
The Importance of Forensic Audit and Differences in Relation to Financial Audit

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Abstract

Financial statements are one of the most important factors affecting the overall business, in particular investment decision making. External audit aims to determine accuracy and objectivity of financial statements, i.e., disclosure of funds, resources and business performances in the financial statements, and to form an opinion based on the information provided. Therefore, the purpose of external traditional audit is not fraud detection that frequently appears in the background of an incorrect, unfair and unlawful presentation of financial statements. This has triggered the necessity to provide a new kind of auditing services that would be directed towards fraud prevention and detection. The answer to this need is the emergence of forensic audit, which differs from external audit in terms of its goals and character. There is no generally accepted definition of this concept, and the paper suggests differences in its definition and characteristics and differences in relation to external audit. The authors also attempt to point out to certain limitations that impede the development of a new audit discipline, which has justified its existence and indicated the necessity for its further development, both in theory and practice.

Keywords: forensic audit; forensic accounting; fraud; financial audit.

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1. Introduction

Audit is professionally regulated by mandatory standards, but it should be noted that those same standards in certain cases prevent external audit to gain its full potential. This is particularly true in the case of fraud detection. The expansion of major financial scandals, which usually as the background had scams and in the ever-growing number of frauds in previous decades, as well as the very substantial amounts of damages caused by frauds, has made an entrance for forensic audit, as well as other specialized audit services. When it comes to this type of audit, there is more information and knowledge from practice than from theory, and that is substantial difference in the conceptual, theoretical and practical perspective of this type of audit. The very nature of forensic audit stipulates differences in relation to external audit. These differences, resulting from different needs to which external audit cannot properly respond, are primarily related to prevention and detection of fraud with the elements of the offense, as well as preparation of relevant evidence for court proceedings [1]. The restrictions that stand in the way of this type of audit are numerous. However, the main limitation is that the forensic audit is not mandatory, as in the case of external audit. The standards apply changes resulting from not so long practice. Historically, the demand for this type of service appeared sporadically, from case to case, and when the fraud is evident, it appeared as the subject of subsequent judicial proceedings. Only in the last few decades, especially after numerous financial scandals, the need for this audit service is becoming increasingly important. It is stressed out by all ever growing demand for this type of audit. Besides the lack of legal regulations and standards, the procedure itself is conducted by forensic auditors who must have special training and knowledge which is approved by license. In this sense, the process requires special training of experts on techniques and activities performed during court proceedings. All previously listed restrictions are not the only ones. There are more limits and new restrictions that arise from the practice and particular cases that are simultaneously reflected in the practice of forensic audit [2].

2. Characteristics of forensic audit

The forensic audit involves the use of auditing and investigative skills to situations that may involve legal implications. Forensic audits may be required in the following instances:

- Fraud investigations involving, misappropriation of funds, money laundering, tax evasion, and insider trading.
- Quantification of loss in case of insurance claims.
- Determination of the profit share of business partners in case of a dispute.
- Determination of claims of professional negligence relating to the accountancy profession.

Forensic auditing goes a step beyond the traditional financial audit. It examines the very nature of transaction and checks for possibility of any asset-theft taking place by means of investigative techniques. For example, an employee may create a fictitious account and release payment in order to siphon off money from the company/firm. Such a transaction may go unreported as far as the financial reporting is concerned provided it is properly accounted for. In the instant case, the company will get an unqualified report in a financial audit.

Forensic auditing covers a broad spectrum of activities, with terminology not strictly defined in regulatory guidance. The work of a forensic audit appears much like that of a financial audit. Both types of audit involve careful examination of financial records. The difference lies in the objective and intent of the search. Forensic audits require analysis of financial transactions and compilation of the information for use in court cases. The forensic auditor may also examine a company's financial systems to determine reliability, accuracy and the strength of internal control systems. Court cases requiring the evidence provided by a forensic accountant may include commercial litigation, business valuation, divorce, bankruptcy and, of course, fraud. A forensic accountant's report must meet the standards of presentation before a court of law. Court presentation of evidence requires thorough, complete and well documented work. To an external observer, financial audits and forensic audits may look similar. Both types of auditors closely examine and confirm accounting records, using similar methods. The two types of audits differ significantly in their end product – the auditor's report. A financial audit results in a statement from the auditors (or the audit firm) that they have examined the books of XYZ Corporation. The statement notes that the auditors find that the financial statements report the company's financial position fairly. Because companies engage forensic auditors to answer specific questions, a standard forensic audit report format does not exist. The forensic auditor must supply the requested information and provide sufficient evidence to argue the results in court, if needed. Forensic auditing refers to the specific procedures carried out in order to produce evidence. Audit techniques are used to identify and to gather evidence to prove, for example, how long the fraud has been carried out, and how it was conducted and concealed by the perpetrators. Evidence may also be gathered to support other issues which would be relevant in the event of a court case. Such issues could include:

- the suspect's motive and opportunity to commit fraud;
- whether the fraud involved collusion between several suspects any physical evidence at the scene of the crime or contained in documents;
- comments made by the suspect during interviews and/or at the time of arrest;
- attempts to destroy evidence.

3. Elements of financial audit

Financial audit, also known as external audit and the statutory audit, involves the examination of the truth and fairness of the financial statements of an entity by an external auditor who is independent of the organization by a reporting framework such as the IFRS. Company law in most jurisdictions requires an external audit on an annual basis for companies above a certain size. A financial audit has one purpose – to provide assurance that a company's financial record keeping follows generally accepted accounting principles, or GAAP. To this end, the auditor must objectively examine the company's financial records and use his best judgment in making the appropriate determination. A financial audit may or may not uncover intentional fraud or misrepresentation of facts. An auditor plans his work in a way that allows him to focus on gathering sufficient objective, verifiable evidence to support his report. To obtain the information he needs, a financial auditor investigates documents and traces documentation. Financial audits dig deep into a company's financial situation, probing accounting records, internal controls policies, cash holdings and other sensitive financial areas. Publicly-traded corporations are subject to external financial audits on a regular basis, and even privately

owned small businesses can be subjected to an external financial audit by the IRS or other government authority.

Audits of financials are required mainly for the following reasons:

- To ensure the company has followed True and fair business practices.
- Accounting transactions are true and fair.
- The concern has followed the basic concepts Going Concern, Consistency and Accrual methods and if not, a proper disclosure to that effect.
- The funds of the company has been utilised only for the purpose of business.
- The representation made in the financials are real and proper.
- The law of the land has been properly complied with.

The general process of statutory audit includes:

- Client interview - Before the auditor signs a client up, they will interview the client, find out who are the key management personnel, shareholders, industry etc. This is for their own internal risk review.
- Engagement Letter - Assuming the client fits the risk profile i.e. management, industry risk etc, the auditor will issue an engagement letter. This spells out the scope, what's expected of the client (i.e. schedules, documents to be prepared etc), audit fee. In general, engagement letters are relatively standard unless it is a special engagement. Examples acquisition, insurance certifications or whatever a client might need done.
- Audit Planning - The audit team will be formed and planning for audit begins. Risk areas are identified and procedures defined. In general statutory audits are governed by Auditing Standards. Each auditing firm will have their own audit approaches.
- Audit field work - At an agreed date, the audit team will do field work. The work is reviewed internally to ensure sufficient work is done to arrive at an audit opinion i.e. the financial statements present a true and fair view. This could be in the form of process review, analytical review, vouching (looking at documents that make up an account balance).
- Representation letter - The directors declare that representations made during the audit true and they are not aware of any material mistakes or fraudulent activities during the period under review.
- Directors resolutions approving the financial statements - Directors must approve the financial statements.
- Post balance sheet review - The auditors will review the entity to determine whether there have been any developments that could change the audit opinion e.g. lawsuits, industry changes, regulations etc.
- Auditors sign the accounts - The audit report is signed and this brings the audit to a close.

4. Differences between forensic and financial audit

The primary difference between financial and forensic audits lies in the purpose of the audit. A financial audit confirms the validity of a company's financial records, providing investors and creditors with confidence in the financial information. Forensic audits relate directly to an issue defined by the audit client. This issue may involve employee fraud or a dispute with a vendor or customer. The auditor's report must meet the standards for presentation in court. Overall, the fact that the number of frauds has increased in recent years, has motivated the companies to seek new directions and ways of combat with the activities with scams in their shadows. Forensic audit is one of the most important responses to this challenge. In the literature, but in technical terms, according to Singleton and his colleagues (2006) there is no clear demarcation of concepts of fraud audit, accounting investigations, forensic accounting, forensic auditors and so on, especially highlighting the conceptual differences between forensic accounting and forensic audit. Forensic audits or fraud audit as a synonyms aims primarily to specialized approach and methodology to recognize fraud and to provide a testimony. The same authors treated forensic accounting as a comprehensive approach in the investigation of fraud, which includes auditing of accounting records, in order to prove or disprove fraud. It also includes an interview with related parties which are related to the fraud and the role of forensic accountants as expert witnesses or expert in court [3]. A good description of differences in the definition of the term forensic audit gave (Silverstone and his colleagues 2012), which stated that if you ask a question of two forensic auditor to define the forensic audit, you will get two different answers, which can be similar, but will not have the desired dimensions of consistency. Their replies will primarily depend on the practice and specialization in certain area of auditing. In an effort to highlight the consistency of different definitions, the authors point out that forensic audit focused primarily on deception, fraud prevention and investigation of fraud which would be its main role. This paragraph, therefore, recognizes the elements of generally accepted definition of forensic audit, but does not go beyond that. Bearing in mind that the fraud was basically a criminal act, forensic accounting is the application of investigative and analytical skills to address financial issues in a way that will meet the required court standards [4]. The terminology in the literature is often used as a synonym for the term "accountant", and as an accountant and auditor, as is the case in the definitions above. This is somewhat unclear use of the term, as a synonym provides mild confusion in the precise delimitation of the concepts of forensic auditors and forensic accountants, as already noted Singleton and his colleagues (2006). Conceptual definition of forensic audit and forensic accounting extends to the conceptual definition of the perpetrators of this specialized auditing service. There is also no generally accepted definition of the term of forensic auditors, because different definitions are used both theoretically and terminologically. According to Singleton and his colleagues (2006), fraud auditors must know what is fraud from the legal standpoint and standpoint of audit, then from the perspective of the business environment, fraud perpetrator, as well as from the cultural point of view. Also, fraud auditor must also have extensive experience in external audit, audit scams, but in particular, specific experience in various industries. Forensic accountants appear after the fraud auditors, where their significance lies in the fact that the complex financial transactions are "translated" so that they are understood and easily comprehended by anyone. This approach is necessary, bearing in mind that fraud ends in court, with the jury as non-expert [5]. The scope of forensic accountants is wider than in the case of fraud auditors, because in addition to accounting and auditing they must be knowledgeable in the area of criminal investigation, conduct interviews, writing reports

and testifying in court as an expert. It is believed that the development of forensic accounting and auditing is mostly affected by empirical knowledge acquired through business practices, while the theory in this case had a smaller impact. According to Petkovic (2011), an independent forensic audit is a new specialized service in external audit of financial statements. The same author states the definition of the Institute of Forensic Auditors (IFA), according to which the forensic audit is an activity of collecting, verifying, processing, analysing and reporting data in order to obtain facts and evidence that could be used in forensic financial disputes arising due to criminal activity [6]. Differences between external and forensic audit are reflected in several elements that can be said to represent a particular line of demarcation between the two auditing services. A thin line that separates forensic audit and external audit, is that forensic audit is a newly formed branch and has no generally accepted standards and does not differ significantly from external audit. According to the author, it would be more interesting to discuss about the development of audit in accordance with contemporary needs of business entities, with ever-growing participation of crime. However, a deeper analysis of the differences between these two types of audit services does not indicate that the differences are substantial and in some elements are very pronounced, depending on the character of these two audit services. Differences in external audit and forensic audit can be observed from the aspect of differences in the definitions and characteristics of these two types of audit services. According to Stanisic (2008), audit can be defined as a systematic review of books and financial statements conducted by the auditor and experts to express a competent, professional and independent opinion on the validity, truthfulness and accuracy of the same [7]. The legislation also defines audit as the process of verification and evaluation of financial statements, as well as data and methods to be applied in preparing the financial statements on the basis of which an independent expert opinion is provided on whether the financial statements give a true and fair view of the financial position and results of operations of the legal entity in all material aspects and in accordance with the appropriate regulations for financial statement preparation.

5. Financial accounting

Forensic accounting is a specialty practice area where accounting, auditing and investigative skills are used to analyze information that is suitable for use in a court of law. Forensic accountants are often engaged to quantify damages in instances related to fraud and embezzlement as well as on matters involving insurance, personal injury, business disputes, business interruption, divorce and marital disputes, construction, environmental damages, cyber-crime, products liability, business valuation and more. Forensic accounting professionals are skilled at quantifying damages and determining the full extent of a loss. They are involved in four basic areas of forensic analytics: data collection, data preparation, data analysis and reporting. Specifically, forensic accountants perform tasks that include examining business records, analyzing historical statements, looking for irregularities in business practices, reviewing journal entries, analyzing trends, tracing the flow of funds, interviewing relevant parties, analyzing electronic data and performing an overall evaluation of the situation in question. Beyond this, they can serve as consultants or expert witnesses. When required, they also collaborate with other experts. Forensic accountants are sometimes relied on to train internal auditors and investigators. They can also help gauge an organization's vulnerability to issues such as fraud. Plus, they can help companies implement controls that will reduce their exposure to criminal and civil wrongdoing as well as irreparable damage to their reputation. Forensic accountants are regularly called on to provide evidence and expert witness

testimony in courts, arbitrations and mediations. This evidence may be used to help an attorney establish their case or reinforce the merits of their argument. In other instances, the evidence may be utilized to refute the conclusions that are being proposed by opposing counsel. When serving as expert witnesses in court proceedings, forensic accountants give testimony that is based upon sufficient facts or data that is the product of reliable and accepted principles and methods. Most forensic accountants have a Bachelor's degree in Accounting or a related field. They generally have at least one of the following designations: Certified Forensic Accountant (CFA), Chartered Accountant (CA), Certified Public Accountant (CPA), Certified Management Accountant (CMA), Certified Fraud Examiner (CFE), Certified Valuation Analyst (CVA), Certified in Financial Forensics (CFF) and Investigative & Forensic Accountant (IFA). Forensic accountants are used around the world by insurance companies, independent adjustment firms, lawyers, government and law enforcement agencies as well as by businesses of all sizes – from multi-national corporations to small businesses. Generally, the term 'forensic accounting' is used to describe the wide range of investigative work which accountants in practice could be asked to perform. The work would normally involve an investigation into the financial affairs of an entity and is often associated with investigations into alleged fraudulent activity. Forensic accounting refers to the whole process of investigating a financial matter, including potentially acting as an expert witness if the fraud comes to trial. Although this article focuses on investigations into alleged frauds, it is important to be aware that forensic accountants could be asked to look into non-fraud situations, such as the settling of monetary disputes in relation to a business closure or matrimonial disputes under insurance claims. The process of forensic accounting as described above includes the 'forensic investigation' itself, which refers to the practical steps that the forensic accountant takes in order to gather evidence relevant to the alleged fraudulent activity. The investigation is likely to be similar in many ways to an audit of financial information, in that it will include a planning stage, a period when evidence is gathered, a review process, and a report to the client. The purpose of the investigation, in the case of an alleged fraud, would be to discover if a fraud had actually taken place, to identify those involved, to quantify the monetary amount of the fraud (ie the financial loss suffered by the client), and to ultimately present findings to the client and potentially to court[8].

6. Types of investigation

The forensic accountant could be asked to investigate many different types of fraud. It is useful to categorise these types into three groups to provide an overview of the wide range of investigations that could be carried out. The three categories of frauds are corruption, asset misappropriation and financial statement fraud.

6.1 Corruption

There are three types of corruption fraud: conflicts of interest, bribery, and extortion. Research shows that corruption is involved in around one third of all frauds.

- In a conflict of interest fraud, the fraudster exerts their influence to achieve a personal gain which detrimentally affects the company. The fraudster may not benefit financially, but rather receives an undisclosed personal benefit as a result of the situation. For example, a manager may approve the expenses of an employee who is also a personal friend in order to maintain that friendship, even if the

expenses are inaccurate.

- Bribery is when money (or something else of value) is offered in order to influence a situation.
- Extortion is the opposite of bribery, and happens when money is demanded (rather than offered) in order to secure a particular outcome.

6.2 Asset missappropriation

By far the most common frauds are those involving asset misappropriation, and there are many different types of fraud which fall into this category. The common feature is the theft of cash or other assets from the company, for example:

- Cash theft – the stealing of physical cash, for example petty cash, from the premises of a company.
- Fraudulent disbursements – company funds being used to make fraudulent payments. Common examples include billing schemes, where payments are made to a fictitious supplier, and payroll schemes, where payments are made to fictitious employees (often known as ‘ghost employees’).
- Inventory frauds – the theft of inventory from the company.
- Misuse of assets – employees using company assets for their own personal interest.

6.3 Financial statement fraud

This is also known as fraudulent financial reporting, and is a type of fraud that causes a material misstatement in the financial statements. It can include deliberate falsification of accounting records; omission of transactions, balances or disclosures from the financial statements; or the misapplication of financial reporting standards. This is often carried out with the intention of presenting the financial statements with a particular bias, for example concealing liabilities in order to improve any analysis of liquidity and gearing[9] .

7. Conducting an investigation

The process of conducting a forensic investigation is, in many ways, similar to the process of conducting an audit, but with some additional considerations. The various stages are briefly described below.

7.1 Accepting the investigation

The forensic accountant must initially consider whether their firm has the necessary skills and experience to accept the work. Forensic investigations are specialist in nature, and the work requires detailed knowledge of fraud investigation techniques and the legal framework. Investigators must also have received training in interview and interrogation techniques, and in how to maintain the safe custody of evidence gathered. Additional considerations include whether or not the investigation is being requested by an audit client. If it is, this poses extra ethical questions, as the investigating firm would be potentially exposed to self-review, advocacy and management threats to objectivity. Unless robust safeguards are put in place, the firm should not provide audit and forensic investigation services to the same client. Commercial considerations are also important, and a high fee level should be negotiated to compensate for

the specialist nature of the work, and the likely involvement of senior and experienced members of the firm in the investigation.

7.2 Planning the investigation

The investigating team must carefully consider what they have been asked to achieve and plan their work accordingly. The objectives of the investigation will include:

- identifying the type of fraud that has been operating, how long it has been operating for, and how the fraud has been concealed
- identifying the fraudster(s) involved
- quantifying the financial loss suffered by the client
- gathering evidence to be used in court proceedings
- providing advice to prevent the reoccurrence of the fraud.

The investigators should also consider the best way to gather evidence – the use of computer assisted audit techniques, for example, is very common in fraud investigations.

7.3 Gathering evidence

In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

Evidence can be gathered using various techniques, such as:

- testing controls to gather evidence which identifies the weaknesses, which allowed the fraud to be perpetrated
- using analytical procedures to compare trends over time or to provide comparatives between different segments of the business
- applying computer assisted audit techniques, for example to identify the timing and location of relevant details being altered in the computer system
- discussions and interviews with employees
- substantive techniques such as reconciliations, cash counts and reviews of documentation.

The ultimate goal of the forensic investigation team is to obtain a confession by the fraudster, if a fraud did actually occur. For this reason, the investigators are likely to avoid deliberately confronting the alleged

fraudster(s) until they have gathered sufficient evidence to extract a confession. The interview with the suspect is a crucial part of evidence gathered during the investigation.

7.4 Reporting

The client will expect a report containing the findings of the investigation, including a summary of evidence and a conclusion as to the amount of loss suffered as a result of the fraud. The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organisation to prevent any similar frauds occurring in the future.

7.5 Court proceedings

The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified. It is imperative that the members of the investigative team called to court can present their evidence clearly and professionally, as they may have to simplify complex accounting issues so that non-accountants involved in the court case can understand the evidence and its implications.

8. Conclusion

In summary, a forensic investigation is a very specialist type of engagement, which requires highly skilled team members who have experience not only of accounting and auditing techniques, but also of the relevant legal framework. There are numerous different types of fraud that a forensic accountant could be asked to investigate. The investigation is likely to ultimately lead to legal proceedings against one or several suspects, and members of the investigative team must be comfortable with appearing in court to explain how the investigation was conducted, and how the evidence has been gathered. Forensic accountants must therefore receive specialist training in such matters to ensure that their credibility and professionalism cannot be undermined during the legal process. However, forensic audit is not a legal obligation, but may also be made periodically to the client's request, as well as regular checks, based on internal or external alarm, doubt or for other reasons. Therefore, there is no legislation that would make this activity mandatory, so it is a matter of possible and special needs of the company. The growing number of frauds and the amount of damages due to fraud represent the proof that this type of audit should gain some form of legal obligation, as is the case of external audit. Despite certain differences in various definitions of forensic audit, considering that the audit theory has not provided a unique response in terms of defining the audit services, one of the elements is still common in nearly all definitions. That is the focus of forensic audit on the prevention, investigation and detection of fraud and the term fraud is a term that is included in almost all theoretical efforts to define forensic audit. However, fraud is not the only term used to define these auditing services, but it represents the essence of any definition while other terms in the theoretical sense have primarily practical application. Conceptual and theoretical differences in the definition of external and forensic audit, resulting from the character or nature of the two audit services, which

mostly originate from the practice rather than from theoretical approaches and from attempts to define the term forensic audit. In particular, by relying on both theory and practice, eleven elements could be differentiated. They show the difference between external and forensic audit. It cannot be claimed that those are the only differences, as the practice and theory progress over time and point out to other differences. The restrictions that stand in the way of development and involvement of forensic audit into practice in terms of commitment are primarily legal in nature. Bearing in mind that this type of audit is still developing through practice, the limitations arising from the nature of forensic audit are very important for the decision-making process. Also, the theory, which attempts to define forensic audit, have encountered certain issues, mainly due to the emergence of new limitations. On the other hand, the theory will get better chance in defining the concept and providing new directions for development, because of the constant progress of forensic audit.

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