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The Importance of Forensic Accounting in Detecting False of Financial Reporting

Abstract

This paper deals with the problems that arise in the detection of fraudulent financial reporting. Financial reporting is a legal obligation of all economic entities that operate in accordance with the law and good business practice. Analysis of financial statements should provide insight into a company's financial health, identify strengths and weaknesses, identify trends and predict future performance. The financial report as the subject of analysis provides key information about the financial state of the company. The aim of this paper is to point out the role and importance of forensic accounting in the detection of fraudulent actions and fraudulent financial reporting. The importance of the

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development of forensic audit as an important segment in the fight against fraudulent financial reporting was particularly pointed out.

Keywords: *Financial statements, forensic accounting, fraudulent financial reporting, forensic audit.*

1. Introduction

Financial fraud and false financial reporting are becoming a global problem today. Research related to these frauds may be different by region, but the schemes and fraud are very similar. The job of an auditor of financial statements today is challenging, especially when there are loopholes in legislation that allow the long-term presence of criminal activities that harm business. The efficiency of the competent state authorities can be crucial in detecting and suppressing these actions.

The subject of this paper is forensic accounting, which deals with a detailed and in-depth examination of the regularity of the company's operations in order to detect financial fraud. The work aims to investigate the need for the development of professional forensic accounting, both due to the increase in traditional and new crime, and due to the lack of special knowledge and experience of existing supervisory and executive bodies in the process of investigations, as well as giving opinions on illegal actions.

Independent audit reports are intended to reduce information risk and provide information security to external users. However, it is not rare that they are associated with managerial manipulations and accounting tricks. Such behavior damages the reputation of the accounting and auditing profession, which has built its credibility over decades. Loss of investor and creditor trust in the financial reporting system has long-term consequences, and restoring trust is extremely difficult.

The aim of this paper is to point out the importance and responsibility of all participants in the financial reporting process. Quality risk management, transparency and professional ethics are key factors for restoring trust in financial reporting and maintaining the integrity of financial information.

2. Financial reporting

Financial accounting is aimed at satisfying the interests of external users of accounting information, i.e. the preparation and presentation of general-purpose financial statements. These financial statements are strictly formal and, for certain legal entities, are subject to audit in accordance with the laws regulating the obligation to audit financial statements. These are regular annual and, in certain cases, extraordinary financial statements that are submitted to state authorities, financial market institutions, shareholders, investors and other external users.

Legal regulations and international professional accounting regulations (International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS)) are the basis for a true and fair presentation of the property, financial and profitability position of companies (Đorđević, 2020: 21).

A financial report is a document that provides information about the financial condition, performance and activities of a company. Financial statement analysis allows managers, investors, creditors and other interested parties to assess the financial health and efficiency of a company's operations. A financial statement consists of a balance sheet, an income statement, a statement of cash flows, and a statement of changes in equity. Each of these components provides specific information about the financial condition of the company in a certain period of time.

Financial reports and accounting documents represent a confirmation of the property and financial position as well as the business success of the business entity (Cvetković, 2018: 81). The analysis of the financial report includes the application of various methods and techniques to assess the financial performance of the company. Financial indicators are important because they provide information about the profitability, liquidity, indebtedness and efficiency of the company's operations.

According to our the Law on Accounting (Zakon o računovodstvu "Sl. glasnik RS", br. 73/2019 i 44/2021 - dr. zakon), legal entities and entrepreneurs have the obligation of financial reporting. Financial reporting includes several reporting obligations, such as the recognition and measurement of assets, liabilities, as well as income and expenses. The most important duties are certainly keeping business books, compiling, presenting and submitting financial reports. The complexity of business operations on the one hand and the impossibility of monitoring by developing accounting rules for recording every business situation that arise during the business year on the other hand, open room for maneuver for the appearance of fraud in financial statements (Gogić, 2022: 7).

If some manipulative techniques are applied during the creation of financial reports in order to show better business results, the quality of the report is impaired. A large number of financial frauds led to enormous distrust in the financial reporting system and the accounting and auditing profession (Budimir, 2023: 152).

3. Transparency and quality of financial reports

Financial reports that comply with international professional regulations have the character of quality reports, providing relevant and reliable information. Having this information about the efficiency of using the company's capital in the past, as well as about its business potential in the future, is of key importance for investors when making decisions about investing their funds.

The interests of investors are in conflict with the differences in the way of shaping accounting information, which is why they, seeing the numerous problems that arise on that occasion, become one of the key drivers of changes in the financial reporting system, demanding its standardization" (Leković, 2013: 92).

Standardized and high-quality financial reports play a key role in reducing information asymmetry and adverse selection, providing greater certainty to investors. Although meeting financial reporting standards is important, it does not in itself guarantee the accuracy and objectivity of financial reports that reflect the actual state of a company. One who considers and makes a decision takes into account several aspects of the problem he is solving: some reasons speak in favor of making a decision in one way, but other reasons say that such a decision is reviewed and often revised (Ristić, Miljković, & Milunović, 2021: 65).

That is why it is crucial to approach the process of compiling and presenting financial statements with a high degree of responsibility, conscientiousness and in accordance with good accounting practice. This further means the reliability of information provided through financial reports. "Obscuring and faking results is punishable by law, and decisions that investors can make based on inaccurate financial reports are not in the function of efficient capital allocation." True and honest financial reporting is a first-class public interest" (Stojiljković, 2005:110).

Professional and legal regulations represent the minimum standards of behavior of professional accountants and all those who participate in the preparation of financial reports, and

ethics builds on them" (Malinić, 2011: 246). Users of financial reports expect relevant and reliable information about the financial position, success and company perspectives. Internal users, such as managers, rely on an internal accounting control system to provide them with security and peace of mind. On the other hand, external users seek trust through positive opinions of authorized public auditors. However, the problem arises when users are manipulated, not only by management and corporate accountants, but also by independent auditors.

A certified forensic accountant (according to the terminology from the Rulebook) is a person who applies his knowledge and skills in accounting, auditing and finance in the resolution of financial relationships, facts and transactions, but also in the determination of errors, corruption, theft, illegal business, forgery, etc. (Pušac, 2024: 146).

The principles of corporate governance state that: the corporate governance framework should ensure that all material facts related to the company are disclosed in a timely and accurate manner, including the financial situation, results, ownership and management of the company. In other words, the obligation to disclose and be transparent about information relevant to the company and corporate governance should encourage greater responsibility on the part of management to conduct management in accordance with the best practices of corporate governance. The financial reporting system and the accounting and auditing profession have often been accused of causing fraud and losing confidence in the reliability of financial information by numerous users and economic decision-makers (Krstić, 2009: 295). According to Spalević and Dimitrijević (2017), in order to be successful in combating fraud and restoring confidence in financial statements, the development of forensic accounting as a separate scientific discipline involves the examination and interpretation of evidence and facts, as well as the provision of a certain expert opinion.

The company is obliged to disclose corporate financial statements prepared in accordance with international financial reporting standards. In addition to the reports, companies also publish other information that is not contained in the official financial statements, but which is important for investors and which is in line with its business interest, for example, risk management policy, business ethics, etc. It has been empirically proven that the shareholder information regime and the transparency of relevant material facts have a direct impact on attracting new investments, the stability of existing investments and thus the impact on economic development and economic competitiveness.

4. False financial reporting

False financial reporting is most often manifested in the form of the following five interconnected forms: fictitious income, false time allocations, concealment of obligations and expenses, improper disclosures, and other techniques of false financial reporting" (Petković, 2010).

Fictitious income is a form of deception in financial reporting. This implies the recording of non-existent income from the sale of goods and services with the aim of deceiving users of financial statements. The main forms of fictitious income are the posting of non-existent income, false sales to existing customers and sales to non-existent customers. Posting non-existent income is one of the easiest ways to create fictitious income, often with the use of false supporting documents. False sales to existing customers is a more complex form of fictitious income that involves falsified documentation such as invoices, packing slips and shipping documents. When services are not provided or goods are not delivered, and fictitious invoices are issued, fraudulent sales to existing customers occur. Often, at the beginning of the next accounting period, the false sales are reversed to cover up the fraud, but this leads to a decrease in income in the new period and creates the need for new fictitious sales.

The principle of causation of income and expenditure is one of the basic accounting principles. This principle requires that income and expenses in one accounting period are properly attributed to that period. The perpetrators of criminal acts in the financial statements deliberately violate this principle by means of false time allocations, thus providing an inaccurate picture of the realized income of the legal entity. These procedures knowingly violate basic accounting principles, national laws and international accounting standards.

Concealment of obligations and costs is most often caused by omission of obligations and improper capitalization of costs. These are just some of the techniques used to hide liabilities and expenses. If management and employees properly report assets, users of financial statements can get an accurate insight into the financial position of a legal entity. When financial statements are accurate, they respect the principle of objectivity in accounting, providing information on the value of assets, liabilities, capital, income and expenses.

When compiling financial statements, it is important to record all categories in accounting (assets, liabilities, capital, income and expenses), in order to provide a complete picture of the situation and changes. Improper disclosure implies the omission of certain parts of accounting categories, thereby reducing the value and usefulness of accounting information. This opens the possibility for various frauds and abuses. By introducing the term manipulation in accounting, it is possible to conclude that manipulative actions, whether fraud or errors, aim at two different outcomes: 1. increasing profit and 2. decreasing loss (Anufrijev, 2024: 210).

Compilers of fraudulent financial statements use a variety of methods to mislead users. They exploit legal regulations, International Accounting Standards and improper accounting estimates to present an incorrect financial position of a legal entity. Professionals, such as auditors, must constantly monitor these criminal activities, which often change in their enforcement techniques. Forensic accounting should not only detect a criminal act, but also assess the level of damage to the company on that basis (Aleksić, 2015: 230).

Forensic accounting can be preventive and curative. The purpose of preventive work is to prevent the occurrence of illegal economic and financial actions. In curative work, there are already phenomena that indicate illegal actions. A forensic accountant should review and evaluate such actions, provide an independent and unbiased opinion, and provide evidence of the criminal action (Đorđević, 2020: 21).

5. Audit of financial statements

Auditors of financial statements focus on objectively presenting the financial situation, business results and cash flows of the entity being audited. Their role is to determine whether financial statements are accurately and completely presented, so that users of those statements can make informed decisions. The audit of financial statements includes the collection and evaluation of evidence in a systematic way, which creates a basis for validating financial statements and checking their compliance with international accounting standards and international financial reporting standards (Krunić, 2023: 2).

While auditors investigate errors or misstatements, forensic accountants focus on detecting fraud. Fraud is often more difficult to detect than error, so detecting fraud requires more

detailed research and analysis, which usually goes beyond the scope of a standard financial statement audit (Đekić, 2016:74).

In order to overcome information asymmetry and reduce risk for investors, it is important that there is adequate regulation that requires transparency and accuracy of financial reports. It is also necessary to invest efforts in educating and empowering investors so that they are able to correctly interpret financial statements and identify potential risks. In addition, independent auditing of financial statements plays a key role in maintaining the integrity and confidence in companies' financial information. "Investing in unhealthy, high-risk and over-indebted companies due to lack of adequate information is known as adverse selection." It is clear that this is an unprofitable investment and an irrational capital allocation that has far-reaching negative consequences for the national economy" (Mrvaljević, 2014).

During the audit of financial statements, the auditor may encounter different categories and forms of criminal acts, which include numerous techniques or ways of execution. It is important to note that this typology is the basis for many other possible techniques, which are continuously changing and adapting to changes in the business environment. Some of these procedures may be unclear to the auditor, so it is desirable to have knowledge of the criminal laws of the country in which the financial statements are being audited.

6. Forensic audit

The term business forensics consists of forensic accounting, forensic auditing, money laundering and embezzlement. Forensic accounting and forensic auditing are two similar and closely related fields (Petrović, 2023: 343).

The increase in the number of corporate scandals around the world, caused by criminal acts in financial statements, has led to the fact that large global audit firms increasingly provide forensic audit services. This area is still not clearly regulated by professional regulations and standards. In this sense, audit practice offers services that are not yet defined and directed by standards, a challenge is posed for audit theory to correctly define forensic audit, recognize its goals, characteristics and correctly express results and findings.

Forensic accounting is a relatively new career field that has expanded rapidly since its inception (Mackenzie, 2018) Given that forensic auditing is a new discipline within auditing,

there is still no comprehensive and universally accepted definition around the world. However, many theoreticians, national and international organizations and associations offered their answers regarding the importance and role of forensic audit in audit theory and practice, thus laying the foundation for its proper definition. Forensic auditing can be described as a type of auditing service that uses accounting and auditing procedures to detect criminal activity in financial statements and present them in a manner that is acceptable to court proceedings.

A forensic auditor must approach the verification of financial statements in a completely different way due to the peculiarities of this type of audit. Forensic audit procedures are more intuitive compared to the formal analytical methodology used in a traditional independent audit of financial statements. Sometimes it is necessary for the forensic auditor to think like a criminal, not just an auditor. While financial auditing examines events, transactions and the environment in their overt aspects, criminal auditors tend to look at them in terms of their hidden aspects. In order to be successful, the auditor must be curious, persistent, creative, open to all possibilities, scrutinize small details, but at the same time look at the bigger picture.

7. Conclusion

Forensic accounting plays a key role in the detection, investigation and prevention of financial reporting crimes. Forensic accounting uses special techniques and tools to analyze financial data, identify irregularities and gather evidence that can be used in legal proceedings.

In addition, auditing financial statements plays an important role in detecting criminal activity and ensuring the integrity of financial information. The audit is performed independently and objectively, with the aim of assessing the accuracy and reliability of financial statements. Through the audit process, auditors review financial transactions, internal controls and business processes to identify potential irregularities or signs of criminal activity.

In order to reduce the risk of criminal acts in financial reporting, it is necessary to establish effective control mechanisms, transparency and accountability in financial reporting. This includes strengthening internal controls, training employees on ethical business and financial integrity, as well as regular monitoring and auditing of financial reports by independent experts.

It is also important that investors, creditors and other users of financial statements are educated about the risks and signs of criminal acts so that they can make informed decisions and be more careful when investing or cooperating with certain companies.

Suppression of financial reporting crimes requires cooperation between regulatory bodies, legal institutions, auditors, companies and the general public. Only through joint efforts and strict application of laws and regulations can we create integrity and trust in financial reporting, thereby reducing the risk of future fraud and protecting the interests of all participants in the financial world.

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