Category: original scientific paper

Sever Mališ Sanja [1]
Novak, Ana [2]

FRAUD RISK ASSESSMENTS: AN EMPIRICAL ANALYSIS

Abstract:

This paper provides the theoretical review of the fraud risk characteristics, systematization of the existing fraud knowledge and the causes of fraud occurrence. Moreover, it determines the roles and the responsibilities of managers and auditors in the fraud risk assessments. In addition, risk factors relating to the misstatements arising from fraudulent financial reporting have been examined. According to the results of numerous scientific and expert studies it is obvious that a system of internal controls, including fraud risk assessments as an elementary component of this system, contributes to reducing fraud occurrence. In order to gain information about the factors that could cause fraudulent financial reporting, the empirical research has been conducted on the sample of companies operating in the Republic of Croatia. The respondents, accountants and auditors, revealed how often they meet fraud risk factors.

Although, according to respondents' answers, companies rarely encounter circumstances that indicate the possibility of fraud, the obtained data imply that there are possibilities that financial statements contain misstatements as a result of fraud. Examples of circumstances indicating the possibility that the financial statements contain a material misstatement resulting from fraud include: last-minute adjustments that significantly affect financial results, followed by transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy and unsupported or unauthorized balances or transactions. The problems, which the accountants most frequently encountered were undue time pressures imposed by management to resolve complex or contentious issues, an unwillingness to address identified deficiencies in internal control on a timely basis and missing documents.

Keywords:

fraud risks, auditing, fraudulent financial reporting, fraud risk factors

Author´s data:

[1] Sever Mališ, Sanja, Assistant Professor, University of Zagreb, Faculty of Economics and Business, Trg J. F. Kennedyja 6, 10000 Zagreb, ssever@efzg.hr

[2] Novak, Ana, Assistant Professor, University of Zagreb, Faculty of Economics and Business, Trg J. F. Kennedyja 6, 10000 Zagreb, anovak@efzg.hr

Introduction

The fraud risks represent significant or very significant risk for every organization. In that sense the most important factor is proactive fraud risk approach which is primarily related to the increased awareness of possibility of fraud occurence in the company, identifying the most sensitive areas and early detection of fraud. Large frauds have led to the downfall of entire organizations, massive investment losses, significant legal costs, incarceration of key individuals, and erosion of confidence in capital markets [10]. Due to these facts regulators very often require implementation of proactive fraud prevention programs. In that sense the role of management, board of directors, accountants and auditors have been highlighted in ensuring reliable financial reporting. Fraud has a negative impact on organizations in different ways, including financial, reputational, psychological, and social [9]. Fraud causes, not only tremendous losses to business world, but also morale problems in workplace [19]. Since many fraudulent schemes remain undiscovered, or months and even years may pass till they are discovered, and because there are often no reports of fraud, it is very difficult to calculate the exact amount of losses due to fraud. It is estimated that the typical organization's annual loss of revenues is 5% [2].

This paper discusses managements' and auditors' responsibility for preventing and detecting fraudulent financial reporting. The implementation of fraud prevention activities is much more complex issue then detecting fraud as a result of undesirable events. Fraud prevention activities, among other activities, include fraud risk assessments, testing fraud controls and fraud auditing. In modern business environment detecting and investigating fraud activities is by far the most complex issue due to the fact that perpetrators "cover their tracks". Fraud, by definition, entails intentional misconduct, designed to evade detection [10].

In order to gain information about the factors that could cause fraudulent financial reporting, the empirical research has been conducted on the sample of companies operating in the Republic of Croatia. The aims of this empirical research are to identify the fraud risk factors, to investigate how often do the accountants and auditors encountered circumstances indicating the possibility of fraudulent financial reporting. In addition, this paper explores the perception of the accountants about the fraud risk assessments in their companies.

Theoretical background

Singleton et. al. stated that there is no definite and invariable rule that can be laid down as a general proposition in defining fraud, as it includes surprise, trick, cunning and unfair ways by which another is cheated [20]. In business environment fraud is an intentional deception, misappropriation of a company's assets, or manipulation of its financial data to the advantage of the perpetrator [7]. For an act to be fraudulent there must be: a false statement, representation, or disclosure; a material fact, which is something that induces a person to act; an intent to deceive; a justifiable reliance; that is, the person relies on the misrepresentation to take an action; an injury or loss suffered by the victim [18]. Fraud always involves a deliberate action by one person to gain an unfair advantage over another person, and can take many forms [23]. In addition, fraud can be defined as "any intentional act or omission designed to deceive others, resulting in victim suffering a loss and/or perpetrator achieving a gain" [10]. Fraud usually can be divided into internal and external fraud. According to Jans et. al. merely all research is conducted in the field of external fraud, and concerning internal fraud, there is a gap in the academic literature [12].

One of the most commonly used classifications of fraud is from The Association of Certified Fraud Examiners (ACFE), which have identified three primary categories of fraud based on numerous investigated fraud cases. These are asset misappropriations, corruption schemes and financial statement fraud schemes. According to ACFE, asset misappropriations are those schemes in which the perpetrator steals or misuses an organization's resources; corruption schemes involve the employee's use of his or her influence in business transactions in a way that violates his or her duty to the employer for the purpose of obtaining a benefit for himself or herself or someone else; and financial statement fraud schemes are those involving the intentional misstatement or omission of material information in the organization's financial reports [1]. Although fraud is a broad legal concept, for the purposes of the International Standards on Auditing, the auditor is concerned with fraud that causes a material misstatement in the financial statements, and accordingly two types of intentional misstatements relevant to the auditor are misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets [11].

For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur incentives/pressures, opportunities, and attitudes/rationalizations [11]. According to Rezaee and Riley, financial statement fraud occurs for a wide variety of reasons, including when motives are combined with [17]. Motivated person, being able to rationalize his or her behaviour, will find a way to commit fraud.

There is a lack of academic research in the field of financial fraud investigations and assets misappropriation. Most of the research was carried out by the professional organizations. According to the latest 2016 global fraud study, asset misappropriation was the most common (83% of cases) type of occupational fraud, as well as the least costly, while financial statement fraud involved less than 10% of cases, but those cases had the greatest financial impact. In accordance with report, the median duration of the fraud was 18 months, and the losses rose as the duration increased. The study also highlighted that organizations of different sizes tend to have different fraud risks. According to the study, corruption was more prevalent in larger organizations, while check tampering, skimming, payroll, and cash larceny schemes were twice as common in small organizations as in larger organizations. In accordance with report, while the implementation rates of anti-fraud controls varied by geographical region, external audits of the financial statements, code of conduct, and management certification of the financial statements were consistently among the most commonly implemented across organizations in all locations. The study also highlighted that formal fraud risk assessments were present in less than 40% of the reported cases. According to the study, victim organizations that implemented this control experienced losses 47% smaller and schemes 50% shorter than organizations that did not. [3]

The PwC's 2014 Global Economic Crime Survey stated that accounting fraud had always been one of the major crimes reported in their surveys. In 2014 22% of respondents reported experiencing accounting fraud. On the other hand, asset misappropriation is by far the most common economic crime experienced by the organisations reporting any fraud (69% of cases) [13]. According to the PWC's Global Economic Crime Survey 2016, there was a decrease in the detection of criminal activity by methods within management's control, with detection through corporate controls down by 7%. The study indicated that 22% of respondents have never carried out a fraud risk assessment and a further 31% only carry out such an assessment annually. The PWC's findings also indicated that one in ten economic crimes are discovered by accident. [14]

According to PWC's 2016 study, economic crime is a serious issue affecting organisations in Croatia, with no industry being immune. Conducted survey indicates that approximately one out of four Croatian organisations (26%) reported having experienced one or more instances of economic crime in the last two years. This study highlited that although the reported rate of economic crime is lower than the global and Eastern European results (36% and 33% respectively), it may be that fraud incidents are not always detected. According to the study the role of fraud risk assessment is underestimated, as 25% of Croatian respondents have not performed this assessment. The study also indicated that a key pre-requisite for efficient crime prevention and detection is awareness of the risks an organisation is actually exposed, and in this respect, organisations should be encouraged to implement risk assessment exercises on a regular basis. [15]

From these studies it is possible to conclude that fraud is a worldwide problem. Fraud prevention programs which include fraud risk assessments are necessary to address the risk of fraud.

Internal controls and fraud risk assessments

There is numerous definition of internal control in expert and scientific literature. Internal control is broadly defined as a process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations [5]. It is conducted by all employees at all levels within the organization in order to achieve effectiveness and efficiency of operation.

The internal control system must be tailored according to the company's needs. To achieve that, the process of organizing and implementing internal control system should be established by the management. In other words, the primary responsibility for internal controls and the preparation of financial statements rests with both, those charged with governance of the entity and the management.

It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment [11]. In broader sense, every employee plays an important role in implementing internal control process. For example, the role of accountant is "important in the design of internal control procedure to ensure compliance and the achievement of the company objectives" [16].

However, understanding internal control system is crucial for managers and employees but also for those who are in charge for its supervision. In that sense internal and external auditing has the most significant role. Due to the fact that internal control is a key component of the risk management process internal auditors "must assess the adequacy and efficiency of controls for responding to the risks of managing the business and their information systems" [8].

When performing financial statements audit, external auditor should assess the risk of fraudulent financial reporting. In making these assessments the auditor is required to have sufficient understanding of internal control systems in order to design audit procedure that are appropriate in the circumstances. The auditor is not expressing an opinion about the efficiency of internal control. The

UDK 657.632:303.7; DOI 10.2507/IJVA.2.1.2.24

auditor "responsibility is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements" [11].
In that sense external auditors are contributing to the achievement of company objectives. In addition, auditing is conducted in order to ensure the "true and fer" financial reporting. Reliability of financial reporting and compliance with applicable laws and regulations are set as basic internal control objectives. When expressing independent and objective audit opinion about the financial statements, auditors provide to the management useful information about any internal control deficiencies detected in the process of financial statements auditing. In that sense they provide reasonable assurance regarding the achievement of the company's objectives.
The most commonly used framework for the assessment of internal controls is the COSO framework. COSO Framework provides a "standard for all the companies to assess their internal controls and determine a way to improve them" [5]. According to this framework internal control consists of five interrelated components: control environment, risk assessment, control activities, information and communication and monitoring. This paper puts an emphasis on the risk assessment component of the COSO framework.
Once the aims and appropriate control environment have been established the company should assess the risks that can jeopardize the established aims. Every entity faces a variety of risks from internal and external sources that must be assessed. "Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed" [8]. The foundations of an effective fraud risk management program are rooted in a risk assessment. The assessment may be integrated with an overall organizational risk assessment or performed as a stand-alone exercise, but should, at a minimum, include risk identification, risk likelihood and significance assessment, and risk response [10].
Management has overall responsibility for risk management in the company. They should ensure the functioning the process in order to achieve the objectives of internal controls and therefore the objectives of the company. According to the COSO Framework definition „enterprise risk management is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives [6]." The risk assessments in a company should start from the „characteristics of each business goal, from the highest level (for example, keeping a company profitable) to the lowest level (for example, safeguard a cash), to document collected information and assess every risk that can undermine or block the achievement of the objective"[22]. The effectiveness of fraud risk assessments "depends on the understanding of the fraud concept within the environment (a company, time period and the effectiveness of internal controls)" [21].
The risks of fraudulent financial reporting include identifying, analysis and managing the risks of preparing true and reliable financial information. The examples of fraudulent financial reporting risks include: transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy, unsupported or unauthorized balances or transactions, last-minute adjustments that significantly affect financial results, missing documents [11].

Management of the company has overall responsibility for fraud risk assessments and implementing controls for fraud prevention and detection. These assessments can be made annually or continuously. The nature, extent and frequency of managements' assessments vary among the companies. If the management has not made the fraud risk assessments can be an indicator that the management does not attach the required attention to the internal controls. Futhermore it is necessary to emphasize the importance of the role of the chief accounting officer in preventing and detecting fraudulent financial reporting, because, "as a member of top management, the chief accounting officer helps set the tone of the organization's ethical conduct; is responsible for the financial statements; generally has primary responsibility for designing, implementing and monitoring the company's financial reporting system; and is in a unique position regarding identification of unusual situations caused by fraudulent financial reporting" [5].

External auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. When obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The auditor may suspect or, in rare cases, identify the occurrence of fraud, but does not make legal determinations of whether fraud has actually occurred.

According to ISA 240, "the auditor's ability to detect a fraud depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error". [11] However, because of their expert knowledge, external auditors are often in great position to provide useful perspectives on best practices in financial reporting and controls, including the mitigation of the fraud risks [4]. In fact, whenever the external auditor has determined that there is evidence that fraud may exist, the professional standards require that the matter should be brought to the attention of an appropriate level of management in a timely manner. If the external auditor suspects fraud involving management, the external auditor must report these suspicions to those charged with governance.

However, the efficiency of the external auditing in fraud detection has been an object of many expert and scientific research sometimes with the conflict findings. In accordance with ACFE's 2014 global study, external audits are implemented by a large number of organizations (as they were present in more than 80% of the fraud cases), but they present the least effective control in combating occupational fraud. Such audits were the primary detection method in just 3% of the reported fraud cases reported. Furthermore, although the use of independent financial statement audits was associated with reduced median losses and durations of fraud schemes, these reductions were among the smallest of all the anti-fraud controls analysed in the study. Consequently, the study concludes that independent audits serve as a vital role in organizational governance, but data indicates that they should not be relied upon as organizations' primary anti-fraud mechanism. [2]

Accountants' and auditors' perception regarding fraud risk assessment and circumstances indicating the possibilitiy of fraudulent financial reporting

Data and methodology

In order to gather information on the fraudulent financial reporting of companies in the Republic of Croatia, a questionnaire survey was conducted. The respondents were the accountants in medium and large-sized companies and external auditors. Accountants evaluated how often, when performing accounting tasks in the company, faced with certain statements that constitute examples of circumstances that may indicate the possibility that the financial statements contain a material misstatement resulting from fraud. The incidence of the same circumstances has been tested on the second sample made up of external auditors. However, the external auditors were answered how often they meet with the statements in its auditing practices.

Methods used to analyse the collected data were adjusted to the variables which were formed through the questions and statements. First part of the questionnaire consisted of some basic information about the respondents and companies where respondents are employed. In the second part of the questionnaire, circumstances indicating the possibility of financial reports containing significant misstatements as a result of fraud were analysed. Statements, which are part of the International Standard on Auditing 240 - The Auditor's responsibilities relating to fraud in an audit of financial statements, are formed on the bases of examples of circumstances that indicate the possibility of fraud. Examples of circumstances, which are divided into four groups in the International Standard on Auditing, were modified for the purpose of this survey, i.e. simplified and adapted to the survey scale. For the purpose of evaluating how often respondents encountered certain fraudulent financial techniques, on the Likert scale from 0 to 5 (where 0 means "never", and 5 means "very often") respondents evaluated how often they encounter circumstances indicating the possibility of fraud.

Empirical results - Accountants' and auditors' perception regarding circumstances indicating the possibilitiy of fraudulent financial reporting

The information from the survey were gathered from May 27 to July 14, 2012, after eliminating the incomplete questionnaires and those not satisfying the set criteria, the final number of collected questionnaires was 142 from accountants and 42 from auditors.

The following information is gathered in order to describe the characteristics of the respondents. 71% of accountants were employed in medium-sized companies, and 29% in large-sized companies. Most of the auditors were employed in small audit firms (78%), followed by medium-sized firms (20%), and the smallest number in large audit firms (2%). According to the results of research over the 70% of survey respondents are accountants with more than 10 years of work experience, 16% have between 6 to 10 years, 11% have between 1 to 5 years and 5% are performing accounting in less than 1 year period. Considering the many years of work experience it is assumed that accountants should be familiar with the functioning of the accounting information system and internal control system in the companies in which they are employed. As for the auditors in the research period 42% have more than 10 years of experience in the field of auditing, 24% have 6 to 10 years, 29% have 1 to 5 years while 5% have less than 1 year of experience. While performing audit activities, 54% of respondents stated that they were under pressure from the client when they were supposed to express "qualified opinion". 22% of respondents stated that they never gave "qualified opinion". On the question, if the companies to which they had given “qualified opinion” engaged them to perform audit afterwards, 46% of auditors responded that they were still engaged, while 41% of auditors were engaged only in some cases.

On the Likert scale from 0 to 5 (where 0 means never, and 5 means very often) respondents evaluated how often they encountered circumstances indicating the possibility of fraudulent financial reporting. The research results are presented in Table 1.

Statement	Accountntants		Audtiors	
	Rating Average	Response Count	Rating Average	Response Count
Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.	0,94	142	2,98	42
Unsupported or unauthorized balances or transactions.	0,63	142	2,64	42
Last-minute adjustments that significantly affect financial results.	1,13	142	3,21	42
Tips or complaints about alleged fraud.	0,35	142	1,29	42
Missing documents.	1,17	142	2,29	42
Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.	1,06	142	2,24	42
Missing assets of significant magnitude.	0,18	142	1,48	42
Undue time pressures imposed by management to resolve complex or contentious issues.	1,36	142	2,45	42
An unwillingness to add or revise disclosures in the financial statements to make them more understandable.	0,97	142	2,32	41
An unwillingness to address identified deficiencies in internal control on a timely basis.	1,17	142	2,54	41
Frequent changes in accounting estimates that do not appear to result from changed circumstances.	0,6	142	2,32	41
Tolerance of violations of the entity’s code of conduct.	0,57	142	1,78	41

Table 1 The participants’ perception regarding circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud

According to the responses of accountants, companies rarely encountered with the aforementioned fraud risk factors. The problems, which the accountants most frequently encountered were undue time pressures imposed by management to resolve complex or contentious issues, an unwillingness to address identified deficiencies in internal control on a timely basis, folowed by missing documents and last-minute adjustments that significantly affect financial results. Although, according to respondents' answers, company rarely encounter circumstances that indicate the possibility of fraud, averages obtained at the level of enterprises indicate that there is a possibility that the financial statements may contain a material misstatement resulting from fraud.

The auditors are more likely to agree with certain circumstances that indicate the possibility of fraud than the accountants. However, when interpreting the results it is necessary to take into account that the accountants answered how often they meet with asked circumstances of the company in which they are employed, while the auditors answered how often they met with asked circumstances in its auditing practices. Examples of circumstances indicating the possibility that the financial statements contain a material misstatement resulting from fraud, which the auditors most frequently encountered, were last-minute adjustments that significantly affect financial results, followed by transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy and unsupported or unauthorized balances or transactions. Auditors are also set some additional statements, according to which auditors encountered with fewer responses to confirmations than anticipated or a greater number of responses than anticipated (12% very often, and 37% often, rating average 2,98) and unusual delays by the entity in providing requested information (10% or respondent met very often and 32% often, rating average 2,95).

Empirical results - accountants' perception regarding fraud risk assessment component

In order to gather information on accountants's perception regarding fraud risk assessment, accountants also provided data of risk assessment component in their companies. The specified variable was formed as an unweighted average of statements referring to fraud risk assessment, which are based on the examples of questiones for risk assessment principles in COSO's Internal Control over Financial Reporting - Guidance for Smaller Public Companies, Volume III: Evaluation Tools (2006). It should be noted that there is no methodology or framework that would be fully able to consider all the issues related to risk assessment. The areas covered in this paper are examples, based on the COSO framework, which should be considered and they represent a methodology that can help in the evaluation of risk assessment component. For the purpose of evaluating this component of internal control system, again Likert scale from 0 to 5 (where 0 means "strongly disagree", and 5 means "strongly agree") was used.

Statement	Midium-sized companies		Large-sized companies		Total	
	Rating Average	N	Rating Average	N	Rating Average	N
Financial statements are align with the requirements of accepted accounting principles.	4,75	101	4,73	41	4,75	142
Information presented in financial statemets are classified and summarized in a reasonable manner, neither too detailed nor too condensed.	4,63	101	4,68	41	4,65	142
Risk identification consider both internal and external factors and their impact on the achievement of financial reporting objectives.	4,10	101	4,15	41	4,11	142
Fraud risk assessment is an integral part of the identification and analysis of risks.	3,93	101	4,00	41	3,95	142
The company's assessment of fraud risks consider incentives and pressures, attitudes, and rationalizations, as well as opportunity to commit fraud.	3,93	101	3,90	40	3,92	141
The company's assessment consider risk factors that influence the likelihood of someone committing a fraud and the impact of a fraud on financial reporting	3,88	100	3,88	41	3,88	141
The company's assessment consider the possibilities of fraud in high-risk areas of accounting (eg, revenue recognition, important estimates).	4,05	101	4,17	41	4,08	142
Risk assessment - total rating average	4,19	100	4,20	40	4,19	140

Table 2 The accountants' perception regarding fraud risk assessment

Total rating average for the risk assessment component for all respondents was 4,19, which means that employees generally agree with the claims of a risk assessment that should exist in companies. Almost all respondents strongly agree that in their company financial statements are prepared in accordance with the requirements of accounting standards. However, in medium- and large sized companies the claims relating to the assessment of the fraud risk, which can be seen as an integral part of risk assessment at the company level, are at least represented. Respondents are at least agreed with the statements that in their companies are considerd risk factors that influence the likelihood of someone committing a fraud and the impact of a fraud on financial reporting, as well as with statement related to consideration of incentives and pressures, attitudes, and rationalizations, as well as opportunity to commit fraud.

Conclusion

Risks that modern companies are facing today are changing and complement as a result of changes in environment, the use of modern technologies, ways of communication and also due to more stringent legal and regulatory frameworks. In that sense one of most significant risk with a possible serious impact on the organization is the risk of fraudulent financial reporting. Significant time, financial and human resources are necessary in order to manage properly these risks due to the fact that fraud risks can be various and very complex. Fraud risk management includes identification, assessment and surveillance of fraud risk. Many frauds can be prevented if the fraud risk factors are on time identified by the auditors and accountants.

The conducted empirical research investigated how often do the accountants and auditors encounter circumstances indicating the possibility of fraudulent financial reporting. Based on the results of conducted empirical research it can be concluded that the fraud risk assessments are at satisfactory level by the accountants' perception. However, the companies should devote more attention to assessing the risk of fraud. Moreover the assessment of the fraud risks should be considered as an integral part of the overall risk assessments at the company level. The results of the study show that the companies rarely encounter circumstances that may indicate the possibility that the financial statements contain a material misstatements resulting from fraud. Althought these study identified a number of problems that can cause the financial statements can be misstated. In that sense it is crucial that those charged to the quality of financial reporting process, management, accountants, external auditors, devote enough time and their resources to identify, access and manage the fraud risk factors in order to create addition value for the organization.

This empirical research has its limitations inherent to the applied research method. In addition, the respondents - accountants can be included or familiar with some form of fraudulent activities. The limitations of the research can be viewed throught the size of sample, as well as the fact that 37% of auditors have less the five years of working experience. However, the presented results of research certainly provide valuable information.

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UDK 657.632:303.7; DOI 10.2507/IJVA.2.1.2.24