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Forensic Review of Financial Statements of Legal Entity Tuš-Trade

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Abstract

Large corporate scandals in the US and Europe, from the early 21st century, such as Enron, Parmalat, WorldCom and many others, have seriously shaken public confidence in the auditors' work. Consequently, many countries have recognized the need for introduce the forensic accounting as a more advanced and reliable form of protection against manipulative financial reporting by companies, and have completed the accounting profession with the forensic accountant title, as an active fighter against various types of frauds in companies.

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Unfortunately, the new Law on Accounting and Auditing of the Federation of Bosnia and Herzegovina did not include the forensic accountant title in the list of professional accounting titles.

In parallel, we are witnesses of numerous cases of economic scandals in Bosnia and Herzegovina, and the case of the company Tuš-Trade Ltd. Bihać, which stopped operate suddenly in 2014, by leaving unpaid million-dollar liabilities, was caused an attention of public. The authors of this paper want to answer on the question of whether the forensic review of financial statements could previously indicate risky areas of financial reporting in the company and reduce the losses that followed with the bankruptcy of the entity.

1. Introduction

The purpose of accounting is through the process of preparation and presentation of financial statements to supply numerous business decision-makers with information for decision-making purposes. Though information discrepancy exists between managers and external users of financial statements, it is a constant source of the growing need to audit the work of companies. Business owners as the primary external users of financial statements rightly ask: does the management act in the best interest of the company or perhaps manipulate information to achieve its own goals, and other external users of financial statements think similarly. Although many auditors do their job professionally in accordance with the requirements of the regulatory framework, accounting scandals from the beginning of the 21st century have clearly pointed to the fact that auditors are not enough, and no the best solution for the effective fight against fraud in companies.

Therefore, there is a justified need for a special scientific discipline which primary role will be to detect fraud in the financial statements and in general in the company's operations. Forensic accounting is new science from the area of accounting and auditing designed for the purpose of comprehensive fraud investigation in the business entities and whole society. Accordingly, the research area of the paper is the role of forensic accounting in the function of prevention and detection of fraud in financial statements of companies, and the contribution of the work is the presentation of the methodology which can be used by forensic accountants in the forensic review of financial statements. The main goal of this paper is to point out the importance of forensic accounting in the efficient fight against fraud. In addition, this paper will answer the question of

whether the forensic review of financial statements can earlier indicate risky areas of financial reporting in the companies and reduce the losses that will follow the bankruptcy of the entities.

The structure of the paper is as follows: firstly, the concept, prevalence, and economic consequences of frauds will be presented, then the concept, scope, and methodology of forensic accounting will be elaborated, and finally, forensic review of financial statements of the legal entity Tuš-Trade Ltd. Bihać and discussion of research results will follow. Lastly, concluding remarks are considered, including limitations and recommendations for further research.

2. Fraud: concept, prevalence and economic consequences

The term fraud refers to various forms of deviation from fair relations between the parties in a business relationship with the intention of gaining benefits for themselves. In doing so, the perpetrator of fraud in the company can be anyone from the ranks: employees, management but also external persons, business partners of the company, such as customers, suppliers, investors. In addition, the prevalence of illicit behaviour is manifested in the forms: assets misappropriation, unscrupulous business, illicit trade, adulteration of securities, tax evasion, identity alienation, illegal mediation, damage to computer data and programs, fraudulent financial statements, and numerous other examples of cheating in order to gain an unfair advantage over other actors in the business.

The wide range of different fraud that occurs in practice has resulted in numerous divisions of fraud in theory, and Association of Certified Fraud Examiners (2020, p.4), as the most recognized and well-known organization that reports frauds committed around the world, frauds are grouped, according to the method of execution, into three segments: assets misappropriation as unfair use of company funds by employees; corruption, i.e. misappropriation of personal influence in society by employees; and fraudulent financial statements as the intentional preparation and presentation of incorrect financial statements.

True financial reporting of companies is considered extremely important for strengthening the trust among market actors, acting positively on the volume of realized business activities, and achieving results. On the other hand, due to fraud in the financial statements of companies, individuals, the economy and the whole society suffer great losses. The exact and final effect of

fraud on the property status of individuals, financial result of the company, gross domestic product of the country, or ultimately the level of the economic well-being of society, cannot be determined due to a number of limiting factors, among which the factor of the impossibility of detecting numerous cleverly hidden frauds stands out.

Nevertheless, ACFE measurements and assumptions (2020, p.4), whose Reports to the Nations about professional fraud and abuses are considered representative and estimates reliable, indicate that companies around the world lose an average of 5% of their revenue annually due to fraud, while total annual social losses reach $ 3.6 billion. The same report indicates that the assets misappropriation represents, quantitatively seen, the most common type of fraud committed in the world, but fraudulent financial statements, qualitatively seen, with an average loss of nearly $ 1,000,000 has by far the greatest negative impact on the deceived company as well as the whole society.

As Coenen (2009, p.133) points out, persons who do not understand the purpose and practical value of the financial statements of companies may ask with astonishment what losses exist due to fraud in the financial statements, when there is only manipulation of numbers on paper. Unfortunately, the negative consequences of manipulating the values of financial positions in the financial statements are felt and suffered by many people: creditors because they approved risky loans, shareholders because they have invested cash in shares of questionable quality and overstated value, government authorities because they are deprived for their income, employees because their possibility of long-term work engagement and wages for their works were endangered, etc.

3. Forensic accounting: concept, scope and methodology

Aware of the negative economic consequences of fraud in the field of financial reporting, fraud investigators are increasingly showing interest in early detection of fraud in this domain, and for these purposes are additionally educated in the field of forensic accounting, in terms of understanding the manner and technique for manipulating financial information and financial statements, as well as the application of various methods and models for early detection of fraud in the financial statements.

Although there are beliefs that certain primitive forms of forensic accounting existed as far back as ancient Egypt, forensic accounting get the outlines of a scientific discipline yet in the 80s of the last century (Isaković-Kaplan, 2016, p.57-58). Forensic accounting can be briefly defined as a comprehensive fraud investigation (Singleton & Singleton, 2010, p.12), which includes the application of accounting, auditing, and investigative skills in order to clarify the value of financial positions, as well as the detection of manipulations in the financial statements.

Thus, the task of forensic accounting is to apply appropriate investigative skills to answer the questions such as is there a fraud in society, which frauds were committed, what financial impact of fraud is, etc. These tasks are most often performed by a forensic accountant on the order of judicial authorities for the needs of court expertise. However, forensic accounting activities are not limited to court needs - in the case when there is a suspicion of fraud in the operations of a certain company and/or in its financial statements, investigative accounting services, are often arranged on a commercial basis at the request of various persons/entities.

In the investigation process, the forensic accountant uses information from various sources, but still, the starting point of any investigation is the financial statements of the company as the ultimate financial reflection of the destination of its business policy. Analysis of financial statements as a scientific method of examining the company's activities in order to express opinions on the financial position and income of the company, in theory, it was known as a separate area of research, and in practice, it is recognized as an extremely useful skill.

Although the use of various mathematical models for the purpose of detecting fraud in the field of financial reporting has been recorded recently, classical analysis of financial statements remains the most important tool for many forensic accountants in the fraud investigation process. Therefore, the fraud detection process in the financial statements, a forensic accountant usually begins by applying procedures horizontal data analysis, ie. observes groups of the same magnitude in time continuity, in order to notice the tendencies and dynamics of changes in certain observed data in a series of successive periods, and then performs vertical data analysis procedures, expressing individual positions as a percentage in relation to the total value of all recorded positions or some other relevant base value, in order to compare the quantities thus obtained with the identical items of previous periods, other companies or other observed phenomena.

Analysis of the relationships that exist between individual items presented in the financial statements and which appear as carriers of various information on the financial position and results of the company is the next activity of a forensic accountant on the way to a forensic review of financial statements. Thereby, the forensic accountant does not dwell only on the analysis of business indicators that are commonly used in assessing the financial performance of the company, i.e., performance indicators (productivity, profitability), security indicators (liquidity, solvency), activity indicators (turnover ratios), investment indicators, etc. are already used in a number of models, i.e., indicator systems, such as Altman's Z-score model, Kraličeк's model, Bex model, and similar synthetic models.

Although the previously outlined prognostic financial models of indicators are not primarily intended to prove/disprove the existence of fraud in the financial statements of companies, they already indicate the probability of bankruptcy in companies, that is a possibility, ability, and quality of business of analysed companies, prominent models have shown their useful value in forensic accounting because they can serve as a way of noticing the existence of pressure to commit fraud in societies. According to fraud triangle theory as a basic and still leading theory for understanding the motivational factors for committing fraud, pressure is the focus of every fraud (Dorminey et al., 2011). Forensic accountants through the process of fraud investigation answer a number of questions from the so-called. fraud chain: how, why / wherefore, how / where / when the fraud was committed. The answer to the most important question: who committed the fraud is usually found/confirmed at the end of the investigation, but answers to the questions: why / wherefore the fraud was committed can be provided by previously highlighted prognostic models of indicators, while for the purpose of answering the questions: how / where / when the fraud was committed in the financial statements, it is necessary to apply forensic models of indicators, specially created to indicate suspicious areas of financial reporting.

Therefore, the forensic accountant in the further steps of forensic analysis to assess the possible degree of manipulation, submits the financial statements to the application of the Beneish M-score model, i.e. the forensic synthetic indicator by Messod D. Beneish (1999), which was by analysing the quantitative relationships between individual positions in the financial statements of public companies that were by the U.S. Securities and Exchange Commission get labelled manipulated and unmanipulated financial statements calculated indicators that indicate statistically significant

differences between the values of indicators calculated on the basis of financial positions from manipulated and non-manipulated financial statements. The model includes 8 variables with defined limit values for each individual variable, as well as for a complete synthetic expression. In this way, the model can be interpreted at the level of the whole and at the level of individual indicators, i.e., to assess whether the complete financial statements have been manipulated or indicate only certain individual areas of the financial statements as potentially forged areas of financial reporting. Despite the many usability options of the model, the Beneish M-score model is limited to the application of unmanipulated financial statements as base statements, because otherwise, the model may result in false-negative results and potentially lead to incorrect conclusions.

In order to identify financial indicators that are statistically significantly different between manipulated and unmanipulated financial statements which will ultimately result in a model for calculating the probability of falsifying financial statements, in Lithuania in the period 1998-2009. a survey was conducted on a sample of 40 manipulated and 125 unmanipulated financial statements (Kanapickiene & Grundiene, 2015). The financial indicators tested in this study were divided into five groups: profitability indicators, liquidity, indebtedness, activities, and structural indicators. Out of a total of 52 financial relations tested within the listed groups of indicators, 4 indicators were identified with statistically significant differences between manipulated and unmanipulated financial statements, and as such included in the model. A special advantage of this model is reflected in the easiness of interpretation of results that are in the range of 0 - 100%, where a score above 50% is interpreted as a signal that the financial statements have been manipulated, and vice versa. Unfortunately, this model is still not sufficiently recognized or highlighted in the literature in the field of forensic accounting.

In addition to the previously presented models, it is important to mention that the results of earnings management models can be used as earlier signals of certain manipulations and frauds (Jones et al., 2006). According to Perols & Lougee (2011), these models have the capacity in the future to help further develop fraud detection models because it is more likely that fraud to be committed by those who have previously managed earnings. The authors' finding was recognized that aggregated discretionary accruals are possible earlier indicators of fraud since the probability of committing fraud increases significantly. For the above, aggregated discretionary accruals were

determined by using the Jones model (1991) and the modified Jones model with certain modifications tested by Kothari et al. (2005). Also, we believe that the Timeliness in loss recognition test (Ball & Shivakumar, 2005) is estimated for Bosnia and Herzegovina (Muratović-Dedić & Serdarević, 2017) may signal poorer quality of financial information, i.e. earnings management.

4. Forensic review of financial statements of the legal entity Tuš-Trade and discussion of research results

The company Tuš-Trade Ltd. Bihać has been operating in BiH since 2008, as a trading company, and in accordance with the provisions of the Law on Accounting and Auditing of the FBiH, it was classified as a large legal entity, and accordingly it was obliged to audit of financial statements. The company Tuš-Trade Ltd. stopped operate suddenly in 2014, by leaving extremely large unpaid liabilities toward suppliers, creditors, employees and government. The bankruptcy proceedings were initiated in Tuš-Trade in 2015 and closed in 2019 due to the insufficiency of the bankruptcy means (www.stecaj.ba).

For the purposes of this paper, a forensic review of the financial statements of the company Tuš-Trade was performed during its active operation period 2008-2013, applying the Altman Z-score model, the Beneish M-score model, the Fraud detection model in financial statements based on financial relationships, and also the Jones model, the modified Jones model and Timeliness in loss recognition test.

Altman based his primary research on observing manufacturing companies, whose shares are listed on the stock exchange, two basic limitations of applying the Z-score model were aroused: the impossibility of applying it to companies whose form of organization is not a joint stock company and the impossibility of applying it to non-manufacturing companies. Therefore, subsequently, Altman formulated two additional adapted models: the first for non-joint stock companies and the second for companies whose core business is not manufacturing (Altman, 2000). Since Tuš-Trade was a trading (non-manufacturing) company registered as a limited liability company, the adapted variant of the Z-score model for non-manufacturing companies was applied to the financial statements of Tuš-Trade company, and results are shown in Table 1.

Table 1: Results of the Adapted Altman Z-score model for Non-Manufacturers (Altman, 2000)

Indicators and formula	2008	2009	2010	2011	2012	2013
X1= Working capital / Total assets	0,83	-0,35	-0,41	-0,31	-0,51	-1,11
X2= Retained earnings / Total assets	0,83	0,30	0,17	0,00	0,00	0,00
X3= Earnings before interest and tax / Total assets	-0,02	-0,15	-0,21	-0,20	-0,27	-0,56
X4= Book value of equity / Total liabilities	4,85	0,18	0,00	0,00	0,00	0,00
Model = 6,56 X1 + 3,26 X2 + 6,72 X3 + 1,05 X4	13,12	-2,13	-3,57	-3,41	-5,16	-11,04

Source: Author's calculation based on Tuš-Trade Ltd. financial statements

For the adapted model Z for Non-Manufacturers, Altman defined a lower limit value of 2.6 in the range of expected values from -4 to +8, as a signal that the company will not experience bankruptcy in the future two-year period (Žager et al., 2008, p.272). In accordance with the defined limit values, the results of Altman's Z-score model showed a positive business prospect for Tuš-Trade only in the first year of operating, and significantly above the expected theoretical value of the model, which for a forensic accountant should be a red flag/marker for further forensic examinations. The results in the last two years of the research period show negative values that are outside the range of expected theoretical values, which is an indicator of serious financial problems that burden the business of Tuš-Trade. Ultimately, the results of Altman's Z-score model indicate that the observed company did not meet the basic assumption in terms going concern. For a forensic accountant, the results of the Altman model are indicators of business problems which can often put pressure on business results management.

The application of the Beneish M-score model (1999, pp. 27-29) to the financial statements of Tuš-Trade company resulted in the values shown in Table 2.

Table 2: Results of the Beneish M-Score model (1999)

Indicators and formula	09/08	10/09	11/10	12/11	13/12
DSRI - Days' Sales in Receivables Index	0,01	0,61	1,88	1,20	0,91
GMI - Gross Margin Index	5,47	0,94	1,04	1,03	1,17

AQI - Asset Quality Index	-34.924	21,24	3,78	1,64	1,55
SGI - Sales Growth Index	1.985	1,39	1,05	0,98	0,90
TATA - Total Accruals to Total Assets	-0,72	-0,05	0,07	-0,07	-0,16
DEPI - Depreciation Index	0,00	0,66	1,01	1,62	1,01
SGAI - Sales, General and Administrative Expenses Index	0,04	1,02	0,93	1,01	1,04
LVGI - Leverage Index	4,97	1,06	1,11	1,00	1,00
M = -4,84 + 0,92 DSRI + 0,528 GMI + 0,404 AQI + 0,892 SGI + 0,115 DEPI – 0,172 SGAI + 4,679 TATA – 0,327 LVGI	-12.345,62	5,36	-0,18	-2,30	-3,09

Source: Author's calculation based on Tuš-Trade Ltd. financial statements

Beneish defined the value -2.22 as the limit value with the interpretation that values greater than the limit value is a signal that the company was manipulating the financial statements, and vice versa. Results of the Beneish M-score model on the financial statements of Tuš-Trade indicate possible manipulation of financial statements in 2010 and 2011, with a simultaneous directing the attention to a significant deviation of the results from the limit value in the first year of research, ie. 2009, while the values of the model for the financial statements for 2012 and 2013 do not indicate manipulations, which generally corresponds to the theoretical framework in terms of the usability of the model in certain circumstances, i.e., the model requires true financial statements as a basis for detecting manipulated financial statements, while otherwise, the model results may be false-negative findings.

The application of the Fraud detection model in financial statements based on financial relationships (Kanapickiene & Grundiene, 2015, p.326) resulted in fraud probability values as shown in Table 3.

Table 3: Results of the Fraud detection model in financial statements based on financial relationships (Kanapickiene & Grundiene, 2015)

Indicators and formula	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Inventories / Total assets	0,05	0,22	0,31	0,38	0,45	0,57

Sales / Fixed assets	37227	4,54	7,92	10,44	15,33	29,81
Total liabilities / Total assets	0,17	0,85	0,95	1,28	1,62	2,47
Cash / Current liabilities	0,00	0,03	0,02	0,07	0,03	0,02
Probability of fraud $P = 1/ (1 + e^{5,768-4,263 \cdot \frac{INV}{TA}-0,029 \cdot \frac{SAL}{FA}-4,766 \cdot \frac{TL}{TA}-1,936 \cdot \frac{CACH}{CL}})$	1,00	0,36	0,59	0,91	0,99	1,00

Source: Author's calculation based on Tuš-Trade Ltd. financial statements

The fraud detection model based on financial relations applied to the financial statements of the company Tuš-Trade shows the probability of manipulating the financial statements in all observed years, except in 2009 when the probability of manipulating reports is below 50%. As can be seen from the results presented in Table 3, the applied model indicates a worryingly high probability of manipulating the financial statements in 2008, 2011, 2012, and 2013, which is approximately or equal to 100%. The selection of financial statement items included in the presented model determines inventories, sales revenue, fixed assets, and current liabilities of the company Tuš-Trade as risk areas for further forensic investigations.

The second direction of forensic review is focused on earnings management models application. Therefore, in order to of the Jones model (1991), the modified Jones model according to Kothari *et al.* (2005) and the Timeliness in loss recognition test estimated for Bosnia and Herzegovina (Ball & Shivakumar, 2005, Muratović-Dedić & Serdarević, 2017).

Table 4: Results of earnings management models

Year	**Aggregate discretionary accruals results from the Jones model**	**Aggregate discretionary accruals results from the modified Jones model**	**Results from the Timeliness in loss recognition test**
2008	-0,1221	-0,1202	-0,51648
2009	0,1293	0,1276	0,409719
2010	0,5627	0,5718	-1,1896
2011	-0,1957	-0,1949	-0,89395

2012	-0,4481	-0,4478	-1,22464
2013	-0,5093	-0,5088	0,018

Source: Author's calculation based on Tuš-Trade Ltd. financial statements

Therefore, the results of the aggregate discretionary accruals as well as the timeliness in loss recognition test show high variability especially in 2009, 2010, 2011 and 2012. The variability of these indicators reflects the overall activity of earnings management, poorer quality of information reported in the financial statements, i.e., another confirmation of the significantly increased probability of realized manipulation of financial statements.

Ultimately, the previously presented and elaborated results of the forensic review of the financial statements of the Tuš-Trade company are unique in indicating the long-term presence and markedly unfavourable business results of the observed company. In addition, the Beneish M-score model and the Fraud detection model based on financial relations, the financial statements of Tuš-Trade over several periods were evaluated as probably manipulative. However, the forensic accountant would be most concerned about the extremely high values of the Altman Z-score and Beneish M-score models in the first years of business which exceed the theoretical limits of the model, because the forensic accountant in his analysis is guided by sceptical thinking and general distrust of the correctness of the presented data, of course, without compromising its objectivity in the work. In the financial statements of 2008, the company Tuš-Trade stated liabilities in the amount of KM 2 mil, while liabilities in 2013 amounted to KM 38 mil. with a loss above the amount of capital of KM 22 mil. (Tuš-Trade Ltd. financial statements). This research has clearly shown that a forensic review of financial statements can indicate risky areas of financial reporting in companies many years before financial problems were recognized in public.

Although many countries recognize the need to introduce forensic accounting, as currently the best form of protection against manipulative financial reporting of companies that accounting theory recognizes and offers, the new Law on Accounting and Auditing of the Federation of Bosnia and Herzegovina (2021, art. 121) has not yet completed the accounting profession with the much-needed the forensic accountant title.

5. Conclusion

Financial statements as a structured presentation of the financial performance of a legal entity, provide information about the financial position, income statement, cash flow and changes in the equity of the legal entity, and other information that is useful to a wider range of users for business decision making. If the information presented in the financial statements is incomplete and/or incorrect, the image of the economic entity, which we gain by looking into them, will be wrong, as well as the business decisions made based on such financial statements.

For a long time, the eyes of the public have been focused on auditors, expecting that through the process of auditing financial statements they will reveal all errors and fraud in companies whose financial statements they audited, which is still just a utopia for those who do not know the role and task of auditing. Today, the world public expects a more effective fight against fraud from forensic accountants as a new professional accounting profession, and forensic accounting as a new accounting discipline considers the forensic review of financial statements as the first step in the algorithm of prevention or at least early detection of fraud in companies.

The purpose of this paper was to answer the question of whether the forensic review of financial statements can earlier indicate risky areas of financial reporting in the companies and reduce the losses that will follow the bankruptcy of the entities. The conducted research has shown that a forensic review of Tuš-Trade Ltd. financial statements could indicate risky areas of financial reporting many years before financial problems were recognized in public. But, readers of this paper must be aware of certain limitations of each used model in conducted forensic review, i.e., Altman Z-score model is not primarily intended to prove/disprove the existence of fraud in the financial statements of companies, Beneish M-score model is limited to the application of unmanipulated financial statements as base statements, Fraud detection model in financial statements based on financial relationships is limited for the detection of fraudulent financial reporting for trading companies. So that, it is important to mention that the presented forensic tools and earnings management models can be used only as indicators of potential manipulations in financial statements, but not as a basis for concluding that fraud has occurred in the entity. Those results are symptoms, not evidence of the fraud.

In the case of suspected fraud in the financial statements of entities, the investigation of fraud should be entrusted to people who have adequate knowledge to prove/disprove fraud. Unfortunately, in the Federation of Bosnia and Herzegovina's the training and certification

program for forensic accountants have not been implemented yet. So that, this paper can contribute to the practical work of external and internal auditors and other persons who audit, review, and analyse the financial statements of companies for different purposes. Finally, the authors' recommendation is that Law on Accounting and Auditing of the Federation of Bosnia and Herzegovina should be amended with a new professional title forensic accountant based on the generally accepted practice from the world.

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Sažetak

Veliki korporativni skandali u SAD-u i Evropi, s početka XXI stoljeća, poput Enrona, Parmalata, WorldComa i brojni drugi ozbiljno su uzdrmali povjerenje javnosti u rad i prezentirane rezultate rada revizora. Posljedično, mnoge države prepoznale su potrebu uvođenja forenzičnog računovodstva, kao naprednijeg i pouzdanijeg oblika zaštite od manipulativnog finansijskog izvještavanja privrednih društava, te su računovodstvenu profesiju upotpunile zvanjem forenzičnog računovođe, kao aktivnog borca protiv različitih vrsta prevara u privrednim društvima. Nažalost, novi Zakon o računovodstvu i reviziji Federacije Bosne i Hercegovine nije predvidio sticanje zvanja forenzičnog računovođe. Paralelno, svjedoci smo brojnih slučajeva privrednih skandala u Bosni i Hercegovini, a slučaj trgovačkog društva Tuš-Trade d.o.o. Bihać koje je 2014.godine naprasno prestalo poslovati, ostavljajući neizmirene milionske obaveze iza sebe, izazvao je veliku pažnju javnosti. Autori predmetnim radom žele odgovoriti na pitanje da li je forenzični pregled finansijskih izvještaja mogao ranije ukazati na rizična područja finansijskog izvještavanja u predmetnom društvu, te eventualno smanjiti gubitke koji su uslijedili stečajem istog.

Ključne riječi: finansijski izvještaji, prevare, forenzično računovodstvo, forenzični pregled.