

# DETECTION OF FINANCIAL FRAUDS – A CHALLENGE FOR ACCOUNTING PROFESSION<sup>1</sup>

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## **Abstract:**

*Quality of business decision-making largely depends on the quality of information presented in financial statements. Despite the fact that the requirements of stakeholders are focused on reliable and efficient financial reporting with the aim to reduce the informational risks, a numerous examples of financial frauds are still present in business practice. The far-reaching consequences of financial frauds to which all business entities can be subjected to, regardless of its size, type of business and country in which they operate, have led to increase in the level of protection of stakeholders' interests.*

*Providing preconditions for financial reporting free from bias has been set as a primary task of regulatory bodies and professional organizations of accountants and auditors at national and international level. This paper introduces the concept of forensic accounting as a response of profession to fraud schemes that cause huge losses not only to the business entities, but also to the society as a whole. Taking into account the fact that fraud schemes bring into question the useful value of financial statements, this paper analyzes the key categories of financial frauds that are detected at a global level. The analysis is conducted from the aspect of causes of occurrence, perpetrators of frauds and detection methods.*

**Keywords:** *financial frauds, forensic accounting, fraud indicators, detections of frauds*

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## **INTRODUCTION**

Financial fraud is a global problem facing even market economies with a highly developed institutional and regulatory accounting framework. According to international statistics, a typical company loses 5% of revenues each year to fraud. (ACFE, 2014). In times of global economic crisis financial pressures are particularly pronounced encouraging additionally business entities to fake financial statements and employees to commit frauds. In order to counter financial frauds successfully, it is necessary to know the types of fraud schemes, causes of their creation, as well as warning signs that indicate the existence of a fraud.

Demands to prevent, detect and investigate financial frauds fostered the development of forensic accounting which covers two broad areas: litigation support and investigative accounting. Litigation support refers to the provision of consulting, advisory services and expert witness services in court cases (Crumbley, 2014). Investigative accounting encompasses fraud examination and forensic auditing, and is focused on detecting manipulations and preventive checks in order to eliminate possibilities of occurrence of frauds. Fraud auditor examines in detail suspicious transactions, collects evidence that confirm or deny indications of fraud, and expresses an independent expert opinion in forensic report.

### **1. GLOBAL OCCUPATIONAL FRAUDS**

The need to detect and prevent financial frauds prompted the establishment of various international associations for combating financial frauds. The most important and the largest international professional organization is the Association of Certified Fraud Examiners (hereinafter ACFE). Together with nearly 75,000 members in more than 150 countries, this association is reducing business fraud worldwide and providing the training and resources needed to fight fraud more effectively. ACFE sets high standards for admission of members, requiring them to pursue continuing professional education and to adhere to the codes of ethical conduct.

According to the ACFE, occupational frauds can be classified into three categories: asset misappropriation, corruption and financial statement fraud. At the same time, each of these categories can be broken down into subcategories. „Misappropriation includes more than theft or embezzlement. It involves the misuse of any company asset for personal gain“ (Singleton et al., 2006). Cash schemes dominate the asset misappropriations cases, but other forms of assets are not immune to this type of fraud either. Corruption manifests itself in the form of conflict of interests, bribery, illegal gratuities or economic extortion. Finally, false financial reporting refers to

deliberated, premeditated manipulation of information in financial statements in order to ensure a misconception regarding performance of a company.

*Table 1* shows the types of frauds, frequency of its occurrence and the median losses caused by frauds. The above data are results of ACFE research published in 2014. The analysis of 1,483 cases of fraud indicates that the most common type of fraud is asset misappropriation with a share of 85%, while frauds in financial statements make only 9%. Corruptive frauds occupy a central position with 36.8%. Overall frequency above 100% indicates that in some of the analyzed companies two or even all three types of frauds were recorded.

*Table 1: Occupational frauds - Frequency and median loss*

Type of fraud	Frequency	Median loss
Asset misappropriation	85.40%	\$120,000
Corruption	36.80%	\$200,000
Financial statement fraud	9.00%	\$1,000,000

*Source: 2014 Report to the Nations on Occupational Fraud and Abuse*

Manipulations in balance sheet positions are not numerous, but are the most prevalent form of fraud in terms of median loss. Through detection and analysis of frauds in financial statements it was found that this type of fraud in 2013 caused the median loss of 1 million dollars. Damages suffered by companies are significantly less than in 2009, when the median loss was \$4,100,000 (ACFE, 2014), but these are still disproportionately higher as compared to other frauds. The unlawful appropriation of assets by employees, with the median loss of \$120,000 represents a financial fraud with the least negative financial effect. Corruption occupies a central position, with the medial loss of \$200,000 in 2014.

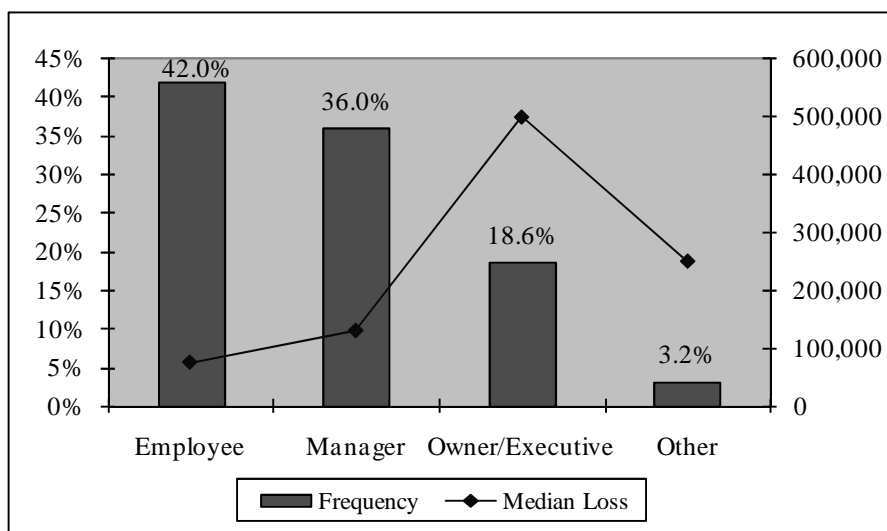
ACFE research results show that more than 2/3 of financial frauds are detected in private companies (37.9%) followed by public companies (28.5%). At the same time, these companies recorded the greatest damages incurred – the median loss of \$160,000 and \$200,000 respectively. Share that belongs to the government, nonprofit organizations, and other forms of legal entities was 15.1%, 10.8% and 7.7%, and they recorded the lower median losses compared to the profit-oriented companies.

When the analysis is focused on size of organizations, the results of forensic investigations indicate that small organizations are the most common victims of financial frauds (28.8% of the total number of frauds in 2014). The reason for this lies in the fact that small companies lack internal controls to identify and prevent

financial frauds, and for whose establishment often do not have sufficient funds. The median loss due to frauds in small organizations is \$154,000, and in large companies with over 10,000 employees is \$160,000. However, when ratio between the median loss and the average number of employees is observed, it is evident that the small companies achieve significantly higher negative financial effects per employee.

The sectors most exposed to financial frauds are banking and financial services, government and public administration, and manufacturing. On the other side, the sectors with the lowest frequency of fraud cases were mining, communications and publishing, and arts, entertainment and recreation. Even 77% of frauds are carried out in the following seven departments: accounting, operations, sales, executive/upper management, customer service, purchasing and finance.

*Graph 1: Position of perpetrator – Frequency (%) and median loss (\$)*



*Source: 2014 Report to the Nations on Occupational Fraud and Abuse*

Results of research have confirmed a link between perpetrators and types of frauds. In most cases unlawful appropriation of assets is carried out by an employee and lower levels of management, alone or in concert with third parties. Employees use their positions to execute the misuse of any company asset for personal gain. The perpetrators of frauds in financial statements usually are chief executive officers (hereinafter CEOs) or senior management levels (Škarić, 2006). In corruption schemes, the fraudster could be anyone but always involves at least two parties. The highest number of frauds are committed by employees 42%, by managers 36.2% and by owners/CEOs 18.6%. Although the most frequent frauds are

committed by employees, their financial effects are minimal. Employees committed 42% of occupational frauds but only caused a median loss of \$75,000. On the other hand, frauds committed by owners and CEOs have the lowest share, but they caused the largest median loss in the amount of \$500,000. Managers ranked in the middle, committing 36% of frauds with a median loss of \$130,000.

Frauds with the highest median losses were performed by employees in senior positions holding university and postgraduate degrees. The more highly educated fraudsters possess greater technical knowledge and skills that help them be more successful in their fraud schemes.

## 2. FINANCIAL STATEMENTS FRAUDS SCHEMES

Factors that have a crucial impact on occurrence of frauds have been the motive, opportunity and propensity to commit fraud (Petković, 2010). Manipulations in the financial statements are triggered by financial or non-financial pressures to show result better or worse than it really is or to ensure “equalization” of results in several accounting periods in order to create an impression that business is running without any major oscillations. Regardless of the pressures, a fraud cannot be executed if there is no opportunity for it. In business practice, there are various opportunities/chances for implementation of illegal activities, such as flexibility of IAS/IFRS, ineffective internal control and internal audit, inefficient accounting and IT systems, vague provisions of the accounting and tax regulations, complex process of recording business transactions and so on. The probability of fraud increases if employees, management and CEOs do not have the integrity and moral values. It is about propensity for fraud, as the third stimulating factor.

Depending on whether those lead to an overstatement or understatement of financial performance, fraud schemes in the financial statements can be classified into subcategories, as shown in *Table 2*.

*Table 2: Financial statements frauds*

<b>Asset/revenue overstatements</b>	<b>Asset/revenue understatements</b>
Timing differences	Timing differences
Fictitious revenues	Understated revenues
Concealed liabilities and expenses	Overstated liabilities and expenses
Improper asset valuations	Improper asset valuations
Improper disclosures	

*Source: 2014 Report to the Nations on Occupational Fraud and Abuse*

The types of manipulations that are shown in the table above are part of a fraud tree, or fraud classification system established by the Association of Certified Fraud Examiners. In business practice financial statements frauds are more common and result in showing a greater profit as compared to real. Motives for showing assets and revenues overstatements is to attract potential investors or to retain existing ones, increase the market price of shares or gain bonus after reaching a certain level of profits (Malinić, 2008). On the other hand, management chooses the result understatement strategy driven by tax evasion or concealment of good financial performance from competition.

Revenues manipulations fall within one of the most common types of fraudulent activities. Fraud scheme timing differences refer to inappropriate accounting treatment of revenues or their premature recognition or postponing the moment of recognition. When management wants to show better financial performance, it overstates revenues through recognition of fictitious revenues or through premature inclusion of revenues in the financial statement. Both procedures lead to balancing revenues in larger unrealistic amounts, with the key difference in the “weight” of manipulation. Premature recognition of revenues in the income statement is less harmful fraud because they are real revenues that are recognized earlier than they should. Fictitious revenues are the result of non-existent transactions and represent the most insolent manipulation which is contrary to the accounting principles. If management wants to cover up the result then it understates the revenues by deferring their recognition.

Concealed liabilities and expenses is a fraud scheme by which management overstates the current result. One way to perpetrate this fraud scheme is to postpone the recording of liabilities in the current year so that the current year will have less expenses, and record that liability in the first month of the next fiscal year (Serdar and Vranješ, 2013). Concealing of liabilities is also implemented by transferring them to related parties. Significant presence of transactions with related parties, especially at the end of the year, indicates a potential fraud conducted with the aim of concealing a poor financial performances. Overstatement of liabilities and expenses has adverse effects on the financial statements, which are reflected in the presentation of a smaller profit as compared to the real profit.

Improper asset valuations include several types of fraud schemes - manipulations in the initial recognition of assets, manipulations in the subsequent valuation of assets, underestimation/overestimation of the lifetime of assets, aggressive capitalization of costs, inadequate policy of write-off of inventories and receivables, understated/overstated impairment of assets and the like. Unrealistic reported values of company's assets threaten the quality of reported earnings (Stevanović et al., 2013). Finally, the extent and quality of disclosures in the notes

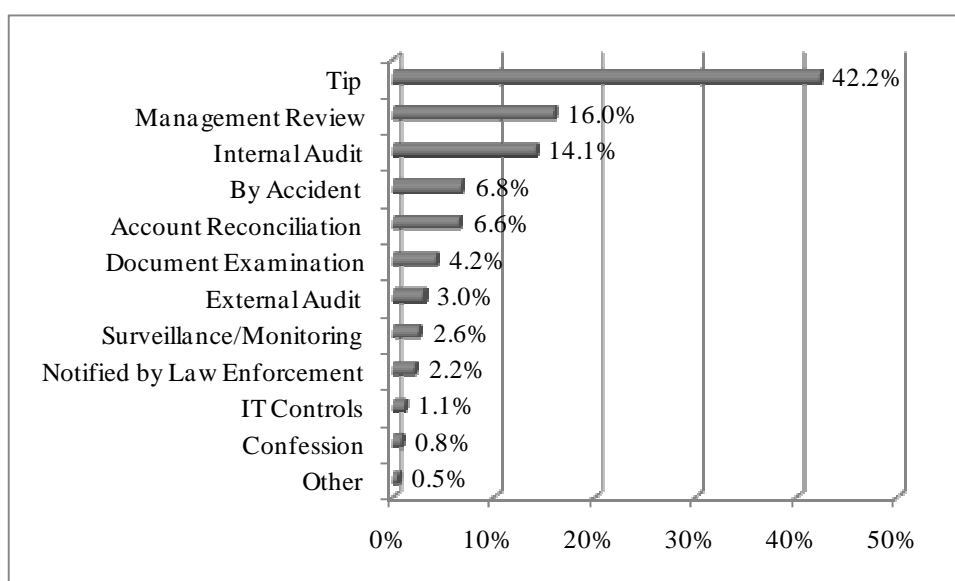
to financial statements determine to a large extent the quality of economic decisions. Regulatory bodies define the minimum information that should be disclosed. Nevertheless, in business practice there are cases of non-disclosure of materially significant information and those less important information are given in notes. An inadequate disclosure can be a way to hide evidence of a fraud. The typical examples of improper disclosures are the omission in disclosures of liability, transactions with subsidiaries, significant events and management fraud (Singleton et al., 2006).

### **3. DETECTION METHODS OF FRAUD SCHEMES**

Fraud auditors implement various forensic techniques in order to detect fraudulent schemes that led to understated or overstated result. The most common methods of detecting frauds are horizontal and vertical analysis of the balance and ratio analysis which identifies the trend of indicators (Singleton et al., 2006). Unusual trends and red flags noticed indicate the risk of fraud, but they do not necessarily be associated with it. Typical red flags are unexpectedly high gain or loss, unexpectedly high other revenues and expenses, the prominence of transactions with related parties and transactions at the end of the year, the greater and more lasting deviations between cash flows and earnings and so on (Malinić, 2009).

Aside from those, the following management activities raise doubts as to manipulation - obstruction of the work of internal and external auditors, frequent changes in auditors, especially if they disagree with management on key issues, rapid shifts of employees in key positions, as well as inconsistent policy regarding employees (Soltani, 2010). Upon detection of fraud indicators, forensic experts carry out detailed investigations and collect evidence to substantiate or reject the suspicion of fraud. Methods and presence of detections of financial frauds are shown in *Graph 2*.

Proactive fraud prevention and detection controls are a vital part in managing the risk of fraud. The typical anti-fraud controls are sudden audit, code of conduct, internal audit department, internal controls that are embedded in business processes, fraud training for managers/executives/employees and job rotation. External audits are implemented by a large number of companies, but they are among the least effective controls in detection of financial frauds. According to ACFE report from 2014, only 3% of the analyzed cases of fraud were discovered by external audit.

*Graph 2: Initial detection of occupational frauds*

*Source: 2014 Report to the Nations on Occupational Fraud and Abuse*

Tips are the most common method of detection of occupational frauds. Employees accounted for nearly half of all tips that led to the discovery of fraud (49%). Besides employees, customers, anonymous and vendors are a valuable source of information for discovering potential frauds – 21.6%, 14.6% and 9.6% of all tips, respectively. As the chart shows, management review and internal audit represent usual detection methods, while confession and IT controls are less frequent.

## CONCLUSION

Financial frauds are a global problem that causes economic damage to countries around the world. The contributing factors to the prevalence of frauds are inadequate control of implementation of regulations and financial reporting quality, as well as undeveloped institutions to oversee the work of professional accountants. Therefore, an effective fight against financial frauds is a task of creators of accounting and auditing standards, professional organizations, regulatory bodies, corporate boards, auditors, accountants, managers, academic professional and others. Forensic accounting is a response of profession to the fraud schemes that endanger the useful value of financial statements and increase informational risks.

International professional organization ACFE has an important role in improving the process of detecting manipulation and development of preventive and control



measures. Cases of frauds recorded at the global level are associated with asset misappropriation, corruption and financial statement fraud. Although in the period between 2009 and 2013 financial loss arising from frauds was in decline, the false financial reporting from the aspect of median loss damaged the companies in 2013 for one million dollars. Over 66% of financial frauds have been detected in both private and public companies, which also suffer the greatest median loss. Analysis of the median loss and loss per employee has shown that, due to inadequate internal controls and lack of financial resources, small organizations are most often the victims of financial frauds. Particularly exposed to frauds are sectors dealing with banking and financial services, government and public administration, and manufacturing. Financial frauds involving owners and CEOs cause the greatest median losses, which in 2013 amounted to half a million dollars.

Proactive fraud prevention and detection controls are a vital part in managing the risk of fraud. Detection and investigation of the causes of false financial reporting, as well as preventative approach and fraud prevention are aimed at increasing the level of safety of users of financial information. Horizontal, vertical and ratio analysis of financial statements represent the most common forensic techniques to detect fraud schemes that lead to asset and revenue overstatements or understatements. After noticing unusual trends and red flags, forensic experts carry out detailed investigations in order to confirm or reject the possibility of fraud.

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