



Continuous Fraud Assessment within the External Auditing

Branko Ljutić

Santa Fe Associates International Montenegro Audit

Zagreb School of Economics & Management;

branko.ljusic@montenegroaudit.com

Radovan Samardžić

Cattaro Audit, Kotor, Montenegro

Faculty for Mediterranean Business Studies, Tivat, Montenegro;

cattaroaudit@gmail.com

Abstract

This paper is dealing with the first pioneering steps to introduce continuous fraud risk assessment tools and techniques in the medium size audit clients in Montenegro. Based on the available experience and audit evidence data gathered in the period 2019 to 2021 statutory audits of medium size enterprise the clients were open and perceptive to adopt simple techniques of the continuous fraud assessment by applying the MS Excel templates. The beforementioned approach is improving the quality of internal control, lowering the levels of asset's misappropriation, improving the quality of financial and non-financial reporting, regulatory compliance and significantly preventing illegal acts within the enterprise.

Keywords: *Continuous auditing, Fraud, Risk Assessment, Montenegro*

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We have primarily oriented our research to narrowly focus on the methodological, International Auditing Standards approach as a start-up venture in this long-term strategic development new field. The paper conclusion based on the external audit experience of two independent audit firms in Montenegro, period 2019-2021 is in favor of continuous corporate fraud assessment and recommending using IT automated continuous fraud risk monitoring tools, while using the obvious benefits of simple automated tools, like risk based assessment approach.

1. Introduction

Continuous fraud risk assessment is a tool of the future while the standard – classical methods of fraud risk assessment as a management control tool to identify, understand, mitigate, and control the business internal control weaknesses. In the corporate internal control systems, incorporated in the financial reporting and internal auditing the detection and reporting are based on the regular internal reporting cycles, which in the extreme circumstances could be once a year, and even then, based on inertia as an operation of copy-cat the previous year testing of controls and creation of internal auditing working papers. Continuous fraud assessment is giving opportunity to change from the periodical updating to more frequent at the beginning than with a time a continuous embedding the fraud assessment in the internal processes and controls. Organization structure should be updated to reflect this “Copernican revolution“. It could be even argued that the business which do not implement standard classical procedures of fraud risk assessment could be able to introduce system of continuous monitoring. Continuous monitoring should focus on the following key aspects:

- Asset’s misappropriation;
- Financial and non-financial reporting (Integrated, ESG, Sustainability);
- Regulatory compliance;
- Illegal acts.

External auditing as a process is and objective analytical and evidenced review of the performance and activities of the reporting entity, independent of management. In the field of anti-fraud activities and assessments auditing (both external and internal) are performed with the objectige of

identifying weaknesses in the processes of internal controls of fraud and mapping the opportunities to improve. Continuous auditing is rather new methodology and technique as audit activity which is performed on a continuous base during the current operating and financial reporting cycle. Continuous auditing is going further from the annual audit plan and those selected point in time audit attestation, and it is a frequent almost continuous data mining, reviewing, analyzing of information based on the extensive use and application of information technology and recently even more on the artificial intelligence.

Main goal of this paper is to point out that the relatively new continuous auditing methodology as a very valuable audit tool in effective anti-fraud policy and performance, enabling the full application of the four main audit approaches with a focus on No. 4:

1. Substantive Audit Procedures;
2. Balance Sheet Analythics;
3. System Based Analythics;
4. Risk Based Audit.

2. Literature Review

External auditors in transition economies like of the European Western Balkans area (Albania, Serbia, Montenegro, Bosnia and Hercegovina, North Macedonia, Kosovo) as ex-socialist economies, governments and societies are in the phase of slow development and progress since the value of assurance services is not at the top of social values and the development of financial and regulatory institutions and the rule of law and democracy is in the early development phase. Corporate governance is concept in its infancy and the quality of management is in its initial stages of development, On the role of external auditing in fighting corruption more in Ljutić, 2005, and the new focus of auditing in testing for fraud internal control system and detecting the weaknesses in internal control (Ljutić, 2014). The foundation is the regulatory framework for financial reporting and auditing, with a focus fight against corporate fraud and organized financial crime, Thompson, 2022. Continuous audit in the function of prevention and detection of corporate frauds and financial crime has been extensively elaborated by Mantelaers (2022), while Ljutić (2022) has elaborated the

new and redefined role of accounting and audit profession in suppressing frauds and financial crime with a focus on new methodologies, standards, and practices of AICPA and IFAC. Valuable contribution has been made recently by Isaković-Kaplan (2022), on the new avenues and limitations of application of fraud detection models. She applied the quantitative finance analytical techniques to determine functional relationships of financial positions.

Management as the economic crisis after 2008 and with the COVID-19 pandemics started in 2020 and still extremely negative impact in 2022 on the economic climate and corporate performance is facing with the illiquidity, corporate stress, old and new risks. At the global level, the external statutory auditing shoulder to shoulder with the internal auditing is refocusing towards controlling the fraud risk. Board of directors are increasingly aware of the urgent need to continuously prevent and counter corporate fraud. Continuous fraud risk assessment is a new methodological approach giving organizations tool how to develop and implement preventive and detective fraud controls activities. The continuous fraud assessment is really what is says – new effective management control tool to assess the likelihood and significance of fraud which could emerge even if the effective controls are already in place. Our experience that most of the auditing clients, successful medium sized enterprises in Montenegro even do not have implemented the articulated classical anti-fraud policies and tools.

3. Dilemma to Introduce ex-post classical fraud controls and assessment or continuous fraud assessment?

This dilemma is false in its nature, since going the traditional way shall take time, waste resources and the effects would not be commensurate with invested. Our experience is teaching us that it is the best way to design and implement continuous anti-fraud system.

Steps external auditors at Santa Fe Associates International Montenegro are taking in assisting clients to introduce continuous fraud assessment and effective controls:

- Within the testing of the internal control system, we firstly try to establish if there is a written anti-fraud policy, how it has been implemented, methodology. Then we assess the materiality and risks of the effectiveness of the internal controls in general, while we have introduced the AICPA methodology and created auditing working paper to evaluate the

fraud. When determining the existing anti-fraud controls (preventive and detective) we observe that within the framework of all controls, while we almost analyze as of equal importance all other control and fraud controls.

- Step two is to assess the likelihood of future occurrence, which is turning us towards continuous fraud assessment.
- Based on the level of materiality and risk we are concluding on the significance of those risk to the performance of the organization, with a focus on the reflection on going concern risks.
- Since the level and quality of internal control systems in medium sized audited enterprises is in its infancy stage, we stimulate our clients to gradual introduce and to accept the rising importance for the performance.
- In our focus is to assist clients to increase continually the effectiveness of anti-fraud controls.
- In the final phases we stress the importance of fraud risk response in real time, with additional controls and corrective actions to be implemented on continuous day-to-day basis.

If the risk of fraud is increasing from incidental to significant even possibly catastrophic than the only choice is adoption of continuous risk assessment and anti-fraud policy and practice. Only this model is enabling to establish responsible person/s for implementing and monitoring anti-fraud control, without interruptions of periodical and infrequent reviews.

4. Using Automated Continuous Fraud Risk Monitoring Tools: Dreams or Utopia?

To manage or not to manage the risk of fraud is a false dilemma, because the business operations and life cycle are continuous in its nature. If the employee in on calendar year based on the accounting department information was on a business trip 457 days, more than in calendar year, less the holidays, weekends and his vacation, something deeply wrong in the system. If that is to be detected next year what is the real use and benefit of that. Regular check-up of the shell companies in money laundering and tax avoidance jurisdictions, outsourcing of the services firm has, invoicing of the never performed consultancy work. Vine and dine costs, double charging of the same flight

tickets, e.g., double approval of the same costs. With the simple software template even in MS Excel, the auditors could detect with a continuous monitoring to detect fraudulent vendors who are sending the invoices with different dates but really for the goods and services once delivered. It is important to detect ghost employees, connecting the payroll and human resources departments. Such continuous anti-fraud tests could be designed to catch the various fraud schemes. One of the useful financial analysis techniques is monitoring of financial ratios and of the key performance indicators (e.g., other relevant metrics) shall be of an immense help to continuous fraud risk monitoring. This is the only way to convert continuous monitoring on a regular basis to prevent and detect fraudulent actions, as a best anti-fraud risk management. Active real time system is detecting abnormal activities as they are happy, with the very first transactions, but some transaction regardless of the quality of the monitoring shall be always undetected. Real time monitoring is allowing organizations to focus on irregularities in each stage of the fraud cycle from the first breach, concealment, override of controls and how to improve them.

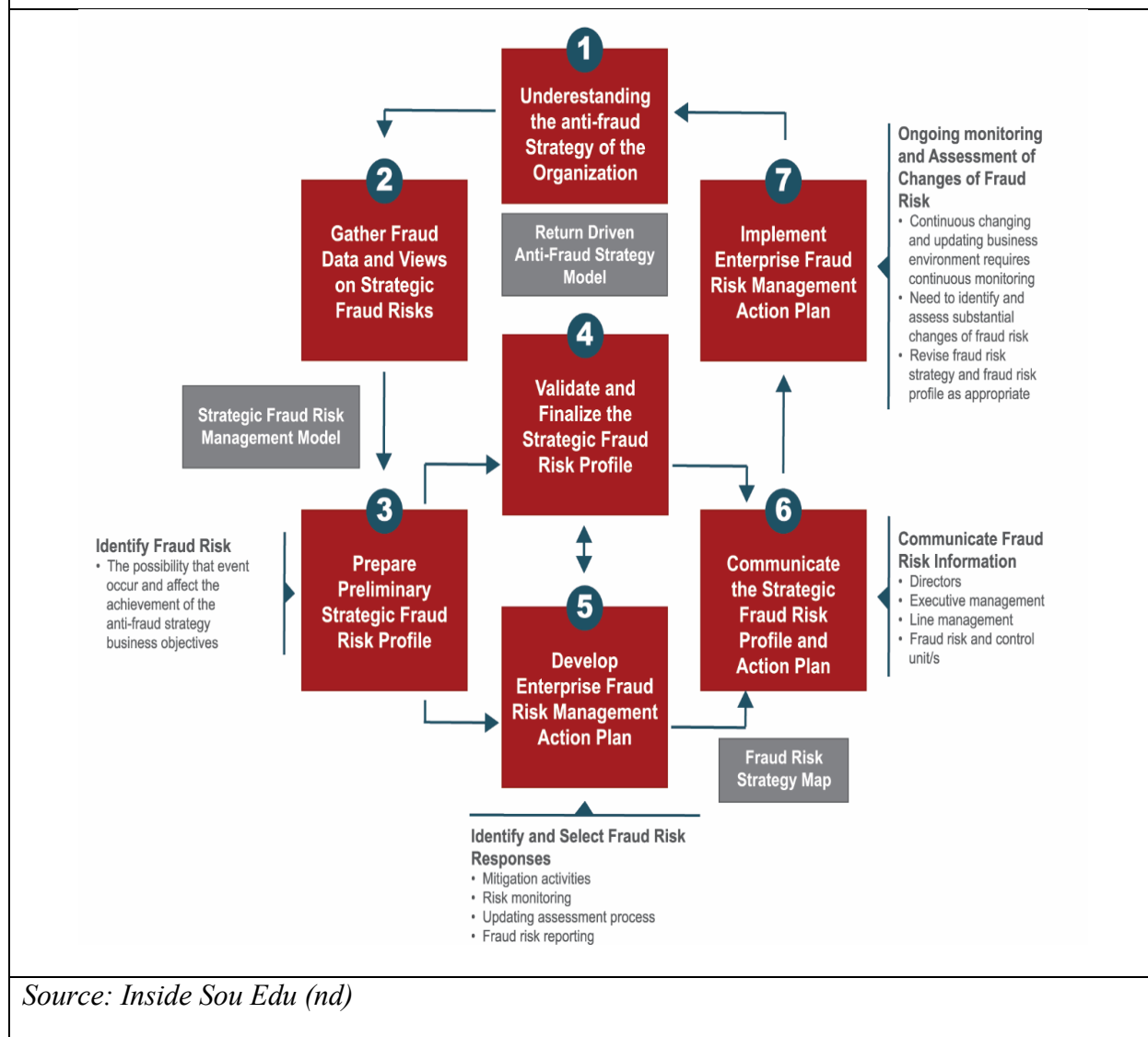
5. Benefits of Simple Automated Tools

Simple automated tools are saving the costs of administrative personnel, give access to big data analytics, data security, speed and efficiency, capability to connect those data with the other data in the firm information system. Preliminary information from our clients data-base for the audits in 2020 fiscal year are pointing out that the clients react positively on the very strong focus on detecting fraud and on the advises to implement some viable methods of continuous monitoring of the fraud risk, taking into account that those are medium sized firms, with management overloaded with work, tasks and responsibilities. All clients are using effectively MS Excel and ACTIVE Data for Excel, so they welcome such solutions and apply in practice. Our experience is pointing out to a conclusion that high quality financial management technique, internal auditing methods is particularly useful.

6. Risk Based Approach to Internal and External Auditing

Auditing (internal, external) and management is focused to achieve more with less, to have properly functioning boards, audit committee, happy stakeholders. The foundation is a robust risk assessment with incorporated continuous monitoring audit software. One of the key areas is to detect red flags for the follow up investigation. New IT technology, partly block-chain, but we should not be naive to think and expect that this technology is panacea for anything and everything, since block-chain is also having an ugly face, but it shall take time to grasp that fact, unknown at this moment to us. IT factor is a critical for organization to maintain a competitive edge. Risk management. Especially anti-fraud management controls are seeking for increasing resources to be invested. Fraudsters are always one step ahead of the controls, and new challenges in the detection and prevention are emerging like on a conveyer belt of the large coal mine. Fraudsters are always ingenious, creative, and managers are educated how implement controls, but also more than capable and having a capacity how to override it. By reducing time to detect fraud and making more efficient efforts to prevent it, consequently, is reducing the costs of fraud. On the Figure 1 are elaborated steps of the flow how to strategically assess the fraud risk in the audit client or a firm, with the last step of effectively communicating the fraud risk information and manage the fraud risk.

Table 1. Process of Continuous Strategic Assessment of the Fraud Risk



Source: Inside Sou Edu (nd)

External auditing responsibilities to act in cooperation with the internal audit, those charged with governance and top management to be an effective deterrence in detection and prevention of corporate fraud is increasing. In the process of corporate risk assessment of fraud there are two-pronged approach. First or identifying the risk and to rate the likelihood and impact of fraud risk event/s. It is highly necessary for external auditors to perform the assessment of internal control, following with the mapping of internal controls. This is a solid ground for the auditor to determine the eventual gaps between fraud risk and internal controls.

Fraud risk event could be defined as a potential fraud or missed opportunity that may impact the enterprise ability to achieve business goals. Regardless on the effectiveness of internal control there is always present inherent risk under the assumption that the management shall not take or not having a capacity to take any actions to alter or mitigate the risk's likelihood of occurrence, while the residual risk of fraud is the remaining after internal controls were in place and the management has taken preventive actions.

Table 2. Risk Control Matrix

| | | Consequence | | | | |
|--------------------------------|------------------------|-----------------|---------------|---------------|---------------|-------------------|
| | | Negligible 1 | Minor 2 | Moderate 3 | Major 4 | Catastrophic 5 |
| Likelihood | 5 Almost certain | Moderate 5 | High 10 | Extreme 15 | Extreme 20 | Extreme 25 |
| | 4 Likely | Moderate 4 | High 8 | High 12 | Extreme 16 | Extreme 20 |
| | 3 Possible | Low 3 | Moderate 6 | High 9 | High 12 | Extreme 15 |
| | 2 Unlikely | Low 2 | Moderate 4 | Moderate 6 | High 8 | High 10 |
| | 1 Rare | Low 1 | Low 2 | Low 3 | Moderate 4 | Moderate 5 |
| Source: Research Gate Net (nd) | | | | | | |

External auditors should have as a starting point diagnostic to attest the internal control of separation of duties, existence of the adequate governing bodies and policies, the elimination of

the existing or perceived the conflict of inters. Procurement procedures and competitive bidding are also high risky areas for the existence and development of fraud, as well as application of high ethical standards in practice.

Table 3. Fraud Risk Assessment Audit Working Paper Template

Fraud Risk Assessment

Continued

*Total Points Earned: 335/395 *Risk Level: Very Low Low Moderate High Very High
> 355 316-355 276-315 200-275 < 200

| | Yes | Pts |
|---|-----|-----|
| 1. Does the entity have adequate basic separation of duties or mitigating controls as outlined in the attached Basic Separation of Duties Questionnaire? | X | 200 |
| 2. Does the entity have governing body adopted written policies in the following areas: | | |
| a. Conflict of interest? | X | 5 |
| b. Procurement? | X | 5 |
| c. Ethical behavior? | X | 5 |
| d. Reporting fraud and abuse? | X | 5 |
| e. Travel? | X | 5 |
| f. Credit/Purchasing cards (where applicable)? | X | 5 |
| g. Personal use of entity assets? | X | 5 |
| h. IT and computer security? | X | 5 |
| i. Cash receipting and deposits? | X | 5 |
| 3. Does the entity have a licensed or certified (CPA, CGFM, CMA, CIA, CFE, CGAP, CPFO) expert as part of its management team? | X | 20 |
| a. Do any members of the management team have at least a bachelor's degree in accounting? | X | 10 |
| 4. Are employees and elected officials required to annually commit in writing to abide by a statement of ethical behavior? | | 20 |
| 5. Have all governing body members completed entity specific (District Board Member Training for local/special service districts & interlocal entities, Introductory Training for Municipal Officials for cities & towns, etc.) online training (training.auditor.utah.gov) within four years of term appointment/election date? | X | 20 |
| 6. Regardless of license or formal education, does at least one member of the management team receive at least 40 hours of formal training related to accounting, budgeting, or other financial areas each year? | X | 20 |
| 7. Does the entity have or promote a fraud hotline? | X | 20 |
| 8. Does the entity have a formal internal audit function? | | 20 |
| 9. Does the entity have a formal audit committee? | | 20 |

*Entity Name: Park City Municipal Corporation

*Completed for Fiscal Year Ending: 2021 *Completion Date: June 17, 2021

*CAO Name: Matt Dias *CFO Name: Mindy Finlinson

*CAO Signature: _____ *CFO Signature: _____

*Required

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Source: Utah Gov (nd)

The history of corporate reporting of fraud and error is the evidence of the integrity. Aspects of IT security, GDPR, handling of cash, level of qualification and records of achieved results of top management is also a particularly good sign, and proper and authoritative functioning of the supervisory board, audit committee and other executive and management board is equally important. In detecting and preventing corporate fraud are significant front lines of defense and deterrent force is fraud hotline, whistleblowing mechanism, developed internal audit function, and not only a formal presence but also a proper high-quality functioning of the audit committee.

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Sažetak

Ovaj rad je usmjeren da ukaže na prve pionirske korake ka uvođenju kontinuiranih revizorskih alata i tehnika za procenu rizika od prevara kod klijenata firmi srednje veličine u Crnoj Gori. Na osnovu raspoloživog iskustva i podataka iz revizorskih radnih papira i dokaza prikupljenih u periodu od 2019. do 2021. godine statutarne revizije preduzeća srednje veličine klijenti su bili otvoreni i perceptivni da usvoje jednostavne tehnike kontinuirane procene prevara uglavnom primenom MS Excel predložaka. Spomenuti pristup je unapređenje kvaliteta unutrašnje kontrole, snižavanje nivoa pronevere imovine, poboljšanje kvaliteta finansijskog i ne-finansijskog izveštavanja, regulatorno usaglašavanje i značajno sprečavanje nezakonitih radnji unutar preduzeća. Ovaj rad je prije svega orijentisan da se usko fokusira na metodološke aspekte, posebno na Međunarodne revizorske standardi pristupa kao početni poduhvat u ovom dugoročnom strateškom razvoju novog polja. Zaključak preliminarne istraživanja je zasnovan na eksternom revizorskom iskustvu dvije nezavisne revizorske firme u Crnoj Gori, period 2019-2021. godine. Kao takav ide u prilog kontinuiranoj procjeni korporativnih prevara, kao i korištenju IT automatizovanih alata za praćenje rizika od prevare, uz korištenje očiglednih prednosti jednostavnih automatizovanih alata, kao što je pristup procjene zasnovan na riziku.

Ključne riječi: kontinuirana revizija, pronevjera, procjena rizika, Crna Gora