Objective and Purpose of Financial Statement Audit and Forensic Audit

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Abstract: *Though International Standards on Auditing (ISAs), issued by International Auditing and Assurance Standards Board (IAASB), limit auditors without any categorical requirements on fraud detection in financial statements, users of financial statements believe that auditors are able to identify by performing audit procedures the risk of misstatement formed by fraud. Audit procedures are designed to detect only material misstatements and thus auditors might not be able to detect all fraud even if they apply reasonable procedures that react on arising of fraud. Nowadays, there are various techniques that could be used for fraud detection. One of the suggestions is forensic audit using specific procedures, methods and techniques. The main objective of this article is to summarize the detection of fraudulent activities and prevention from their happening by audit of financial statements as well as forensic audit.*

Keywords: audit of financial statements, forensic audit
JEL codes: M42

1 Introduction

As it might be well known, the primary objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (Kareš, 2010). The final opinion is concerned on providing reasonable assurance that a material misstatement of financial statements (regardless of the reason) has not been identified by auditor. First at all, it is important to consider what "misstatement", "material misstatement" and "reasonable assurance" mean.

2 Methodology and Data

The term "misstatement" is defined in International Standard on Auditing ISA 450 - Evaluation of Misstatements Identified During the Audit as a difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework (IAASB, 2014).

Generally, misstatements can arise from fraud or error where is a difference between the reported figures, and what is expected to be reported in order to financial statements be truly and fairly presented. Misstatements could be factual in case of requirements of a financial reporting framework and their breaching, or judgmental, arising from unsuitable estimation techniques or selection of inappropriate accounting policies. Misstatements are "material" if they are large enough to make a difference to a user of the financial statements. For users of information from financial statements is important to know whether financial statements do not contain the misstatements (Krišková, 2011).

Apart from the fundamental expression material misstatement which also means that auditor of financial statements has to identify the risks of material misstatement, there is also another important expression as "reasonable assurance".

Auditors declares they have taken the appropriate procedures in accordance with International Standards on Auditing ISAs and obtained the evidence in order to provide an assurance.

Auditors give reasonable assurance that material misstatements have been uncovered, but not total assurance. The level of materiality is determined in context of risk assessment and auditor´s professional judgment.

Audit of financial statements and fraud detection

Secondary objective of audit of financial statements refers to detection and prevention of frauds or errors. Auditors have some responsibility for the detection of errors and frauds that are material, but this responsibility is not absolute. For example, in case of false or incomplete evidence, auditors cannot consider the obtained evidence as absolute. For these reasons, there is a risk that the auditor during the audit will not identify and reveal all kind of irregularity.

This type of risk is in literature determined as detection risk and needs to be reduced on minimal level and accepted by auditors (often called minimal acceptable level of audit).

Auditors cannot influence from the range of risks the inherent risk as well as control risk. Part of those risks, there is usually also the potential risk of fraud.

Although it is understood that auditors might not be able to detect all fraud, the significant factors that make fraud detection difficult are following:

- Auditor´s knowledge of an entity and its environment may not always be 100 %. Requirements for a knowledge of an environment would also include the detailed technology because in addition to financial flows there are material flows, too. Only by confrontation of these two flows it can provide an accurate risk assessment (Kouřilová and Drábková, 2011),
- Audit of financial statements involve the testing, usually on sample basis, of the entirety of the financial statements. Auditors of financial statements select a sample and test the transactions in order to ensure that they were properly recorded in the entity´s accounting system. It means that all transactions are not tested because of inherent limitation in sampling,
- Auditor´s responsibility for fraud detection in the financial statements is still addressed in terms of materiality and reasonable assurance. Auditors are required to design audit test and provide reasonable assurance that fraud would be detected only if it was significant,
- As is stated also in International Standard on Auditing ISA 240 – The Auditor´s Responsibilities Relating to Fraud in an Audit of Financial Statements, the primary responsibility for implementing internal control system and detecting fraud has the entity´s management. It is in line with auditor´s objective: to conduct an audit in accordance with ISAs and obtain reasonable assurance that the financial statements are taken as a whole and they are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

Forensic audit and fraud detection

Fraud detection requires unique skill sets and the development of forensic techniques. For this reason, forensic audit is a better strategy in resolving the suspects of fraudulent activities as signs can be initially detected in a variety of ways – by accident, by auditors of financial statements, by internal audit, or by the organization´s management.

Forensic audit involves examination, techniques, regularity, investigation as well as audit of financial statements. The primary objective is to find out whether or not true business value has been reflected in financial statements and by examination to find whether any fraud has taken place.

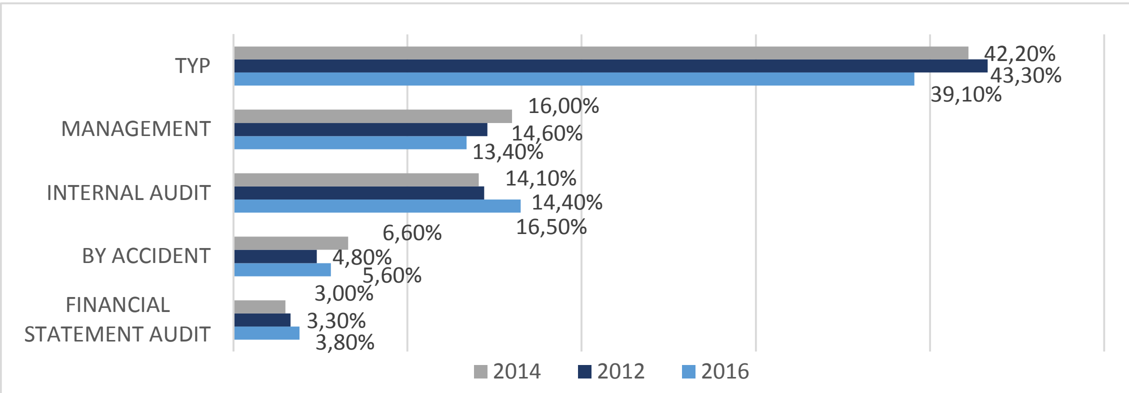
These are the following methods that are usually adopted for examination:

- Tests of reasonableness including checks of weaknesses in internal controls, identification of questionable transactions indicating wide fluctuations from the normal ones and not relating to main objectives and review of questionable transaction documents,
- Historical comparison including identification of questionable accounts and relationships between accounts, finding variances from current expectations and past relationships and gatherer evidence corroborating asset losses, fraudulent transactions, financial misstatements, too. Forensic auditors, of course should take in consideration also certain transactions not discussed in the financial statements, usually called off balance sheet items.

3 Results and Discussion

About the fact that audits of financial statements reveal a very small percentage of fraud even informs the Association of Certified Fraud Examiners ACFE. The survey confirms that most of fraud in Europe was discovered by other ways than statutory, see Figure 1.

Figure 1 Initial Detection of Occupational Frauds



Source: ACFE. 2016. Report to the nations.

The course of the audit of financial statements and its procedures can be divided into five phases which can be possible to assign a forensic audit procedures, see table 1.

Table 1 Distinction between Financial Statement Audit and Forensic Audit

<table>
<tr><th>Audit of Financial Statement</th><th>Forensic Audit</th></tr>
<tr><td>Audit procedures before accepting the engagement</td><td>Concluding the contract for forensic audit service</td></tr>
<tr><td>Audit procedures related to obtaining and understanding of the client´s business and industry</td><td rowspan="2">Preparation procedures:
1. Collection initial information
2. Setting objective
3. Setting scope of investigation
4. Development plan
5. Setting approach
6. Identification requirements</td></tr>
<tr><td>Audit procedures related to planning the audit</td></tr>
<tr><td rowspan="2">Audit procedures related to performing audit tests</td><td>Risk assessment and identification possible schemes of non-standard activities</td></tr>
<tr><td>Obtaining the relevant evidence and perform the analysis</td></tr>
<tr><td>Audit procedures related to reporting the finding</td><td>Preparation of findings and report</td></tr>
</table>

Source: Own processing

4 Conclusions

The article follows on the distinction between audit of financial statements and forensic audit. Though the International Standards on Auditing ISAs do not indicate that is possible to detect all financial statements fraud, users of financial statements often expect from auditors to detect financial statement fraud. The article illustrates also the methods of forensic audit for which forensic audit could be considered as more effective way for fraud detection as audit of financial statements. In summary, a forensic audit is a very specific type of engagement, including the approaches necessary for detection, prevention and control in order to incite of fraud.

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