



# FEATURES OF IMPLEMENTATION OF FUNCTIONS OF THE SUBJECT OF PRIMARY FINANCIAL MONITORING BY THE AUDITOR DURING REALIZATION OF PROFESSIONAL ACTIVITY

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**Д** *Basing on systematization and generalization of existent normative statements of domestic and international regulation of realization of the financial monitoring by auditors (auditing firms), the article substantiates methodical approaches in relation to detection risk assessment and improvement of the mechanism of selection of effective auditing procedures for such type of risk assessment during realization of auditing verification for the purpose of observance by the entity of legislation in the field of prevention and counteraction of legalization (laundering) of profits, which have been got in a criminal way.*

**К** *Financial monitoring, legalization (laundering) of criminal profits, predicate crime, fraud, risk, risk assessment, risk assessment criteria.*

## ОСОБЛИВОСТІ ВИКОНАННЯ ФУНКЦІЙ СУБ'ЄКТА ПЕРВИННОГО ФІНАНСОВОГО МОНІТОРИНГУ АУДИТОРОМ ПРИ ЗДІЙСНЕННІ ПРОФЕСІЙНОЇ ДІЯЛЬНОСТІ

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**Д** *На основі систематизації та узагальнення чинних нормативних положень вітчизняного і міжнародного регламентування здійснення фінансового моніторингу аудитором (аудиторськими фірмами) у статті обґрунтовані методичні підходи щодо оцінки ризику невиявлення та вдосконалення механізму відбору дієвих аудиторських процедур для оцінки такого ризику при здійсненні аудиторської перевірки на предмет дотримання суб'єктом господарювання законодавства у сфері запобігання та протидії легалізації (відмиванню) доходів, отриманих злочинним шляхом.*

**К** *Фінансовий моніторинг, легалізація (відмивання) злочинних доходів, предикатний злочин, шахрайство, ризик, оцінка ризику, критерії оцінки ризику.*

## ОСОБЕННОСТИ ВЫПОЛНЕНИЯ ФУНКЦИЙ СУБЪЕКТА ПЕРВИЧНОГО ФИНАНСОВОГО МОНИТОРИНГА АУДИТОРОМ ПРИ ОСУЩЕСТВЛЕНИИ ПРОФЕССИОНАЛЬНОЙ ДЕЯТЕЛЬНОСТИ

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**Д** *Основываясь на систематизации и обобщении существующих нормативных положений отечественной и международной регламентации осуществления финансового мониторинга аудитором (аудиторскими фирмами), в статье обоснованы методические подходы к оценке риска не выявления и совершенствования механизма отбора действенных аудиторских процедур для оценки такого риска при осуществлении аудиторской проверки на предмет соблюдения хозяйствующим субъектом законодательства в сфере предотвращения и противодействия легализации (отмыванию) доходов, полученных преступным путем.*

**К** *Финансовый мониторинг, легализация (отмывание) преступных доходов, предикатное преступление, мошенничество, риск, оценка риска, критерии оценки риска.*

### Statement of the problem

Effective and safe functioning of the financial system of Ukraine is unthinkable without adequate institutional mechanisms and measures of restriction of legalization (laundering) of profits, which have been got in a criminal way. The effective mechanism of restriction of the above-mentioned phenomenon, and illegal entrepreneurship in general, is implementation of the totality of measures of organization of the financial monitoring at the level of subjects of primary financial monitoring (SPFM), among which one can distinguish auditors (auditing

firms). Reporting to the State Financial Monitoring and appropriate law enforcement agencies on financial operations of their clients, in relation to which there are grounds to suspect, that they are involved in legalization (laundering) of profits, which have been got in a criminal way, or intended for financing of terrorism, is one of the duties of auditors (auditing firms) as SPFM [11]. The exposure of such operations by the auditor (auditing firm) is possible during realization of auditing verification, which planning and organization is accomplished by SPFM on the basis of risk-oriented approach, which

provides the choice of the most optimal methods of detection risk assessment and its further analysis. At the same time, the detection risk assessment in the process of rendering audit services was not disclosed in full measure in scientific literature and the effective mechanism of its realization was not formed as well, that determined the relevance of the research.

Analysis of recent researches and publications. The range of problems of assessment of audit risk on theoretical and practical levels was presented in works of Garnaga E.V., Zahorodnii A.G., Kravchenko Ju.P., Mamyshev A.V., Rozdobudko V., Petrenko S.M., Proskurina N.M., Chumakova I.Yu. and others.

Despite the significant contribution of indicated authors to the investigated problem, previously formulated conclusions and suggestions regarding to the methodology of detection risk assessment during the realization of audit verification by the auditor as SPFM remains disclosed not in a full measure. Also the application of risk-oriented approach during planning and realization of audit on the subject of identifying operations of client, that provide his involvement in the process of legalization (laundering) of criminal profits, requires wider usage in practice of professional activity of auditors (auditing firms). Therefore, substantiation of methodical approaches to detection risk assessment and improvement of selection mechanism of effective audit procedures for such risk assessment during realization of audit verification are especially actual in contemporary conditions of functioning of the financial system of Ukraine.

The goal of the article is to improve methodical receptions of planning and realization of audit verification basing on determination and improvement of selection mechanism of effective audit procedures for the detection risk assessment during realization of professional activity by the auditor - subject of primary financial monitoring (SPFM).

Presentation of basic material. The process of management risks of money laundering and financing of terrorism embraces all types of services, which is given by auditors (by auditing firms), and also all groups of clients and their operations. At the same time, audit services that are given by auditors (by auditing firms) allow to find themselves in a rather advantageous position regarding the possibility of exposure of suspicious activity. Such state of auditors is caused by the access to the documents of clients and to the management processes, and also by close business relationships with guidance and owners. Auditors must constantly be prepared (to treat with professional skepticism) to situations and

events which give cause for suspecting of money laundering or financing of terrorism, using their work experience and assessments for forming of suspicions, if it is necessary. Professional skepticism must become the main feature during implementation of such an activity.

In order to evaluate doubtfulness of client's operations (that prove his activity) for the purpose of the risk of legalization (laundering) of profits, the auditor (auditing firm) must subdivide operations into the groups, taking into consideration the type of audit services, that are enshrined by the articles 8 and 16 of the Law of Ukraine "On prevention and counteraction to legalization (laundering) of profits which have been got in a criminal way, financing of terrorism and financing of distribution of massive weapon" № 1702-VI [2].

At the same time, the auditor (auditing firm) evaluates the risk of operation's relation to money laundering with the aim of acceptance of one of possible solutions:

- it is all right, without suspicions;
- the operation requires more detailed studying;
- the operation is a subject to the obligatory monitoring, the information is being passed to the State Financial Monitoring;
- the operation is not a subject to the obligatory monitoring, but there are reasonable suspicions, information is being passed to the State Financial Monitoring.

The level of risk of every separate operation can be determined, basing on the sum of operation, types of financial instruments (for example, operations with cash, bearer securities, bank metals), complication of operation, presence of operation's economic sense, that is those risk criteria, that are used by the auditor (auditing firm). At the same time, in order to make decision about whether an operation is suspicious or not, auditors may need an additional information about the client or his activity. Additional information should be obtained within the framework of implementation of duties to the client, and can help in determining the status of specific operation for the purpose of its doubtfulness.

Therefore, a special interest in the sphere of realization of the financial monitoring by auditors (auditing firms) presents the risk assessment of presence of the client's operations with the third persons, that prove the legalization (laundering) of profits, and their exposure during realization of audit verification.

Such operations, as a rule, belong to the "illegal profits" or "dirty" money category. Legalization of criminal profits ("dirty" money) is a difficult

process, that includes the enormous amount of operations, which is accomplished by the different methods and its constant improvement.

According to the Criminal code of Ukraine the legalization (laundering) of profits, which have been got in a criminal way, is attributed to the crimes in the sphere of economic activity. According to the part 1 of the article 209 of the Criminal code of Ukraine (CCU) [6] legalization (laundering) of profits, which have been got in a criminal way, is “commission of financial operation or operation with money or other property, which have been got as a result of commission of socially dangerous illegal act that was preceded to legalization (laundering) of profits, and also commission of actions directed on the concealment or disguise of illegal provenience of such money or other property or its possession by them, rights on such money or property, sources of their provenience, location, movement, and also acquisition, possession or usage of money or other property, got as a result of commission of socially dangerous illegal act, that preceded legalization (laundering) of profits”.

Currently, there are a few models of laundering of criminal profits. Most common include two-phase, three-phase and four-phase models.

According to the two-phase model the main stages of laundering of criminal profits are: money laundering and recycling. Three-phase model is most common, which is characterized by such stages of “laundering” of criminal profits as placement, stratification and integration [12].

Four-phase model to structuring of the process of laundering of criminal profits is used by the experts of the UNO. Following stages are defined according to this model:

I. Release from cash and transferring it to the accounts of dummies.

II. Distribution of available money with the help of buying up of bank payment documents and other securities.

III. Disguise of tracks of committed crime.

IV. Integration of monetary base [1].

The marked models of legalization (laundering) of criminal profits do not take into account the relationship with predicate crime, which dictates method and mechanism of laundering of criminal profits.

Under Convention of Council of Europe on laundering, search, arrest and confiscation of profits, which have been got in a criminal way, and about financing of terrorism of the May 16, 2005 [5], predicate crime is any crime that caused the appearance of profits, that can become the subject

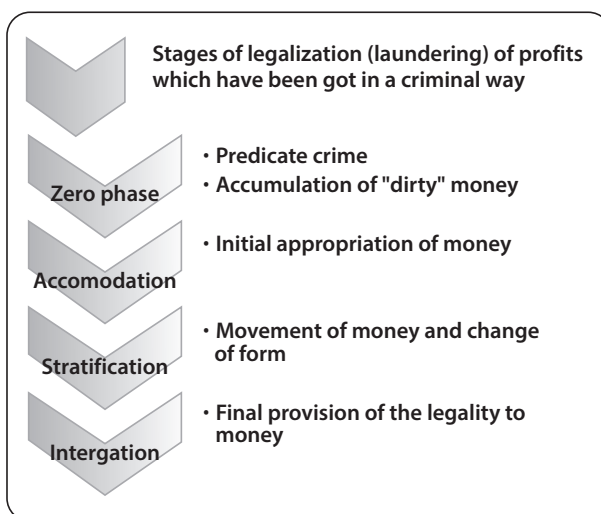
of the crime in accordance with the article 9 of this Convention (fig. 1).

#### Crimes associated with money laundering

- transformation or transfer of property, with understanding of that fact, that such property is a profit, with the aim of concealing or disguising of illegal origin of property or with the aim of assistance to any person who is participating in the commission of predicate crime, in avoidance of law consequences of actions of this person;
- concealing or disguising of the real character, source, location, condition, relocation, rights in reference to the property or its ownership, with understanding that fact, that this property is a profit, and with taking into account its constitutional principles and basic principles of its legal system;
- acquisition of property, its ownership or usage, with understanding during its receiving of that fact, that this property is a profit;
- participation in commission, consolidation or plot in order to commit, to make an attempt to commit, to aid, to instigate, to promote and to provide advices concerning committing any of the crimes established in accordance with this article

Fig. 1. SIGNS OF CRIMES ASSOCIATED WITH MONEY LAUNDERING

Mentioned above shows that predicate crime is the first cause of process of legalization (laundering) of criminal profits. Therefore, the model of legalization of criminal profits should be expanded by the presence of so-called “zero” phase (Fig. 2).



Picture 2. STAGES OF LEGALIZATION OF PROFITS, WHICH HAVE BEEN GOT IN A CRIMINAL WAY

Moving profits across the border using offshore banks and companies is the salient feature of their legalization in many states. According to researches of FATF, in the machinations related to the offshore centers one can observe the following general characteristics: realization through the center of multi-step financial transactions; usage of the appointed persons or mediators for managing these transactions; creation of international network of the “inflated” companies as a “mailbox”

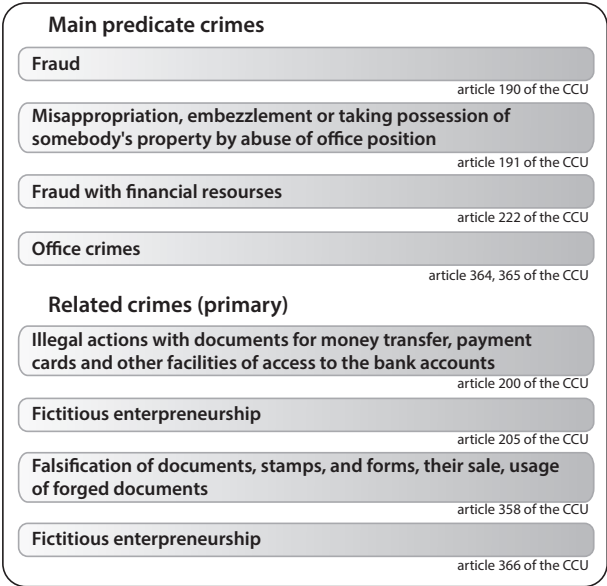
(including their specialized variety of “companies from a shelf”, which immediately mount from the stage after the completion of transactions).

Also, within the framework of researches of FATF [4] five main types of operations with the usage of international transmission, used for legalization (laundering) of criminal profits, were identified. Among them one can name: illegal arbitrage foreign currency operations; transfer of illegal money in other countries with laying out of total amount on a few parts which do not exceed the established threshold; “pesos-brokers” (illegal currency offsets); imitation of attracting of international credits and usage of illegal facilities for financing of legal companies; physical movement of the monetary resources, which have been got in a criminal way.

Besides that, it should be emphasized, that countries with an investment attractive economies suffer from the influx of “dirty” money. At the same time, the problem of countries of Eastern Europe (including Ukraine) is the “contamination” of money, id est there is a crossflow of capital between legal and illegal (shadow) economy. For the Ukrainian enterprises the main way to get “dirty” money is to avoid tax payment. Two directions are distinguished. The first one is related to criminal activity or usage of illegal methods of hiding profits. The second one is legal. It is so-called “optimization of taxation”.

Realization of legalization (laundering) of criminal profits is accompanied by the illegal actions of entities, which are classified by the CCU as predicate crimes. From totality of predicate crimes one can distinguish main and concomitant, and concomitant crimes come forward as a form, method or necessary condition for commission of main predicate crimes (Fig. 3).

At the same time, in providing audit services in order to identify suspicious (doubtful) operations, the auditor should not use norms of the CCU. One must use International standards of audit [9], according to which specified predicate crimes are classified as a fraud - the intentional action of one



Picture 3. PREDICATE CRIMES ACCORDING TO THE CRIMINAL CODE OF UKRAINE

or few persons from the managerial staff, provided with the highest authority, workers or third persons, which is related to the usage of deception in order to obtain excessive or illegal advantage (п.11, ISA 240). In explanatory materials to ISA 240 (D1) it is mentioned, that fraud (untruthful financial reporting or bagging of assets) includes motive or pressure concerning commission of fraud, realized possibility of its commission and certain logic of substantiation of such action. A similar statement was included also in the American statements on auditing standards (“Statement on Auditing Standards No. 99, or SAS 99), adopted in 2002 by the American Institute of certified public accountants (AICPA). In accordance with these statements, fraud is defined as intentional action that causes significant distortion/misstatements of financial reporting.

If one compares signs of crime of legalization (predicate crime, according to the CCU) with signs of fraud (according to ISA) (tab. 1), then we can avouch that during rendering of audit services the auditor must use norms of ISA, which are set to

COMPARISON OF SIGNS OF CRIME OF LEGALIZATION AND FRAUD

Table 1

№	SIGNS OF CRIME OF LEGALIZATION ACCORDING TO THE CRIMINAL CODE OF UKRAINE	SIGNS OF FRAUD ACCORDING TO THE INTERNATIONAL STANDARDS OF AUDIT
1	Commission of financial operation or operation with money or other property	An action for receiving excessive or illegal advantage (illegal bagging of assets)
2	Commission of a socially dangerous illegal act that preceded the legalization (laundering) of profits	The usage of deception for obtaining excessive or illegal advantage
3	Awareness that money or other property was obtained in the result of commission of a socially dangerous illegal acts	An intentional action with the usage of deception (realized possibility of committing of action)
4	Intention	Intentional action



detect fraud for the exposure of crime of legalization of criminal profits. This will allow him to detect the crime of legalizing of criminal profits.

Thus, the auditor should check client's economic operations and financial arrangements, taking into account his possible participation in the process of legalization (laundering) of criminal profits, in other words in implementation of the fraud.

According to the theory of fighting against fraud, taking into account the signs of its origin, one usually distinguishes three terms, under which its manifestations may experience: motive/pressure, inclination/justification, favorable situation [18]

Thus, the auditor should take into account that the exposure of operation from the receipt and legalization of criminal profits can be complicated as the result of their hiding in client's documentation owing to his putting into practice of:

- manipulation, falsifications or changes in registration records or documentation, on the basis of which the financial reporting is formed;
- twisting or intentional admission of events, operations or other important information in the financial reporting;
- intentional misapplication of registration principles, relating to amount, classification, method of presentation or disclosure of information.

At the same time, the auditor should consider that receiving of criminal profits ("dirty" money) is possible during clients' realization of different methods of falsifications (Fig. 4).



**Fig. 4. MAIN METHODS OF FALSIFICATIONS IN ORDER TO RECEIVE CRIMINAL PROFITS**

In order to detect such methods of hiding of operations of receiving and legalization of criminal profits the auditor can use examples of circumstances that indicate the possibility of fraud, which are marked in Addition 3 of ISA 240.

The auditor (auditing firm) is not expected to conduct verifications of every separate operation of their clients. For the purpose of doing that, the auditor should define the optimal volume of information for the research, in order to undertake professional responsibility. Thus, it should be remembered that according to ISA 330 "The auditor's responses to assessed risks" (ISA 330) the auditor's choice of audit procedures is based on assessment of auditor's detection risk. According to the theme of the research, a detection risk is a probability of that fact, that audit procedures of confirmation will not give an opportunity to detect financial operations of legalization (laundering) of criminal profits that exist in the documents of the client, given for audit verification. The higher is the assessment of risk by the auditor, the more reliable and more appropriate should be the auditor's proofs, which are wanted by the auditor from procedures essentially. However, increasing of volume of audit procedures is appropriate only then, when audit procedures are appropriate for particular risk. The examples of possible audit procedures for consideration of assessed risks as a result of fraud are presented in Addition 2 of ISA 240.

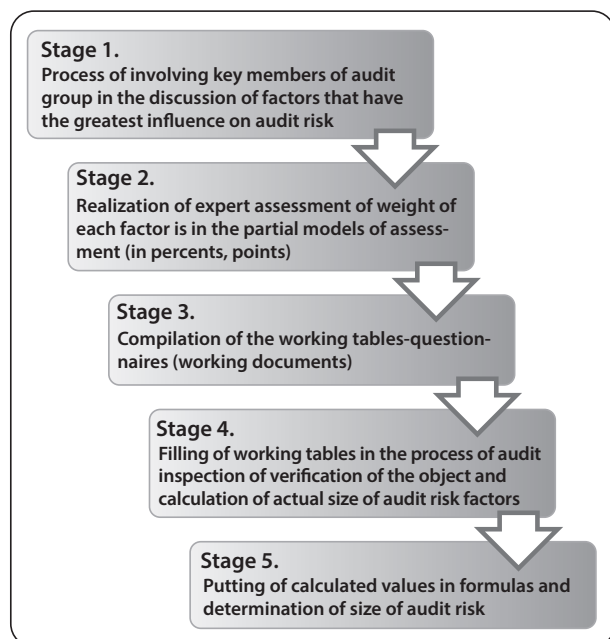
In order to determine the detection risk of client's operations for the purpose of legalization of criminal profits the auditor can use the risk criteria (indexes, signs, characteristics or their totality, which are used to make risk assessment), ratified under the order of the State Financial Monitoring of Ukraine of August 03, 2010 № 126 [10]. This document approved risk assessment criteria, classified by appropriate signs, in particular by the type of client, geographical location of the country of registration of the client or the institution, through which he carries out the transfer (receipt) of assets, and type of goods and services. According to Recommendations of FATF [13, 14, 8] risk criteria are also divided according to the certain types of clients, countries or geographical territories, certain goods, services, operations or channels of supply.

In addition, an important instrument of identification of suspicious operations for auditors as SPFM can be certain criteria (typology) of frauds and crimes on laundering of "dirty" money, grouped by Mamyshev A.V. according to the standards of audit of AICPA [7]. At the same time, the auditor should take into account risk factors of the fraud

the examples of which are presented in Addition 1 to ISA 240.

The above-mentioned information testifies that meaningfulness of legalization risks is widely varied. That is why, it is necessary for the auditor (auditing firm) to work out own list of risk criteria of legalization of criminal profits, using all recommendations of national and international regulation of the financial monitoring. Basing on the developed risk criteria and applying the professional judgment the auditor determines the existence of risk criteria of legalization of criminal profits and the need of its consideration for the risk assessments in every particular situation.

Considering everything mentioned above, in order to determine the volume and the types of audit procedures for the detection of client's operations in relation to legalization of criminal profits, the auditor can make the assessment of detection risk which is based on risk oriented approach according to the following stages (Fig. 5) (according to main statements of the publication [15]).



**Fig. 5. PROCESS OF ASSESSMENT OF DETECTION RISK OF OPERATIONS OF LEGALIZATION OF CRIMINAL PROFITS**

Such model is useful during planning of audit procedures. During the risk assessment, the auditor can find control measures that, probably, will prevent or detect and correct significant distortions in specific statements. In other word, in general the detection risk assessment of operations of legalization of criminal profits has an impact on the volume of auditor's work in relation to counteraction and detection of such operations.

At the last stage of rendering of audit services, the auditor should inform managerial staff and supervisory authorities of the client about detected cases of fraud. This requirement of ISA in relation to the detected cases of fraud contravenes with the requirements of legislation in relation to reporting on operations of legalization of criminal profits. Having assessed the risks of legalization of criminal profits and having detected doubtful (suspicious) operations, the auditor should make decision in relation to the reporting on such operations to the State Financial Monitoring and in no circumstances to inform managerial staff of the client about this. Therefore, the auditor should remember that although operations of legalization of criminal profits correspond the signs of the fraud for the aims of rendering of audit services, but they have the special character in terms of addressness of information about them.

At the same time, according to Recommendations of FATF for accountants [16] the auditor should take into account following factors during the process of decision-making about reporting:

- whether there are cases of legalization of money or financing of terrorism in client's activity, which is analyzed by the auditor in a particular country;
- whether information was obtained under conditions, when auditors had to keep a professional secret or had a professional legal immunity;
- in case of absence in the particular country of requirements to reporting on suspicious operations, whether it possible to report on suspicions, and whether it corresponds with professional and ethic duties of auditors, taking into account interests of the society during realization of their professional activity.

The last two points are regulated by several legislative acts in Ukraine. The law "On auditor activity" [3], testifies about the duty of the auditor to keep in secret from extraneous persons information about the activity of client, which has been got as a result of rendering of audit services. The article 6 of the Law № 1702 - VI obliges the auditor to report on suspicious (doubtful) operations to the State Financial Monitoring, except the cases of presentation of client's interests in a court. At first glance, this is a paradox. However, according to ISA 240 (p. 43 and D 65-66) the auditor should define priority between legal responsibility and duty of saving of confidentiality of information. Besides, the auditor should take into account that fact, that the report on suspicious operations or activity is especially important for the possibility of the country to use financial

information for counteraction to money laundering, financing of terrorism and dealing with other financial crimes. In Ukraine, legal responsibility in questions of legalization of criminal profits prevails over the duty to follow confidentiality.

At the same time, Recommendations of FATF contain a requirement in relation to protection of auditors (employees of auditing firms) by legislative acts from criminal and civil responsibility for violation of any restriction on disclosure of information, that is certified by the agreement or the legislative, normative or administrative act, if they honestly report on their suspicions, even in those cases, when it is unknown to them, where criminal activity is, and regardless of whether criminal activity took place in reality. Such legislative and normative acts, that protect auditors (employees of auditing firms), have not been accepted to introduction in Ukraine at this time.

**Conclusions.** Audit detection risk assessment is based on determination of the level of risk of involvement of client's operations in the process of legalization (laundering) of criminal profits, where

predicate crimes have a special place (according to the CCU). Predicate crimes are classified as a fraud according to ISA, which norms the auditor should use during the implementation of functions of the subject of the primary financial monitoring. Planning and realization of audit verification should be based on detection risk assessment of operations that certify participating of the client in legalization (laundering) of criminal profits. The auditor should assess such risk by applying his professional judgment, that is based on the auditor's experience, developed risk criteria, applied information of national normative acts, Recommendations of FATF, ISA, AICPA and etc. In case of detection of operations of legalization (laundering) of criminal profits, the auditor determines priority between legal responsibility and duty of saving confidentiality of information, and basing on the taken decision should report the State Financial Monitoring on such suspicious (doubtful) client's operations. At the same time, the auditor should remember that in Ukraine legal responsibility prevails over the duty to follow confidentiality.

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