
Determinants of Audit and Forensic Economic Examination in the System of Financial Control of Local Budgets

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Abstract. *Strengthening the fight against economic crimes and fraud in local budget institutions requires improvement of financial control. The article is devoted to the issue of ways and content of introduction of audit and forensic economic examination tools into the internal control system. The research method chosen was an empirical assessment of the state and prospects for improving the control system through a questionnaire. The structure of the questionnaire included grouping of questions into four sections. Questions of informational nature are included in the first section, characteristics of internal control and audit are included in the second section of the questionnaire. The third section contained the issues of contact with external control and audit institutions, and the fourth section assessed the potential capabilities and intentions to use internal and external audit tools and forensic economic expertise. The quality of the survey was ensured by its preliminary pilot testing. The selection of respondents from local government institutions in the five oblasts ensured representation in the survey. Technically, the questionnaire was distributed through open official work emails of representatives of institutions using Google form, which ensured open distribution and anonymity of responses. The paper analyses the results of the responses, which showed the state of the internal control system and the directions of its development. The study provides a comparative assessment of the state of the internal control system and the availability of internal audit services in local self-government institutions. The publication considers the results of questionnaires on the state of interaction between local self-government institutions and external auditors in terms of audits of annual financial statements and consulting. It also identifies the extent of the need to supplement the internal control system with external audit tools. The author identifies differences in assessments of the needs for interaction with external auditors and forensic experts, and substantiates the directions for improving the internal control system of local budget institutions. It was also suggested that the effectiveness of control in preventing, detecting and combating fraud should be strengthened based on foreign experience of cooperation with external auditors and forensic experts.*

Keywords: *local budget, internal control system, fraud, audit, forensic economic examination.*

JEL Classification: *M40, M41, M42*

1 Introduction

Information about the misuse of local budget funds by local budget institutions, as required by the needs of wartime, has intensified the discussion on the implementation of various strategies to control the use of local budget funds. The rhetoric of previous years regarding the strong pressure of controlling bodies on local self-government, which is in the process of decentralisation, and recommendations to reduce external pressure from state financial control bodies, did not provide conditions for the actual prompt implementation of internal control and audit at the local level.

Whatever the precise cost of mismanagement and economic crime with local finances, building internal control and audit capacity alongside a more active fight against fraud can be an effective solution. However, in a period of austerity, it is difficult for local budgets to increase spending on any area of activity, even if these needs are caused by the need to organise a reliable line of defence against theft of funds. The organisation of an internal audit service will necessarily require adequate funding, which is not easy to implement in a time of wartime economy. However, the foreign experience of implementing anti-fraud tools has

already demonstrated the "payback" of the costs of both external audit services for auditing the annual financial statements of local budget institutions and the costs of maintaining internal audit services, which, in turn, complement the internal control system of local budget spending units (Hegazy S., Sangster A. & Kotb A., 2017, p. 47).

The success of the local government decentralisation reform lies in the introduction of quality governance based on the principles of responsibility and accountability (Tytykalo R. S., 2023, p. 114). Thus, the growing threat of fraud, including in the context of the active introduction of digital technologies, requires close attention to the study and implementation of internal and external audit tools. Delays in adopting the new version of the Law of Ukraine "On the Accounting Chamber", which grants this state audit body the authority to conduct external audits of the efficiency and legality of the use of local budget funds, weaken the ability of the financial control system to respond promptly to the needs of combating economic crimes and fraud at the level of local authorities and hromadas. Despite the successful implementation of the decentralisation reform, launched on the eve of Russia's military invasion of Ukraine, a strategic mistake in the architecture of its implementation was the partial loss of control and consistency in terms of audits of the use of local budgets.

Today, there is no developed strategy that would provide options for organising a systematic approach to building control over local finances at all stages of their movement, from budgeting to reporting and development strategies. None of the options for using the experience of internal audit introduced in public authorities is given due attention in regulatory and administrative documents.

Furthermore, their development should be based on the positive experience of foreign countries in the fight against fraud. Simultaneously, this practice should be perceived at the level of local government management as a desirable goal in the struggle to implement the principle of responsibility and achieve success in the fight against fraud. Based on the results of a questionnaire survey of managers and specialists of local budget spending units, this article explores the possibilities of introducing a system of internal control and internal audit in accordance with international standards as a means of counteracting theft of funds and property.

The purpose of this study is to determine, on the basis of a survey of local government officials and specialists, their needs for tools to strengthen control and their readiness to implement these tools

to combat fraud and strengthen control over the use of local finance.

The paper is structured in the following logical sequence: it identifies the problems faced by local governments and their requests for tools to combat economic crime and fraud, describes the empirical research method for the survey, and then presents the results of the survey. The article closes with conclusions and results of solving the existing problem of controllability of local finances.

2 Novelty of the Problem and Analysis of Recent Research and Publications

Numerous reports by the Security Service of Ukraine on the exposure of schemes to embezzle money from the local budget, on the exposure of city council officials for misappropriation of budget funds allocated for major repairs of municipal facilities or for the purchase of materials are increasingly becoming newsworthy reasons for discussions about the high corruption component of the use of local budget funds.

In support of these conclusions, there are materials published in the media by the Bureau of Economic Security of Ukraine (BES), which, together with the State Audit Service, analysing public procurement procedures for the supply of goods and services at the expense of local budgets, establish violations of the procedure for their conduct, including through the unjustified use of a non-competitive procurement procedure, unlawful selection of winners with the least favourable conditions, and others. *"In May, the BES staff prevented the embezzlement and theft of local budget funds worth almost UAH 50 million. Unjustified use of budget funds in time of war is unacceptable," – said Vadym Melnyk, Director of the BES (Biuro ekonomichnoi bezpeky Ukrainy).*

The Office of the President of Ukraine receives petitions demanding that budget funds be banned from being spent on non-critical and unnecessary expenditures during the war and that such funds be directed to the needs of the army. These petitions receive a significant number of votes in support. Journalists also conduct a number of investigations into the theft of local budget funds, exposing illegal and dishonest procurement, and the making of misuse and illegal payments under fictitious transactions. Indeed, fraud in local government procurement is a major corruption risk (Klymko T. Yu., Melnyk O. O., 2015).

Fraud and corruption are costly to local authorities, taking many forms and occurring in a wide range of local government operations. CIPFA, the professional association responsible for training and accrediting the majority of internal

auditors in the US, as well as providing a range of tools and services to local authorities, conducts an annual fraud survey. One 2018 survey identified four main areas of fraud (by volume) affecting local authorities: local taxes, housing taxes, procurement, and business rates (CIPFA, 2018). It has been estimated that procurement fraud costs local authorities approximately 876 million GBP per year, making it the largest area of financial loss due to fraud in local government.

Another important factor that increases the number and size of fraudulent attacks on local authorities is digital technologies, which are being actively implemented today through the Diia app and other electronic services. Many types of cybercrime are relatively easy to commit in the context of low IT literacy of users, but for a number of reasons, they are difficult to combat (May T. & Bhardwa B., 2018).

The strategy of counteracting fraud of local authorities provides for internal and external control measures, which are mentioned by domestic and foreign authors (Stetsiuk O. Ya., Chubai V. M., 2023; Levi M. & Burrows J., 2008). The authors emphasise the importance of using external and internal audit tools that can provide a reliable system for monitoring deviations in the formation and use of local budgets. Although there may be practical challenges, anti-fraud strategies for local governments can help prevent, detect, investigate and recover fraud. This is the focus of auditors' actions in accordance with International Standard on Auditing 240, Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements (CIPFA Counter Fraud Centre, 2020).

In addition, foreign literature describes the positive practice of involving forensic accountants in detecting fraud (Huber D. & DiGabriele J. A., 2014). Thus, defending the position that it is necessary to create a sustainable system of internal control to prevent fraud in local authorities, this study considers ways to strengthen internal control by involving the tools of external audit and forensic economic expertise in the process of preventing embezzlement.

This issue is new to the scientific field of research in Ukraine due to the lack of experience and regulatory framework. However, it has become an urgent task to study the possibility of implementing and perceiving effective tools for preventing fraud and economic crime in local authorities.

To solve these problems, a questionnaire with questions on the system of financial control of local budget institutions was developed on the basis of empirical research methods. The questions were identified on the basis of scientific sources and practical information and grouped into four sections. The first section included questions of an informational nature, such as the name of the institution, the respondent's position, and the estimated amount of funding and number of employees. The second section contained questions on the characteristics of internal control and audit, and the third section on the external control and audit system with which the local institutions have contacted and cooperated. The fourth set of questions contained an assessment of potential opportunities and intentions to use internal and external audit tools and forensic economic expertise.

It should be noted that the author of the article conducted a preliminary testing of the questionnaire among scientists as part of educational activities in the course of advanced training of accountants and auditors of public authorities. The responses received showed that there was no need to make any significant changes to the questionnaire. At the same time, some adjustments were made to make the questionnaire easier to fill out and to improve understanding of the questions.

The survey was sent to the official work e-mails of the respondents, which are publicly available on the electronic resources of the official website of the Cabinet of Ministers of Ukraine.

3 Presentation of the Main Research Material

The questionnaires were sent to the heads, financial specialists, accountants, and lawyers of local budget spending units in five regions of Ukraine. The sample composition and responses are presented in Table 1.

Table 1 Survey of local budget spending units

Respondents (managers of local budgets)	Number of questionnaires, pcs.		Percentage of responses received, %.
	Sent	Received	
Zhytomyr Oblast	98	38	38,8
Kyiv Oblast	166	72	43,4
Kirovohrad Oblast	105	40	38,1
Rivne Oblast	84	18	21,4
Cherkasy Oblast	122	43	35,2
Total	575	211	36,7

Source: compiled by the author based on the results of personal survey

The responses from respondents depending on the type of local government institution were generally comparable, so there is no detailed description of them. As expected, responses were most often received from heads of institutions (65.8% of responses). Other answers were provided by heads of finance departments, lawyers and internal auditors. The latter category indicated the direct presence of internal audit services in local institutions, which was confirmed by the results of the questionnaire.

The survey was conducted on the basis of anonymity, which was ensured by the technical means of sending the questionnaire - via Google form. It required the mandatory indication of the respondent's position and oblast, as well as the type of local self-government institution from the list provided. The anonymity offered to the respondents was aimed at encouraging them to answer frankly to prevent social bias in their responses, as they related to fraud control and economic crime prevention. The overall response rate was 36.7 %, but by oblasts there is a range of responses from 21.4 % (Rivne Oblast) to 43.4 % in Kyiv Oblast (Table 1).

While a higher response rate would have been desirable, the level of questionnaires received reflects the general trend in the survey area, which can be considered a satisfactory result for a survey of this type. Nevertheless, it should be borne in mind that only one third of the respondents assessed the prospects for the development of control and audit, which is a minority of all those who were sent the questionnaires.

The use of internal and external control and audit tools and the prospects for their development were presented in the questionnaires, as shown in Table 2.

The indicators shown in Table 2 reflect the existence of an internal control system at the majority of surveyed local budget institutions (99.0%). The quality and modernity of such a system is reflected in one of its components – risk management, which involves the identification, assessment and application of control measures in response to identified risks to mitigate them. Therefore, it can be argued that only half of local budget institutions (49.2%) have a risk management element that ensures the implementation of the principles of responsibility and accountability through the implementation of control measures by all authorised persons in accordance with their job descriptions.

The low percentage of internal audit departments (12.8%) can be explained by the fact that most respondents are mostly small-sized village, town and city local governments and hromadas. Therefore, the existence of an internal audit position or unit may not be provided for in the staffing structure of these institutions. At the same time, the rate of integration of this service into the activities of the institution (35.1%) indicates the interest and need to strengthen internal control by the internal audit function in one third of the institutions.

Indicators that record the existence of external audit (control) both on a voluntary basis and through scheduled inspections by the State Audit Service of Ukraine (SASU) are rather low for the array of responses received.

Only 1.4% of institutions cooperate with external audit firms to confirm the reliability of their annual financial statements, and 4.3% engage them to provide consultations. This situation is explained by limited funding for external auditors. However, the need for professional audit services is evident

Table 2 Status and prospects of improving the control system in local budget institutions (based on the survey)

Element of the control and audit system	Available elements		Prospects for implementation or further operation	
	quantity	% in total	quantity	% in total
1. Internal control and internal audit				
Internal control system	209	99,0	210	99,5
including risk management	104	49,2	125	59,2
Internal audit	27	12,8	74	35,1
2. External audit, assessment, expertise				
External audit on a voluntary basis, under agreements with audit firms:				
- audit of annual financial statements	3	1,4	69	32,7
- consulting	9	4,3	148	70,1
External audits of the SASU (number for the last three years)	45	21,3	51	24,2
Cooperation with forensic experts	0	0	0	0

Source: own research by the author

in the responses to the question about the need for such consultations. Thus, the indicators show that 70.1% of institutions would like to receive advice from auditors, and one third of local budget institutions consider it appropriate to confirm annual financial statements with audit reports.

The activities of forensic economic experts in Ukraine are not related to the functioning of the financial control system. Nevertheless, forensic accountants in foreign countries, having the tools to detect fraud, can provide the necessary services to local authorities to detect and prevent fraud and other economic crimes.

There is a practice of involving forensic accountants in strategic or preventive investigations on a permanent or contractual basis. The aim is both to detect fraud and to involve forensic accountants in the prosecution of fraudsters. Some of these services would probably be appropriate for use in the practice of responding to fraud risks and in the activities of spending units of local budgets in Ukraine. The possibility of such involvement lies both in the availability of private forensic economic experts in Ukraine and the possibility of financing their services. The results of the survey show that there is no such practice in Ukraine.

4 Conclusions

Despite the rather low level of use of internal and external control elements in local budget institutions, information was received on a relatively high level of readiness to strengthen control both through the organisation of internal audit and the involvement of external auditors and the tools of forensic experts in terms of detecting and preventing fraud.

A study on forensic accounting providers revealed an increase in demand for the services of

these specialists due to the need to respond to high fraud risks.

The anti-fraud strategy, among other components, involves the use of effective elements of the internal control system available at the internal management level, including the risk management element. It should be used to assess the risks of fraud and take responsibility for responding through control measures to reduce these risks in local budget institutions.

The iteration of decentralisation of local governance introduced not only effective means of influencing the activities of institutions, but also provided for the introduction of control functions and mechanisms for their implementation. A vital element of any effective anti-fraud strategy is an institution's ability to engage competent, professionally accredited fraud specialists trained to the highest professional standards to investigate suspected fraud. Such experts can be either auditors of independent audit firms or forensic economic experts.

Many local government practitioners reported in their responses to the questionnaire that they are ready to implement control measures to combat economic crimes and fraud in the formation and use of local budgets. The possibility of increased control is likely to be reduced as a result of cuts to local government funding associated with wartime austerity.

In such circumstances, it is worthwhile to actively implement internal control and audit tools that do not require additional resources. However, as a strategic objective, engaging the potential of external sources of audit and forensic expertise can fill the gap in the financial control system by providing both additional capacity and specialised skills.

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