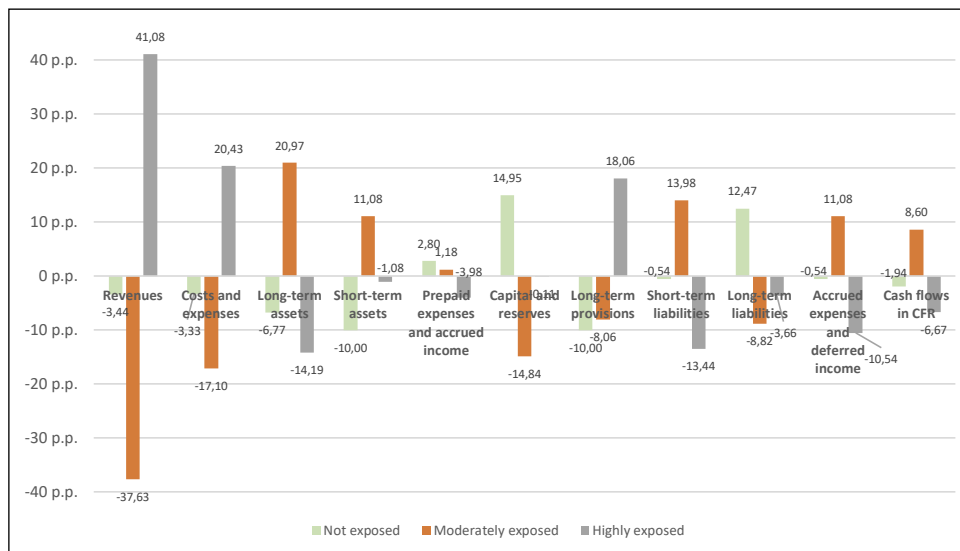


Source: Research results

Another area of research focused on financial statements fraud. Figure 9 presents the differences in exposure to manipulation of financial statements positions between external and internal auditors' points of view. The biggest differences were related to revenues and costs, and expenses, where external auditors considered that these positions are highly exposed to manipulation while internal auditors considered them moderately exposed. External auditors considered costs and expenses, revenues, long-term provisions, and short-term assets as a position most exposed to manipulation, while internal

auditors emphasized costs and expenses, long-term provisions, and long-term and short-term assets. Such a result can be the consequence of differences in professional experience and focus between two groups of auditors where the external auditors are focused on fair and truthful financial reporting while the internal auditors had a broader focus.

**Figure 9.** Differences in exposure to manipulation of financial statements positions between external and internal auditors

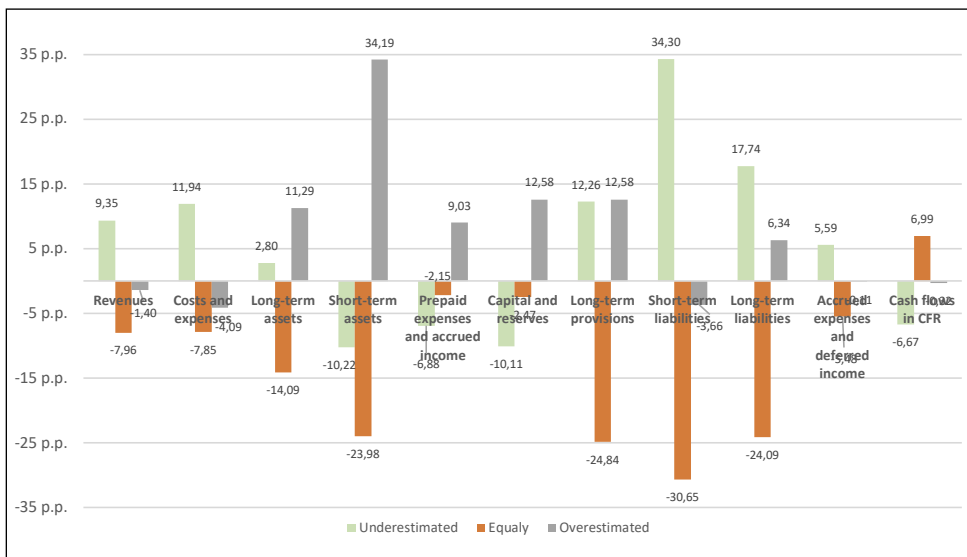


Source: Research results

External and internal auditors were asked to estimate the direction of financial statements' manipulation they observed during their professional experience. The differences in the direction of manipulation of financial statements positions between external and internal auditors are shown in Figure 10. The biggest differences were noticed in the positions of short-term liabilities, short-term assets, long-term liabilities, and long-term provisions. External auditors considered short and long-term liabilities, costs and expenses, and revenues to be more underestimated than internal auditors. The positions the external auditors considered to be more overestimated than internal auditors related to short and long-term assets, capital and reserves and prepaid expenses, and accrued income. It is interesting to notice that independent external auditors highlight the underestimation of liabilities, revenues, costs, and expenses and the overestimation of assets in relation to internal auditors. Are they more experienced or does their independency influence such a result? Is the research sample representative? Are there some other factors significant to

such findings? These are some of the questions that arise and could be answered in future research.

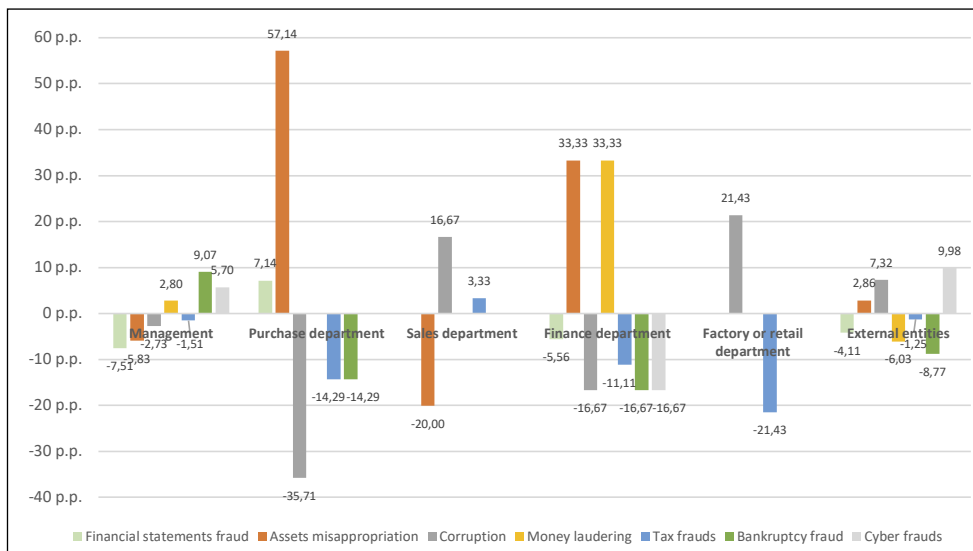
**Figure 10.** Differences in the direction of manipulation of financial statements positions between external and internal auditors



Source: Research results

The last area of research is related to fraud perpetrators. Figure 11 shows the differences in the main fraud perpetrators between external and internal auditors. External auditors found the management responsible for 67% of total frauds followed by external parties (16%), the purchase department (7%), the finance department (4%), the factory or retail department (3%), and sales department (3%). 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 (Zenzerović & Marković, 2023). The biggest differences between external and internal auditors' views on the department in which the perpetrator is employed can be noticed in the purchase and finance department, while the lowest can be seen in management and perpetrators that are not employed in the organization.

**Figure 11.** Differences in the main fraud perpetrators between external and internal auditors



Source: Research results

#### 4. DISCUSSION AND CONCLUSION

External auditors are considered a relevant factor contributing to the quality of financial reporting, giving reasonable assurance that the financial statements are free from material misstatements caused by fraud or error. Research performed among the external auditors operating in the Republic of Croatia indicate that asset misappropriation, tax fraud, financial statements fraud, and corruption represent the most common category of fraud. On the other hand, cyber fraud, bankruptcy fraud, and money laundering are the least represented.

The high proportion of fraud committed by different levels of management emphasizes the need to improve the corporate governance system along with the system of internal controls that will, along with its ordinary activities, focus more intensively on cyber fraud prevention and detection. Corporate governance should be established to assure the prevention of fraud performed by internal perpetrators, which is usually considered to be not so demanding as preventing and detecting the fraud, which is the result of collusion between internal and external perpetrators.

According to external auditors, the most common discovery tool used in fraud research is external auditing as part of the financial statement auditing process.

External auditors considered income statement positions and long-term provisions to be most exposed to fraudulent financial reporting with the direction of their manipulation that overestimates business results. Short-term and long-term assets are other positions significantly exposed to manipulation with the pressure to overestimate their value, leading to an overestimation of company value and success. These results could be of interest to various stakeholders included in fraud prevention and detection when performing their activities as well as to other users of financial statements. They should put more focus on these positions when performing internal/external audit activities, monitoring transactions, performing supervision, or just analyzing financial statements.

There is a significant improvement area when analyzing the auditors' tools in fraud investigation. Most of them used MS Excel, while only less than a third apply specialized software which could make audit activities more effective and efficient.

The comparison of research results between internal and external auditors indicates that there are significant differences in the frequency of fraud they discovered, exposure to manipulation of financial statements positions and the direction of that manipulation, as well as the department in which fraud perpetrators are employed. Such a difference could be attributed to differences in professional experience and focus between two groups of auditors, but some other questions arise as well. Are the differences a result of the independence that external auditors have in relation to internal auditors? Is the research sample representative? Are there some other factors significant to such findings?

The fact is that survey results should always be analyzed with a certain degree of caution. Namely, sometimes the question of the objectivity of the surveyed participants and their sincere responses to the posed questions arises.

Research conducted on a sample of external 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.



## LITERATURE

1. Association of Certified Fraud Examiners (2022) Occupational Fraud 2022: A Report to the Nations., available at: <https://acfepublic.s3.us-west-2.amazonaws.com/2022+Report+to+the+Nations.pdf> [03.05.2023.]
2. Association of Certified Fraud Examiners Croatia (2022) How do we steal? Research on fraud in business in the Republic of Croatia, available at: <https://acfecroatia.hr/> [10.05.2023.]
3. Bartulović, M., Kovačević, I. & Filipović, M. (2022) Trends in Business Frauds: Case of Croatia, 90th International Scientific Conference on Economic and Social Development "Building Resilient Society: National and Corporate Security", Zagreb, 16.-17. December 2022.
4. EY (2022) Global Integrity Report., available at: [https://assets.ey.com/content/dam/ey-sites/ey-com/en\\_gl/topics/assurance/assurance-pdfs/ey-global-integrity-report-2022.pdf](https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/assurance/assurance-pdfs/ey-global-integrity-report-2022.pdf) [15.05.2023.]
5. EY (2021) Financial Crime Data Survey., available at: [https://www.ey.com/en\\_gl/financial-services-technical-resources/emeia-financial-crime-data-survey](https://www.ey.com/en_gl/financial-services-technical-resources/emeia-financial-crime-data-survey) [22.08.2023.]
6. KPMG (2021) Fraud Barometer 2021, available at: <https://assets.kpmg/content/dam/kpmg/uk/pdf/2022/02/fraud-barometer-2022.pdf> [29.05.2023.]
7. International standard on auditing 240 – The auditor's responsibilities relating to fraud in an audit of financial statements, International Federation of Accountants, available at: [https://www.ifac.org/\\_flysystem/azure-private/publications/files/A012%202013%20IAASB%20Handbook%20ISA%20240.pdf](https://www.ifac.org/_flysystem/azure-private/publications/files/A012%202013%20IAASB%20Handbook%20ISA%20240.pdf) [01/06/2023]
8. PwC (2022) PwC's Global Economic Crime and Fraud Survey 2022, available at: <https://www.pwc.com/gx/en/forensics/gecsm-2022/pdf/PwC%E2%80%99s-Global-Economic-Crime-and-Fraud-Survey-2022.pdf> [30/05/2023]
9. PwC (2016) PwC's Global Economic Crime and Fraud Survey 2016 – Croatia Country Report, available at: [https://www.pwc.hr/en/forensic/assets/gecs-2016/PwC\\_GlobalEconomicCrimeSurvey\\_2016-Croatia\\_en.pdf](https://www.pwc.hr/en/forensic/assets/gecs-2016/PwC_GlobalEconomicCrimeSurvey_2016-Croatia_en.pdf) [30/05/2023]
10. U.S. Securities and Exchange Commission (2021) 2021 Annual Report to Congress Whistleblower Program., available at: <https://www.sec.gov/files/owb-2021-annual-report.pdf> [15.05.2023.]
11. Zenzerović, R., Černe, K. & Šajrih Josip (2022) Frauds and internal audit - (post)covid era. In: Mamić Sačer, I. (ed.) 24. Consultation Internal audit and control.
12. Zenzerović, R. Marković, M. (2023) Frauds from the perspective of internal auditors – Croatian experiences, Journal of Accounting and Management, Croatian Accountant – Independent Association of Accountants, Tax Advisors, and Finance Professionals, (accepted and submitted for publication).

## PRIJEVARE IZ PERSPEKTIVE EKSTERNIH REVIZORA - HRVATSKA ISKUSTVA

### SAŽETAK

Financijske prijevare i manipulacije financijskim izvješćima često se događaju i predstavljaju veliki problem za organizacije, vlasnike kapitala, porezne vlasti, vjerovnike, potencijalne investitore i društvo u cjelini. U tom je smislu uloga eksterne revizije od neprocjenjivog značaja, upravo s ciljem zaštite interesa svih navedenih dionika. Eksterna revizija prije svega ispituje objektivnost i točnost temeljnih financijskih izvješća, a pravovremeno otkrivanje financijskih prijevara i manipulacija financijskim izvješćima jedan su od ključnih zadataka eksternih revizora.

Svrha ovog rada je proširiti postojeće znanje o prijevarama i načinima na koje organizacije na njih reagiraju iz perspektive eksternih revizora.

Kao dodatak istraživanju uloge i značaja eksterne revizije u otkrivanju financijskih prijevara te sagledavanju procesa razotkrivanja financijskih prijevara u poduzećima, izvršena je i usporedba uloge i aktivnosti interne revizije u istom procesu.

Glavni nalaz dobiven usporedbom rezultata istraživanja između internih i eksternih revizora ukazuje na značajne razlike u pojavnosti prijevara koje su otkrili, ranjivosti na manipulacije financijskih izvješća, prirodi takvih manipulacija i organizacijskom odjelu kompanije u kojem su počinitelji prijevara zaposleni.

**Ključne riječi:** *financijske prijevare, eksterna revizija, interna revizija, alati, aktivnosti i sudionici otkrivanja financijskih prijevara, počinitelji prijevara*