FACTA UNIVERSITATIS
Series: **Economics and Organization** Vol. 6, N° 3, 2009, pp. 295 - 302

THE ROLE OF FORENSIC ACCOUNTANTS IN DETECTING FRAUDS IN FINANCIAL STATEMENTS*

UDC 343.72:657.375

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Abstract. *Numerous financial frauds from the past and the beginning of the century as well as the appearance of the global financial and later economic crisis have brought to the fore the relevance and reliability of financial information. The system of financial reporting and the accounting and auditing profession are often accused because of the appearance of frauds and the loss of trust in the reliability of financial information on the part of the users and makers of economic decisions. The aim of the paper is to discuss frauds and omissions as the causes of inaccurate financial statements, control mechanisms and institutions responsible for investigating frauds as well as the role and importance of forensic accounting and a forensic accountant in detecting frauds in financial statements.*

Key Words: *Forensic accountant, financial frauds, inaccurate financial statements, control mechanisms and institutions, report on undertaken investigation*

INTRODUCTION

Under contemporary conditions of business activity, securing reliable financial information through disclosing financial statements is considered a generally accepted objective. Numerous financial frauds from the past and the beginning of the century have seriously disrupted the trust of numerous users in financial information contained in financial statements. The greatest frauds of the users of financial information and primarily investors have been committed by presenting false i.e. falsified financial statements.

The responsibility of preventing, detecting and investigating frauds in financial statements lies in the hands of the management of an enterprise, but also in the hands of other control institutions and mechanisms. The system of internal control, internal auditing and audit committee are the key elements for preventing frauds that are created through property misuse as well as those that use financial statements as instruments of fraud. External

Received December 29, 2009
* This paper is a part of the research project entitled "Developing a Competitive Advantage of Serbian Enterprises in the Conditions of European Integrations", Number 149052, financed by the Ministry of the Republic of Serbia

auditing and forensic accounting perform retrospective control of financial data with the aim of detecting omissions and frauds and the aim of securing the reliability and credibility of financial statements.

In the last fifteen years, and increasingly today, the accountants that are called forensic investigators or forensic accountants have been engaged in detecting frauds in financial statements. Engaged by the management, owner or other users of financial statements, forensic accountants investigate and document financial frauds or inaccurate materially significant information. In order to perform the given tasks, forensic accountants must have solid knowledge of accounting and auditing, developed capability of good communication -verbal, written and investigative, independence and a considerable degree of knowledge about the usage of information technology in accounting and auditing procedures.

Accordingly, the paper will discuss frauds and omissions as the causes of inaccurate financial reporting, control mechanism and instructions responsible for investigating frauds and the place and role of forensic accountants in detecting frauds in financial statements.

1. Frauds and Omissions as the Causes of Inaccuracy of Financial Statements

Inaccurate i.e. false financial statements provide incorrect picture of earning capacity and financial position of an enterprise. On the basis of such statements, the users, investors, first of all, make decisions about harmful consequences. Hence, there occurs the need of the broader accounting public and users of financial statements to base their decisions on the information that shows the real picture of financial and revenue position of an enterprise. It goes without saying that the real picture will not be obtained if the omissions and frauds appear in the process of preparing financial statements.

Frauds are acts that are undertaken with the intent of making financial statements incorrect and falsified. They are, as a rule, based on the following four elements: (1, p. 13)

- false presentation of facts that has an important character
- the awareness of a perpetrator about the falsity of presentation and manifestation of the total negligence of the truth
- person that receives information treats it as reliable and relies on it in making decisions
- owing to the above mentioned, the financial damage that the user of the information bears is created

Misrepresentation of facts that are of material nature can be achieved in many ways; first of all, through falsifying and amending either bookkeeping documents that represent a ground for registering business changes and control of the correctness of undertaken booking, or accounting registration on the basis of which financial statements are composed. Also, misrepresentation of facts is achieved through inadequate valuation of balance positions, incorrect disclosure and the like. Therefore, one should have in mind that perpetrators are aware of the intolerability of their acts, where the mentioned acts i.e. actions are marked as intentional. Perpetrators-actors in frauds are at a different level of the management of enterprises, including top management where the third party is also involved.

Besides frauds, the incorrectness of financial statements is also caused by the omissions that appear during the creation of bookkeeping documentation and its processing in preparing and composing financial statements. They usually appear during the collecting of documentation and its processing in preparing financial statements, because of wrong accounting estimates that lead to overestimation or underestimation of certain facts, e.g., balance positions; because of wrong application of accounting principles regarding balancing, presenting and revealing as well (2, p. 35)

Regarding frauds as the cause of incorrectness of financial statements, many questions that merit the attention of the accounting public and the users of financial statements can be made. One of the questions can, surely, involve indicators and features that can indicate to the degree of openness to risk when it comes to frauds in financial statements of the enterprise. It is considered that the sources of risk reside in the areas of corporate i.e. organizational culture, accounting estimates and the use of the option right in accounting policy. In the Handbook of Fraud and Commercial Crime Prevention of the American Institute of the Certified Public Accountants, 28 features that make elements of organizational culture (management style, management orientation, authority distribution, performances, reporting, business ethics, etc) are important for the existence of a high i.e., low potential for fraud (3, p. 5).Circumstances of enterprises making business continually demand the use of accounting estimates in preparing and composing financial statement. In addition, the use of accounting estimates cannot jeopardize the reliability of financial information. In order that this demand could be fulfilled, estimates must be objective. Therefore, the objectivity of estimates is the objective one strives to. However, it is certain that there is an amount of subjectivism in estimates. Thus, one should have in mind that as long as the creators of financial statements have as their aim, the establishment of objective estimates, the reliability of financial statements is not jeopardized. The problems emerge when fraud becomes the aim of composing financial statements. Then, estimates become means for its realization since they lead to overestimation or underestimation of property and results. The users of financial statements, often, cannot see that the estimates are unreal, which in turn increases the possibilities of fraud.

Finally, the possibility of using the right of choice in the accounting policy in the process of financial reporting is considered a source of risk as it has been previously mentioned. It is known that the rights of choice-option in normative basis and practice of financial reporting- have been present for decades. Numerous IAS/IFSR still contain the right of choice. Although their existence makes the comparability of financial statements difficult, it is, however, estimated as a necessity (e.g., the possibility of different levels of valuation on the part of enterprises that do business under different conditions). But, one should have in mind that the use of the right of choice for fraud is not rare. By choosing certain rights of choice, through application of the so-called aggressive accounting policy, it is possible to manage profit that way to achieve the postponing of taxes and to show, in financial statements, the profit that is lower than real (4, p.64).

2. CONTROL MECHANISMS AND INSTITUTIONS RESPONSIBLE FOR INVESTIGATING AND DETECTING FRAUDS IN FINANCIAL STATEMENTS

Investigating and detecting frauds in financial statements represent the primary task of an enterprise management and other controlling institutions (internal auditing, external auditing, audit committee, etc) and regulating bodies that should create proper normative framework and secure their application. The importance of reliable financial reporting accounts for the existence of responsibility in broad terms. However, one should have in mind that the execution of a given task presumes the building of an appropriate system where each segment-institution as a part of the system of gain will have appropriate place and role.

Corporate management, the systems of internal control, internal auditing and audit committee represent the forefront of defense from financial frauds. Corporate management represents the process where managers manage corporate resources with the aim of achieving certain level of performance (5, p.329). It establishes and also monitors objectives, policy and the openness to risk of enterprises. However, the management of the enterprise, besides numerous objectives of the enterprise defined by business policy, has as a task to see to the quality of financial statements. It is responsible for the application of regulations and appropriate standards, hence, it is clear that eventual fraud would be detected and sanctioned.

Besides corporate management, system and internal controls, internal auditing and audit committee comprise the second element whose primary objective is fraud prevention. The system of internal controls presumes all policies and procedures that the management has adopted in order to help in achieving, as much as possible, the management's objective regarding securing of regular and efficient performing of business, including the management's policy, protection of means, prevention from fraud and omissions, correctness and completeness of accounting records and timely preparation of reliable financial information (6 MSR 400). Comprehensive framework for internal control encompasses the following key elements: environment control, activity control, information and communication and monitoring (7, p.207). Internal auditing is the activity of independent, objective assurance and consulting created with the aim of creating additional values and advancement of the organization's business. It helps the organization in achieving its objectives by introducing systematic, disciplined approach to estimation and by advancing the process efficiency in risk management, control and management (8, p.109). Audit committee is a controlling body that a client forms for auditing (the enterprise in which auditing is performed) with the aim of more efficient execution of auditing procedures. Audit committee, as a rule, performs the following jobs: reviews and analyzes financial statements of clients, recommends the change of accounting policies to the management, ensures the implementation of the observations of the internal auditing, recommends the choice of certified auditor, etc. (9, po.194).

External auditing and investigations by forensic accountants represents the second line of fraud prevention. Mentioned control activities perform retrospective control of financial data with the aim of detecting frauds and omissions. Truly, although the primary task of external auditing is not the detection of fraud and omissions, but the research of opinions on financial statements, it is, however, unavoidable in the control process that should secure the reliability of financial statements (10, p.95). The primary task of external auditing is to detect, with appropriate intellectual effort, whether there are materially important omissions or frauds in financial statements. If the management does not remove materially important omissions or frauds, then the auditor is obliged to issue appropriate, generally, negative opinions or reserved opinions and thus draw the attention of the users of financial statements, mostly investors not to rely on the information contained in negative statements. It is understandable that if the auditing procedure does not detect mistakes and frauds, then it expresses unqualified i.e., positive opinion.

3. Forensic Accounting and the Role of Forensic Accountants in Detecting Frauds in Financial Statements

Great financial frauds at the end of the past and the beginning of this century have imposed the need for deeper investigation of irregularities in the area of financial reporting.

In connection to that, control institutions, legislature and profession have as the primary objective the creation of assumptions that frauds through financial reporting should be prevented to a great extent and if they emerge they should be detected before things come out of proportion. As a result of the effort in the area of normative-legislature activities, for example, in the US in 2002 the famous Sarbanes-Oxley Law was passed the purpose of which was to enlarge the reliability and correctness of financial information and in turn reduce the possibility of the creation of financial frauds. The EU, in that sense, has taken similar steps, primarily in the direction of important changes in the Eight Directive and the like. However, within profession, in the time after Enron, as the time after the great financial scandals is called, it has lead to the forming of new regulative bodies and the appearance of a new profession-forensic accounting investigator, forensic accountant. The application of the accounting concepts, principles and procedures in solving legal problems, is often defined as forensic accounting.

In the accounting literature there is no unified definition of forensic accounting. From numerous definitions that can be found in the literature that deals with forensic i.e., investigative accounting, the complete one was that by the Association of Certified Fraud Examiners (ACFE).According to the Association, forensic accounting is the use of skills in potential or real civil or criminal disputes, including generally excepted accounting and auditing principles; establishing losses of profit, income, property or damage, estimations of internal controls, frauds and other that involves inclusion of accounting expertise into the legal system (11, www.forensicaccounting.com). In other words, forensic accounting or otherwise called investigative accounting involves the application of accounting concepts and auditing techniques in solving legal problems. Hence, according to many, the key components of forensic accounting are accounting skills, auditing techniques and investigative procedures.

In accord with the described essence of forensic accounting, forensic accountants, basically, investigate and document financial frauds. Also, they help lawyers, courts, regulative bodies and other institutions in investigations of financial frauds. It goes without saying that in order to perform efficiently tasks and activities that have been assigned to them, forensic accountants must possess solid knowledge and skills in accounting and auditing. Additionally, they should possess developed capabilities of verbal and written communication, capability of perceiving details, capability of efficient application of investigative techniques, experience in investigations as well as independence and high degree of knowledge about the use of information technology in the accounting and auditing procedures. A high degree of independence and objectivity is expected of forensic accountants, in accordance with the ethical codex for professional accountants. Independence has an equal importance for a forensic accountant as well as for an auditor. A forensic accountant will be considered independent if they are intellectually honest, ready to make impartial decisions and have no interests or obligations in relation to the client, management or the owner. Independence is usually considered the prerequisite for objectivity. It is insisted on objectivity when it comes to the proofs that support the claims of the management and belong to the area that make greater subjectivity possible (e.g., with the estimate of future losses). It is estimated that in the following years, in developed market economies, a forensic accounting investigator will be one of the 20 most wanted professions (1, p. 24)

The role of forensic accountants under contemporary conditions is very important. It stems from the need for identifying and analyzing certain causes of fraud appearance as well as the jobs and tasks that forensic accountants perform. When it comes to the need for identifying the causes of fraud appearance, the events and occurrences, whose creation makes existence of frauds evitable, should be indicated. In that sense, according to the frequency of their creation as well as their importance, the following can be identified: anonymous accusations delivered by mail, e-mail or telephone; the fact that a highly ranked manager has given notice for known or possible illegal jobs; company-an enterprise has been identified as a subject of investigation that a legal body performs; an enterprise has received a summons from a court or regular agency; an auditor believes that he/she has deliberately been deceived by verbal information received from an enterprise or that demanded documents have been amended or their delivery has failed; the revelation that the client is a subject of fraud however small it might be, even in those cases when the accused is no longer an employee; indications that suppliers might be fictive and indications stemming from the misrepresentation of income or expenditures as well as the recognition of sale before it has been finalized, delivery before final sale, recognition of income although there is an obligation of performing important services regarding that commodity in the future, obvious recording of non-existent income, postponing of expenditures to future periods or recognition of expenditures of future as well as current periods (2, p. 25).

Besides the above mentioned events and indications, whose creation makes the existence of fraud evitable, there are numerous events and transactions that should lead an auditor, manager or any other user of financial information presented by a company to suspect the existence of fraud. These events are often classified into four groups. The first group relates to the inaccuracy that is the consequence of incorrectly applied accounting rules in encompassing business events and disregard of accounting procedures. Namely, this involves the inaccuracy that has been caused by transactions that are not recorded in the whole, not recorded timely, recorded in incorrect amounts, recorded in the wrong period, classified incorrectly or the wrong policy has been applied in their valuation or recording. Events that represent the reflection of the disregard of accounting procedures and that should also be the subject of the attention of auditors, owners or a management are the following: the increased number of the so-called last minute transactions that greatly affect financial results; the appearance of unsigned financial statements; the existence of evidence that the employees have access to the systems, which is inconsistent with their authority; the existence of sharp disagreement between business books and the existence of transactions that are not recorded in accordance with general and specific approval by the enterprise management. The inaccuracy concerning the second group is created because there is no documentation or documentation in electronic form, unavailability of records and their inexistence, etc. The third group comprises the unusual transactions with joint enterprises. Then, the possibilities of fictive realization of business-policy objectives, for example, are created, through increase of income through sale that is not followed by a real product dispatch, magnified factures for performed services and the like. The fourth group comprises unusual actions like: the refusal of the management to enable access to records, employees, business partners or any other person that could offer auditing evidence; the pressure of the management for solving problems in short time, complaints of managers about the work of auditors, especially about auditor's opinion; intimidating the members of an auditing team; setting formal and informal obstacles for auditors to prevent them from efficient communication with the audit committee or board of directors.

When it comes to the business and tasks of forensic accountants, it can be noted that they are related to deterring, detecting and investigating frauds in financial reporting. A forensic accountant can be engaged by a management or owner as well as by other users of financial statements and regulatory bodies with the aim to investigate the doubts concerning the existence of fraud and to collect the evidence. Their attention is not directed towards financial statements as a final product of the accounting procedure, which is the job of an external auditor, but towards the assessment of transactions, people and environment in order to establish the indications about frauds. Furthermore, one should have in mind that not all transactions are the subject of investigation, but only particular transactions between enterprises and certain business partners regarding the sale and purchase of the precise number of buyers i.e., suppliers as well as the transactions, in whose realization certain people and groups of people have participated. However, successful realization of the mentioned tasks presumes a close collaboration between a forensic accountant, an internal auditor, an external auditor and audit committee. In all the cases when they suspect that there is a fraud that they cannot solve, forensic accountants cooperate with an internal auditor. The reason being that an internal auditor knows the enterprise, ongoing transactions, employees better as well as internal control and information systems than a forensic accountant. Information gained from an internal auditor enables a forensic accountant to increase the efficiency of investigation. Then, for a forensic accountant, of special importance is the insight that an external auditor can give about the types of risk, business transactions, documentation, systems-system of internal control and accounting information and personnel. Working papers of an auditor can also be an important source of data necessary for the understanding of control environment, accounting system and control procedure. The circumstances that the investigation is directed by an audit committee, puts a forensic accountant and other participants in the investigation under obligation to service the audit committee.

Finally, after an investigation has been completed, a forensic accountant makes a report on the undertaken investigation and/or report for the need of court procedure. Regardless of the fact which of the mentioned reports is in question, a forensic accountant must put an effort in making them. This concerns their form as well as their content. Information that the report contains must be accurate, impartial, relevant and timely. In the report, the undertaken stages in investigation, ways of collecting data and their analysis as proofs are given. The quality of reports is conditioned by the quality of undertaken investigation, primarily by a forensic accountant and other control institutions engaged in fraud detection in financial statements, in order that the users, who are presented with statements, could be in the position to make accurate estimates and decisions.

CONCLUSION

Under contemporary conditions of business activity, frauds and omissions appear as causes of inaccurate financial statements. Although the consequences are the same-the creation of inaccurate financial statements, there are important differences between omissions and frauds. Frequent omission are created because of the wrong application of accounting principles in relation to amounts, types and ways of presenting and publishing certain data with no intention whatsoever to do that .In contrast to omissions, frauds represent acts undertaken with the intention to falsify financial statements. In that connection, the ways of performing estimates and of using the right of choice in the process of financial reporting are considered the sources of fraud in financial statements in the area of corporate i.e. organizational culture.

Investigating and detecting frauds in financial statements represent the basic task of the management of an enterprise and other control institutions or regulative bodies that should form certain normative framework and secure its application. Corporate management, systems of internal control, internal auditing and audit committee represent the forefront of defense against financial frauds. External auditing and investigations by forensic accountants represent the second defense line against frauds. It goes without saying that performing the above defined task presumes the building of a proper system where each segment-institution would have its place and role.

The role of a forensic accountant under contemporary conditions is very important. This is because forensic accountants, in accord with the essence of forensic accounting, investigate and document frauds.

By applying accounting principles, auditing skills and investigative procedures in solving certain legal problems, forensic accountants help lawyers, courts, regulatory bodies and other institutions in investigating financial frauds. Therefore, in order to perform tasks efficiently and compose reports on undertaken investigation, forensic accountants must possess solid knowledge and skills in the area of accounting and auditing. Also, they must have a developed capability of verbal and written communication, capability of perceiving details and of the efficient application of investigative activities as well as a considerable degree of knowledge about information technologies in accounting and auditing procedures.

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ULOGA FORENZIČKIH RAČUNOVOĐA U OTKRIVANJU PREVARA U FINANSIJSKIM IZVEŠTAJIMA

Jovan Krstić

Brojne finansijske prevare i skandali s kraja prošlog i početka ovog veka kao i pojava globalne finansijske a potom ekonomske krize ikstakli su u prvi plan relevantnost i pouzdanost finansijskih infomacija. Sistem finansijskog izveštavanja i računovodstveno-revizorska profesija su neretko optuživani za nastanak prevara i gubljenje poverenja u pouzdanost finansijskih informacija od strane brojnih korisnika i donosioca ekonomskih odluka. Cilj rada je da se razmotre prevare i greške kao uzroci netačnih finansijskih izveštaja, kontrolni mehanizmi i institucije odgovorne za istraživanje finansijskih prevara kao i ulogu i značaj forenzičkog računovodstva i forenzičkih računovođa u otkrivanju prevara u finansijskim izveštajima.

Ključne reči: *forenzički računovođa, finansijske prevare, netačni finansijski izveštaji, kontrolni mehanizmi, izveštaj o obavljenoj istrazi*