Internal Audit and its Role in evaluating the Risk of Financial Statement Manipulation in the Area of Costs, based on a Case Study of a Chosen Accounting Unit

Zita Drábková, Zdenka Volkánová

Abstract: The basic purpose of accounting statements is to accurately and truthfully show reality. For most interested parties, accounting data is one of the essential sources of information about a company. Financial statements are also the fundamental source of information for managers and Corporate Governance for company management. The risk of deceptive account reporting or “improving” financial results has been confirmed by many instances of international research done by large auditing companies, and also relates to subjects based in the Czech Republic. The reasons for using dishonest techniques, creative accounting, and deceptive reporting could be many, for example the necessity of reaching specific figures and criteria for parent companies, creditors, and banks. Internal audits and internal control systems should detect creative accounting methods that are far from accurate and truthful, together with accounting fraud, and at the same time prevent companies from acting accordingly. This contribution analyses accounting unit cost which has been causing accounting loss and poor financial health of chosen trade corporations for a long time. At the same time it evaluates specific findings in the area of spending efficiency in connection with revenues. Furthermore, the contribution summarizes aspects of using creative accounting techniques in the area of costs, and the impact of changes in their management including impacts on the efficiency of internal audits and set accounting units control systems.

Key words: Risk of accounting statements manipulation · Internal control system · Internal audit

JEL Classification: G32 · M41 · M42

1 Introduction

An effective strategy against fraudulent actions must be based on company culture, an active approach to risk evaluation, and adequate response in case any specific suspicious activity occurs. Company culture must stress ethical and transparent approaches and these must be applied daily – otherwise all precautions and rules against fraud remain only empty suggestions that are not followed. Rules for preventing fraudulent activity should be part of internal regulations.

In particular it is essential to mention the acceptance and implementation of a company ethical codex that must also be appropriately communicated within the company, especially in the form of training and workshops. Besides stating general aims, these rules must also stipulate the company’s active approach and expectations from their employees in specific positions towards risk evaluation, prevention, and detection of suspicious activities. Specific actions and precautions should be implemented in all decisive business processes. These specific precautions can for example be the screening of new employees and new business partners, monitoring for possible conflicts of interests among employees in charge or the leadership and business partners, internal audits of risky areas, basic analysis of accounting data and documentation, and the search for any irregularities and suspicious circumstances.

According to the Association of Certified Fraud Examiners data, internal audit contributed to uncovering 43.3% of accounting fraud in 2012, 42.2% in 2014, and 39.1% in 2014. The share of Financial Statement Fraud was 9.6% from all types, including property misappropriation (ACFE, 2016).

According to other available statistics most fraud is uncovered as a result of a notification or report from someone. It is essential to facilitate these reports as much as possible, especially by establishing a permanently accessible telephone line (it is recommended to be provided externally) to make it as easy as possible for the person reporting the activity.

Parties and companies commit fraud with the aim of getting finance, possession or service, to avoid paying for specific services or their loss, and for personal or business benefits. An organization’s activities are influenced by basic

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regulations such as laws, government regulations, public notices, etc. as well as internal regulations such as establishment documents, orders, methodical instructions, handbooks, and other standards that are implemented in order to perform the main organization activity as smoothly as possible.

This easy-to-use handbook clearly explains how to develop an effective system of accounting and operational controls and offers the best practices with pragmatic insights and proactive strategies to protect organizations from suffering further substantial losses of assets and reputation that occur from financial dishonesty within an organization (Bragg, 2009).

The guide describes the various types of controls in all core business functions and outlines several frameworks for designing and implementing those controls. Case studies are used to illustrate and offer further guidance on applying these controls (Kyriazoglou, 2012).

2 Methods

This contribution focuses on risks of accounting statements in the area of significant disruption of true and fair appearance. On the basis of detecting a high risk of the disruption of accurate and honest representation of accounting statements by mistake or deliberate fraud, the contribution aims to analyse the relationships among accounting information in 11 accounting periods in a case study of a specific accounting unit where continued future activity was threatened as a result. The chosen accounting unit was tested during 11 accounting periods by a chosen model for detecting manipulation of CFEBT accounting statements.

The selected entity was operated in a construction sector and had a fluctuating operating results and the poor financial health of the reporting period in years 1 to 4. At the same time the selected unit was significantly threatened it’s further operation at the end of year 7. The entity didn’t carry out an internal or an external audit in the period of years 1 to 7. Based on previous research into the possibility of detection of manipulated financial statements, the CFEBT model was designed and based on the hypothesis of a relation between a loss and an increase in cash flow in the period of five years i.e. whether the sum of their value in five years with minor variations lead to a similar result.

The CFEBT model is defined as follows:

$$CFEBT = \frac{\sum_{t=1}^{5} CF_t - \sum_{t=1}^{5} EBT_t}{\sum_{t=1}^{5} EBT_t} \times 100$$  \hspace{1cm} (1)

Where:
- $\Delta CF$ .... Increase of cash flow in period $t$
- $EBT$ .... Earnings before taxes in period $t$

Considered materiality is between 5-10%.

If CFEBT materiality, there is probably a high risk of breaching a true and fair view of the accounts. In this situation we recommend testing significant relationships among accounting statements with a detailed test in the modified versions of the CFEBT model (Drábková, 2013).

The following is a relationship analysis of significant accounting items among statements of the chosen accounting unit which was part of the solution to the assigned task related to its stated profits and aimed at detecting the causes of an undesirable state of accounting unit financial health and repeatedly stated accounting losses. Analysis of the chosen accounting unit’s statements was done for 11 accounting periods based on cost analysis, calculations were done using the proportion calculation method. Another step was evaluating the impact in the accounting unit internal control system including evaluating risks of accounting fraud and creative accountancy beyond true and fair view of accountancy after implementing specific approaches leading to the improvement of the internal control system efficiency during years eight and nine. The effect of the implemented processes and regulations as a result of detected risks in the area of costs integrated into the accounting unit’s control mechanisms is subsequently followed by aspects of impacts in the change to the company’s financial health.

3 Research results

The chosen accounting unit is based in the building industry and in the accounting periods for years one to eight achieved fluctuating management results before taxation with prevailing accounting losses, for more detail see Figure 7 for years one to eight. The accounting unit was solving significant financial problems in the end of year eight including negative consequences in managerial calculations control, profitability with subsequent negative consequences on business corporation competitiveness.
The accounting unit was evaluated as high risk as it did not perform any internal audit processes and in accounting periods one to nine accounting statements were not subject to evaluation by an external auditor. In all observed accounting periods the accounting unit was observed as being in compliance with Czech accounting regulations (CAS).

3.1 CFEBT model for detecting risks of accounting faults and fraud

Accounting statements were tested by the CFEBT score and achieved a result of 98% in accounting periods one to seven. This value is significantly above the considered materiality level.

The following step was a detailed analysis of significant relationships between cash flows change and EBT. Using the modified model, there were significant irregularities detected in accruals and inefficient cost management with the recommendation for detailed cost and profit analysis including implementing cost management approaches.

Based on the analysis of significant accounting relationships among balance sheet, statement of profit and loss, and cash flow development in accounting periods one to seven, the main risk in disruption of the matching principle between costs and profits was detected. Within the CAS conditions the costs without direct matching to factually and timely distinguished profits in compliance with time cost differentiation were shown.

Based on detailed cost analysis the accounting unit showed a breach of CAS in the area of reporting costs when company costs included those unrelated to the company economic activity.

Subsequently, the efficiency analysis of the usage of construction machines which the company included in fixed assets was made.

3.2 Detailed analysis of risky areas

The analysis done detected a risk of accounting statement manipulation beyond true and fair CAS view with aspects of accounting fraud within the observed period of years one to seven.

As a consequence another analysis was performed for individual years of the accounting period and the following areas in five years, or rather periods one to seven, were evaluated:

- Matching principle in accountancy: output consumption and realized actions were compared, see Figure 1:

**Figure 1** Outputs and output consumption in years 3 to 7 (in thous. CZK)

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Sales</th>
<th>Production consumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>29 561</td>
<td>27 530</td>
</tr>
<tr>
<td>4</td>
<td>19 847</td>
<td>17 743</td>
</tr>
<tr>
<td>5</td>
<td>29 661</td>
<td>25 389</td>
</tr>
<tr>
<td>6</td>
<td>38 376</td>
<td>33 375</td>
</tr>
<tr>
<td>7</td>
<td>61 173</td>
<td>52 833</td>
</tr>
</tbody>
</table>

Source: Own processing

As we can see in Figure 1 for years three to seven, year’s three to four show a decline in output and output consumption. The curves for output and output consumption in this period are almost identical. In this period the company was not sufficiently controlled either from the point of view of financial management, nor the point of view of control mechanisms.

Periods five to seven showed specific improvement of the situation, which was caused above all by securing long-term contracts in the building industry.

- Subsequently the development and costs structure were observed. See Figure 2 and Figure 3.
3.3 Evaluations and impacts on the internal control system

In years 10 and 11 outputs and output consumption declined in comparison with the difference in the development of stated realized outputs and output consumption in years 8 to 11 when long-term building contracts were terminated, see Figure 4 and Figure 5.

In year nine the company implemented management for regular observation and planning costs, including controls of individual centres exploitation in terms of responsibility, into the internal control system. The company was using effective tools for financial cost management on cost centres, monthly reports, evaluations of plans, and real exploitation of including evaluating effectiveness of costs spent.

Figure 4 Outputs and output consumption in years 8 to 11 (in thous. CZK)

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Sales</th>
<th>Production consumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>63 693</td>
<td>54 404</td>
</tr>
<tr>
<td>9</td>
<td>82 470</td>
<td>66 191</td>
</tr>
<tr>
<td>10</td>
<td>83 830</td>
<td>67 920</td>
</tr>
<tr>
<td>11</td>
<td>55 422</td>
<td>37 290</td>
</tr>
</tbody>
</table>
Years six and seven were influenced by the first wave of economic crisis in the building industry and Figure 6 shows an obvious stagnation of both outputs and output consumption. Cost items management was positively evaluated in this period as was represented by the decline in outputs and equally in output consumption. Information and data are based on, among other things, company statutory statements valid until December 31, 2015 where line 11 represents added value. It is possible to say that output consumption prevails added value by variable and indirect costs. Items services also include fixed costs, which are mainly rent paid and repairs paid for building machinery, but while elaborating on costs there was no evidence these were significant items in terms of size. In year 10 long-term contracts were terminated and no compensation in the form of new contracts was made.

Figure 7 shows a fluctuating EBT in the reporting periods between 9-11 years in which there has been a significant increase in profits due to implementation of control mechanisms.
3.4 Proportional indicators of financial analysis in years 1 to 11

Table 1 below proved that, within periods 1 to 11, in the beginning the company showed very poor profitability results. The improvement is visible in year 9 or 10, where this improvement corresponds with the initial settings of control mechanisms and financial management.

Table 1 Profitability in years 1 to 11

<table>
<thead>
<tr>
<th>Profitability in percent (%)</th>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROE (15%) (16.97% in year 7)</td>
<td>EAT/VK</td>
<td>-10</td>
<td>113</td>
<td>-918</td>
<td>239</td>
<td>5</td>
<td>-48</td>
<td>-35</td>
<td>-10</td>
<td>112</td>
<td>22</td>
<td>42</td>
</tr>
<tr>
<td>ROE (with the usage of EBIT)</td>
<td>EBIT/VK</td>
<td>x</td>
<td>x</td>
<td>-918</td>
<td>234</td>
<td>-15</td>
<td>-81</td>
<td>-72</td>
<td>-81</td>
<td>147</td>
<td>33</td>
<td>43</td>
</tr>
<tr>
<td>ROA (9%) (7.92% in year 7)</td>
<td>EBIT/Assets</td>
<td>-1</td>
<td>-45</td>
<td>12</td>
<td>-74</td>
<td>2</td>
<td>6</td>
<td>1</td>
<td>1</td>
<td>14</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>ROS</td>
<td>EBIT/Turnover</td>
<td>x</td>
<td>-</td>
<td>0.043</td>
<td>-0.15</td>
<td>0.007</td>
<td>0.020</td>
<td>0.012</td>
<td>0.007</td>
<td>0.081</td>
<td>0.032</td>
<td>0.108</td>
</tr>
</tbody>
</table>

Source: Own processing

where:

- EBIT – profit before interests and taxation
- EAT – profit after taxation
- VK – own capital

Table 2 presents selected fluctuating ratios of costs and revenue in the reporting period. Development of revenues and expenses was negatively affected by the stagnation in the construction market in the period of 6-7 and due to the termination of long-term supply contracts in the years 10-11. However, evidently there is stabilized costs and revenues since the introduction of control mechanisms in years 9 and 10.
Table 2 Expenses in years 1 to 11

<table>
<thead>
<tr>
<th>Expensiveness</th>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ratio of costs and profits</td>
<td>Expenses/Revenue in percent (%)</td>
<td>xxx</td>
<td>127</td>
<td>95</td>
<td>103</td>
<td>96</td>
<td>96</td>
<td>94</td>
<td>94</td>
<td>88</td>
<td>90</td>
<td>79</td>
</tr>
<tr>
<td>Operating costs / Outputs (%)</td>
<td></td>
<td>xxx</td>
<td>xxx</td>
<td>93</td>
<td>89</td>
<td>86</td>
<td>xxx</td>
<td>89</td>
<td>108</td>
<td>86</td>
<td>87</td>
<td>87</td>
</tr>
<tr>
<td>Material &amp; energy/ Outputs (%)</td>
<td></td>
<td>xxx</td>
<td>124</td>
<td>93</td>
<td>39</td>
<td>29</td>
<td>15</td>
<td>16</td>
<td>15</td>
<td>16</td>
<td>29</td>
<td>41</td>
</tr>
<tr>
<td>Personal costs / Outputs (%)</td>
<td></td>
<td>xxx</td>
<td>2</td>
<td>2</td>
<td>13</td>
<td>11</td>
<td>9</td>
<td>8</td>
<td>8</td>
<td>7</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td>Depreciation / Turnover (%)</td>
<td></td>
<td>xxx</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>4</td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>7</td>
<td>9</td>
<td></td>
</tr>
<tr>
<td>Interest/ Turnover (%)</td>
<td></td>
<td>xxx</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Added value margin (%)</td>
<td></td>
<td>xxx</td>
<td>-24</td>
<td>7</td>
<td>11</td>
<td>18</td>
<td>13</td>
<td>14</td>
<td>15</td>
<td>20</td>
<td>20</td>
<td>34</td>
</tr>
</tbody>
</table>

Source: Own processing

4 Conclusions

In conclusion it can be said that breaching CAS leads companies to many incorrect decisions in terms of decisive tasks which company management must deal with. Based on the usage of financial analysis mechanisms, irregularities in stating real accounting company data can be clearly detected. Negatives are that if we are looking for irregularities that are indicated by values of financial analysis indicators, it is also necessary to gain more detailed information both from accountancy such as analysis of some cost accounts to the level of receipts, and the company management. If the evaluator works with publicly accessible statutory statements only, the analysis cannot be done properly. Furthermore, publicly accessible statements with annexes do not always show relevant information.

The CFEBT model is considered to be a basic comprehensive view of the financial statements and the links between them. The model traces the development of the statements and links them to more accounting periods (optimally in five years) and analyses the links between cash flow and profit. Modified CFEBT score presents a detailed test which may become an effective part of the anti-fraud programme of internal controlling systems. The awareness of the risks of financial statements improves the efficiency of corporate internal controlling systems and lowers the information asymmetry between the owners and Corporate Governance.

- In our opinion, user accounts can reduce uncertainty about submitted financial statements on if complete analysis of financial statements was processed for several years.
- The CFEBT model is considered to be a basic comprehensive view of the financial statements and the links between them. The modified version of the CFEBT model respects the individuality of the accounts of a sample entity and substantially eliminates the diversity of national accounting systems such as the Czech accounting standards, IFRS and US GAAP.
- We believe that the suggested CFEBT model may be used by auditors to identify risks of accounting fraud of in accordance with ISA 240 and as part of anti-fraud program into the internal control systems or by any user accounts for testing financial statements. So, we can recommend to manage risk of financial statements for any accounting units (especially managers Corporate Governance and owners) and not to rely only on the results of the ratios, bankruptcy and credibility models which often provide users with conflicting results.

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