

FRAUD AND ERROR IN MANIPULATIVE FINANCIAL SITUATIONS

Isa Tak, Assist. Prof., PhD, Lumina - The University of South-East Europe

Abstract: In this paper I presented the concepts of “fraud” and “error” and the difference between them, their negative effects that influence the “fair image” of financial situations. Another chapter of this paper is represented by the misleading of the financial users information, the harm, the prejudice this action produces and the role played by the Department of Encounter Against Fraud in Romania. The final part of this paper presents my conclusions and proposals in encountering this phenomenon and controlling, confuting the relevant negative effects it has on investors, the management and finally on the hole economy.

Keywords: fraud, error, manipulation, DLAF, effects

I. Fraud and error in the misrepresentation of financial situations

The misrepresentation of financial situations can be caused by fraud or/and error. According with the Romanian Dictionary, these two terms are defined as:

- **Fraud:** fraudulency, dishonesty of someone to gain a certain profit by harming others' rights, theft. Amount gained by stealing;
- **Error:** wrong idea or opinion, what is wrong; misrepresentation of a situation or fact; the difference between the real measurement and the determined measurement of an action.

As we can see by analyzing the content of these two terms, the error refers to a mistake, an involuntary action that affects the reality, while the term of fraud is associated with theft, dishonesty, stealing or affecting others' rights in order to obtain a gain, a profit, an action done with intention, at the same time affecting the reality.

According with the **International Financial Reporting Standards, *International Accounting Standard no. 8 “Accounting Policies, Changes in Accounting Estimates and Errors”***, paragraph 41, the errors can appear as regards the recognition, evaluation, presentation and description of financial situations. If the financial situations contain significant errors, or insignificant errors, but with intention in order to obtain a certain image of the financial position of an entity, the entity's financial performance or the cash-flow of an entity, we consider those financial situations as not being consistant with the International Financial Reporting Standards. I would like to highlight the possibility of discovering potential errors of a current period, according to the ***International Accounting Standard no. 8 “Accounting Policies, Changes in Accounting Estimates and Errors”***, that must be revised before the approval and presentation of the financial situations. The standard also refers to the possibility in which the financial situations contain significant error or errors that are discovered later, where the comparative information must be presented in the financial situations for that subsequent period.

International Accounting Standard no. 8 “Accounting Policies, Changes in Accounting Estimates and Errors”, paragraph 42 states that significant errors must be revised retroactively for the first set of financial situations that were approved to be published by:

- Treating again the comparative values for the prior period when the error appeared;
- Or
- Determining again the balance account of the beginning of the period for assets, liabilities and equities for the first period after the presentation if the error appeared prior to the presentation.

The accounting standards applied in Romania starting with the 1st of January 2010, in compliance with the European standards, containing almost the same recommendations as the **International Financial Reporting Standards** concerning errors and ways of revision. The difference between the European standards and national standards is that the errors can be revised in the current profit¹; another perspective of domestic standards is that errors must be revised in the financial period when they were discovered.

Regarding fraud, I would like to highlight from the very beginning of this paper that fraud can be committed by the management of an entity by avoiding controls, using techniques such as:

- Fictive transactions in the Journal Registry, most likely at the end of a financial period in order to manipulate the results or to achieve other objectives;
- Inadequate adjustments and usage of professional judgment used to estimate the balance account;
- Not registering or delaying the recognition in the financial situations of the events or transactions that should be registered in the accounting period;
- Hiding or not presenting the facts that could determine the modification of registered values in the financial situations;
- The implication of many transactions that are structured in such a way as to misrepresent the financial position or the performance of an entity;
- Modifying the registration or the terms of a significant transaction or unusual transaction.

We can conclude that, according to the **International Financial Reporting Standards**, fraud represents a very interesting action for the financial auditor in case this negative action brings about modifications and misrepresentation of the financial situations.

For an auditor, there are two types of intentional misrepresentation:

- The ones that represent fraudulent misrepresentation of financial situations,
- And
- The ones that represent asset fraud of the audited entity.

The **main difference between fraud and error** is the fundamental action that has as result the misrepresentation of financial situations, more precisely if this action is deliberate, purposeful or not. Fraud, different from error, is deliberate and also reflects the intention of hiding facts or transactions.

¹ **OMFP 3055/2009** for approving simplified accounting standards according to European standards, applied since 01.01.2010, paragraph 63.

Fraud, even if it is a fraudulent misrepresentation or asset fraud, implies gains and pressure to commit the fraud, an opportunity and motivations that represent the beginning of the action², such as:

- Gains or pressure to commit a fraudulent financial misrepresentation may appear when the management is under pressure, internal or external pressure, to reach an estimated target regarding gains or financial result when the consequences of not achieving the financial target can be significant;
- The opportunity to commit such a fraud can appear only when such a person believes that internal controls can be avoided, because that person is in a key position or benefits from trust or has information about the weaknesses of the internal control;
- Some persons possess a set of values and character that allows them to commit an action that is not honest and do this purposefully; there are also honest persons that in an environment marked by pressure can commit a fraud because of the pressure that is exerted upon them;
- The fraud detection studies show that there are three factors that are met when frauds are committed, the so called “fraud triangle” such as: interest or passion to have a wrong attitude; the opportunity to commit a fraud, and thirdly, and last but not least, the authors of the fraud are able to justify their actions.

Financial fraud can be grouped in four categories:

- Fraudulent financial reporting systems;
- Asset fraud;
- Incomes and goods obtained by fraud;
- Costs and debt according to inappropriate targets.

The asset fraud that I mentioned earlier is most of the times committed by the employees of the entity and expresses most of the times values that are insignificant and reduced. In the situation where the management of the entity is also involved, the detection of this process is more difficult because the management hides the misrepresentation. This phenomenon is most likely to imply fake documents and unreal transactions with the objective that those assets that are missing are not to be found.

Asset fraud has many ways of happening, such as:

- Income fraud: collecting the receivables in an erroneous way and stealing the cash-in for the old debts to bank accounts;
- Fraud of tangible assets or intellectual property: inventory stealing for personal use or for selling purposes, secret pacts with competitors and selling information for technical purposes;
- The payment made to an entity for goods or services that were never brought, such as: payments to fictive sellers, bribery and secret commissions of employees that influence the acquisitions of the entity in order to raise the price or to pay fictive employees;
- Using the assets of the entity for one’s own usage: using the assets as guaranty in order to obtain a personal loan or for a third party.

² Wells, J. T., J. D. Gill, *Assessing Fraud Risk*. Journal of Accountancy, 2011.

I would like to conclude this section of this paper by highlighting that frauds committed in an entity can also include corruption, conflict of interests, inadequate and fraudulent reports and technological abuse.

II. Types of errors in financial situations

In the financial accounting there are errors such as:

a. Registration errors

Registration errors usually appear at the moment of transaction registration. These kinds of errors may appear because of wrong registration of an amount in the journals, writing more or fewer figures in the amount, registering in another balance account and so on³.

A financial situation can be misrepresentative due to these kinds of errors. The error represents an unintentional misrepresentation, including an omission or a representation, such as: mistake occurred in collecting or processing the data that are reflected in the financial reports; an incorrect accounting estimation due to a wrong transaction interpretation; a wrong judgment in applying accounting treatments concerning evaluation, classification and presentation or information description⁴.

b. Calculus errors

These types of errors can be described as mathematical errors. The amount of the transaction is incorrectly registered due to a wrong mathematical calculation, for example:

- Errors in drawing up a trial balance: may appear because of erroneously adding columns or wrong transcription of amounts in the journals (figures that are reversed, the addition of supplementary figures to the amount, omission of figures in a certain amount, the transcription of other amount from a different column or row and so on).

In order to eliminate these types of errors one can use techniques such as calculus repetition or amounts confrontation (for the amounts in the trial balance with the ones in the journals).

- Errors in operating a transaction in the trial balance to establish the final balance account: due to wrong addition of debit or credit amounts in order to establish the final balance account.

Identifying this kind of errors is realized by recapitulation of the calculus of each balance account.

- Errors in the registration of the journals: due to a wrong post up on a page of the journal to the following page of the journal.

c. Omission errors

They reveal that the economic transaction was not registered at all. Identifying such errors is possible if the documents are double-checked to observe if all transactions are operated or by discovering documents that do not present a checking mark or signature or due to third parties' complaints regarding a certain transaction.

d. Errors that represent a double registration of a transaction or omission registration

This type of error is usually discovered in entities that usually use proforma invoices. The same amount or invoice is registered two times. In this case the proforma invoice is

³ Nobes C., Parker R. - *Comparative International Accounting*, 6e edition, Londres, Pearson Education, 2010.

⁴ Tuba Yaman, *Finansal Tablolar Aracılığı İle Kullanıcılara Yanıtlı Bilgi Sunulması ve Sonuçları*, İstanbul, 2010.

registered and afterwards the invoice that refers to the same transaction arrives and is also registered. In conclusion, the amount that represents the debt is doubled and this error will have as result a misrepresentation.

e. Procedural errors

The internal control of the entity is not functioning according to the standards that must be applied and which are imposed by the law entailing a qualitative or procedural error. An example of this type of error is the omission of unique identification of invoices that conducts to the monetary error. The monetary error represents a quantitative error and is determined by the procedural errors that have not the same quantifiable effect.

III. Accounting manipulation

Manipulation is a French term and the meaning of this word in the dictionary is the following: “to act, conduct a person with hidden means and methods influencing and controlling his/her attitude in a way that is compatible with the interests of the initiator.”

Manipulation can also be defined as: *financial rights of shareholders that determine the stock value of a share and the published values are influenced by fictive operations of transfer and fraudulent reports and actions.*⁵

In this context, here are a few examples of **accounting manipulation**:

- Applying options allowed by accounting policy in a certain way meant to influence in a negative way the financial statements user;
- Preferential application of accounting evaluation by: the depreciation test of assets, reevaluation of assets and changing the evaluation method of inventory, subjective evaluation of corporal assets and stocks, the modification of the rhythm of irreversible depreciation, internal prices of asset selling between subsidiaries of the same group;
- Balance account manipulation by structuring and delaying the real transactions;
- Rising the difference between accounting value and acquisition price by underestimating the purchased asset;
- Operations such as “lease-back” where the sold asset is leased from the selling entity; the effect of such transactions reflects in supplementary cash-flow, diminishing the debts and improving the benefits;
- Hybrid shares issue, in this way the entity transfers debts into its own funds;
- Transfer of assets to another entity, along with its debts, transaction called “run off of debts”.

By way of conclusion to this chapter of the present work, let us say that those who elaborate and publish financial situations may have as main objective the “make-up” of their reports in such a manner that the respective reports look the best way possible by using techniques such as “profit management” or “fraudulent reporting”.

In a world where the main target is represented by the profit, gain, most of the times the financial auditor has to discover the Machiavellian methods that erroneously inform the financial statements users. Of course, when the financial auditor’s report is used in making decisions by the users, the stake is raised taking into consideration entities that obtain loans

⁵ **Stolowy H., Breton G.**, *A Review of Research on Accounts Manipulation, Paper for the Annual Congress of European Accounting Association*, 2012.

from public share subscription and the important role “played” by the financial auditor, his/her role and responsibility is greater than ever.

IV. The prejudice caused by fraud and error

Economic frauds affect entities irrespective of their size or region, and usually the greater the fraud is, the more powerful the effects are. The degree of anonymity, the employees’ responsibilities and the complexity of systems in a large entity represent breaches in the control system that fraud organizers take advantage of.

According with a KPMG study⁶, the managers of entities are asked if they are concerned about fraud and the outcomes of such actions. As **Table no. 1 – Concerns about fraud** - shows, more than two thirds of the managers (71%) are concerned about a possible loss of public image that is determined by fraud. A more reduced number, and yet more than half of the managers (54%) replied they are concerned about the juridical aspects and penalties or loss of new clients (52%) fraud might entail.

Table no. 1 – Concerns about fraud

Opinions	Percentage
Loss of public image	71%
Juridical aspects or penalties	54%
Loss of new or existing clients	52%
Loss of capacity to attract and keep employees	43%
Prejudice regarding the selling price of the entity	34%
Other concerns	3%

The following percentage is held by the answer regarding the employees (43%) because of the topic’s importance, being able to attract and keep a qualitative resource such as employees is an important and delicate matter.

The companies that have issued public share are also concerned about the selling price of the entity, a fraud scandal, meaning a public, one would mean the loss of the price of shares and so a reduced capacity of investment with negative consequences on the management and loss of jobs and other opportunities for the management.

Regarding fraud and error, and the negative consequences of this phenomenon, I would like to highlight that those entities which present fraudulent errors, both in accounting and financial reports, have common characteristics: their shares are going to be taken out of the public share market and come along with tax penalties that have as result the rise of the entity’s costs. Those who have broken the law or have connections in this scandal are going to leave their jobs, and most likely most of them are going to lose also their freedom.

In KPMG Fraud Survey 2013, the study registered 65% positive answers and 34% negative answers to the question: “**Do you consider that fraud and forgery represent a significant risk to your activity?**” The answer clearly demonstrates that 34% of the

⁶ KPMG Fraud Survey 2013.

managers do not consider fraud and forgery as a risk and they should have thought about this topic.

Another question of the study was: “**Which one of the following categories of fraud represents the most significant risk to your entity?**” The answers were:

- Asset theft (i.e. cash, inventory or intellectual property stealing) - 35%;
- Other illegal or unethical actions (bribery, corruption, conflict of interests) - 31%;
- Fraudulent financial reporting (for example the intentional misrepresentation of incomes, assets or debts) - 14%;
- All the above mentioned factors represent an equal threat - 20%.

Of course these answers vary according to the main object of activity, but what I would like to highlight is that there is not such a large difference between “asset misrepresentation” and other illegal or unethical actions (such as bribery, corruption or conflict of interests).

The most important role of the financial audit⁷ is to discover and expose the corruption and unethical actions, to determine and control the work environment. By exposing frauds and other errors it contributes accordingly to the functioning of the accounting system. The accounting registries must be verified so that fair, viable and necessary information should be presented in order to support the financial situation users. An accounting that is not verified and audited cannot offer correct information. In order to have a “healthy” accounting presentation, the financial audit and the financial auditor “play” an important role. In the financial situations auditors can discover errors and irregularities. Errors committed with intention in the accounting documents or financial situations, in order not to reveal the fair image of the entity, are deliberate errors or more precisely they are frauds. There is no intention in the case of errors or mistakes, just negligence and lack of knowledge⁸.

V. Fraud and error effects on economy

In the investigations conducted by the **Association of Certified Fraud Examiners**, the rates of financial loss were presented by a comparison between the years 2012 and 2013. According to this investigation, 959 of the professional fraud that my study presents, 937 represented an integral loss. The mean of the losses registered in the study was of 175,000\$. As **Figure no. 1 – Loss distribution expressed in US Dollars** - exhibits, more than one fourth of the cases, in 2013, imply losses of 1 million dollars. The distribution of losses in 2013 was similar to the distribution of losses in 2012; in both studies, more that 60% of the entities suffered losses of at least 100,000\$.

⁷ **Rotaru Viorel Horatiu** - *Audit Risk and Materiality Threshold - towards Economic Risk and Audit Failure*, 5th WSEAS International Conference on Applied Economics, Business and Development (AEBD '13), Crete, 2013

⁸ **Sharman, P.**, *External audit failure*. Cost Management, 2011.

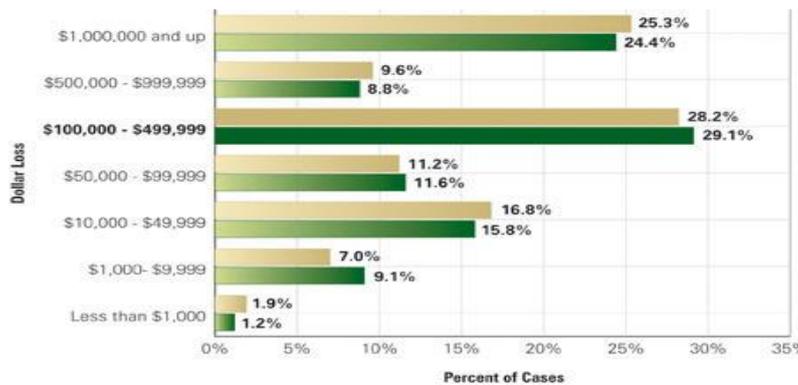


Figure no. 1 – Loss distribution expressed in US Dollars⁹

In fact, the investigation shows that, from the point of view of financial losses, there is not a big difference between 2012 and 2013. The results of this investigation reveal that there were not taken sufficient actions in order to prevent frauds or that there are new techniques used in presenting fraud or fraudulent financial situations.

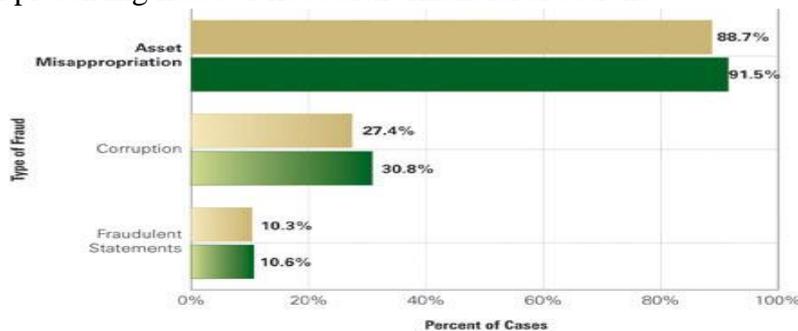


Figure no. 2 – The situation of fraud frequency by category¹⁰

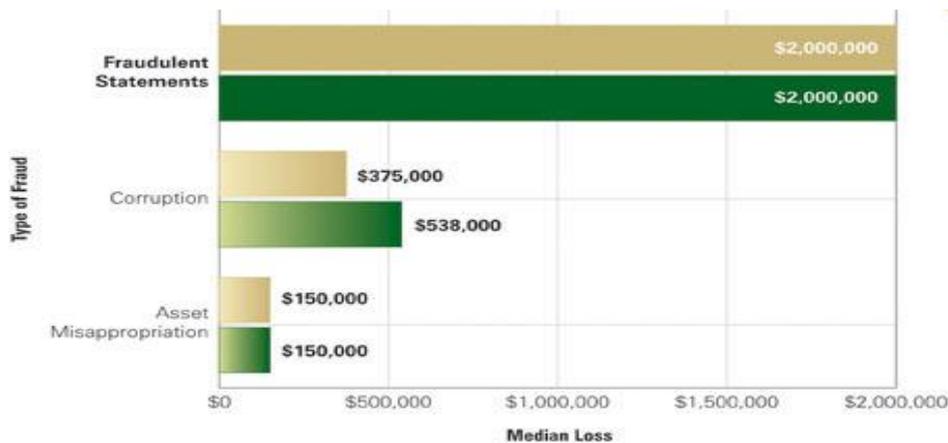


Figure no. 3 – The situation of fraud by category¹¹

I would like to highlight with the help of the figures shown above that fraudulent reporting represents only 10% of all fraud aspects registered. The investigation shows that the most “lethal” prejudice was done by fraudulent financial situations. The estimated prejudice is of 2,000,000 USD. Therefore errors or frauds on the paper (financial situations) have great

⁹ Source: ACFE (Association of Certified Fraud Examiners) 2013 Report to the Nation on Occupational Fraud & Abuse.

¹⁰ Source: ACFE (Association of Certified Fraud Examiners) 2013 Report to the Nation on Occupational Fraud & Abuse.

¹¹ Source: ACFE (Association of Certified Fraud Examiners) 2012 Report to the Nation on Occupational Fraud & Abuse.

effects on the fairness of data transfer. First of all people are affected by errors or fraudulent financial situations. In most of the cases, the financial loss due to errors in the financial situations has been determined in figures. Moreover, fraudulent financial information frequently leads to a loss of jobs for the employees, the rate of unemployment growing along, action that can have a negative effect on the economy. According to the investigation, the most frequent aspect of fraud is “embezzlement of funds”, yet this causes less harm than the fraudulent financial situations. This type of fraud represents 90% of all types of fraud and causes losses of 150,000 USD. If we analyze the figures it can be clearly observed that a large number of assets were stolen from an entity, which is more difficult than the manipulation of financial information and less dangerous than fraud.

The actual cost of fraud activities can be quantified with difficulty for the following reasons:

1. Not all frauds can be detected;
2. The frauds that are detected are not reported;
3. In many cases of fraud incomplete information is presented;
4. Relevant information is not presented to the management of the entity or competent authorities; and
5. Too many times the entity does not take action against the author(s) of the fraud (law suits).

Besides the economic effective loss of the entity, the indirect costs should also be taken into consideration, such as diminution of the productivity, costs related to law suits, the raise of unemployment and the time lost to investigate the fraud in the entity’s activity.

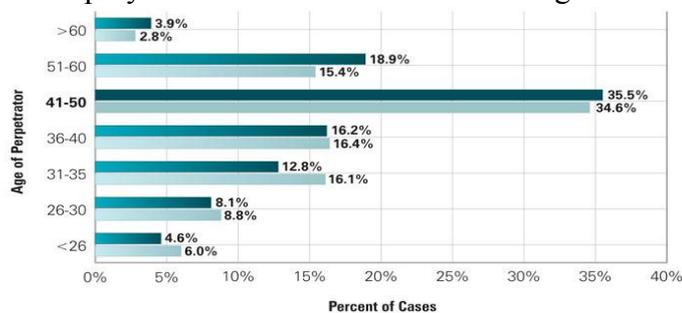


Figure no. 4 – The age of fraud authors¹²

According to the investigation conducted by the **Association of Certified Fraud Examiners**, more than half of the fraud cases studies were committed by persons with the age ranging between 41 and 50 years old. The age distribution was similar to the one in 2012. I succeeded in understanding that the managers that gain economic information and qualified information are using these with a view to trying to create “black holes” in the financial reports and are trying to manipulate in their own interest, this action leading finally to fraud. If we compare 2012 with 2013 we can observe that, from the point of view of fraud, the variation is not so great. According to the same institution, the figure below shows the ages at which fraud is committed and the losses suffered because of this action.

As one can observe, the tendency of fraud is higher for the ages between 41-50 years old, follow by those between 51 and 60 years old, but the negative effects are proportionally reversed. In many cases the most important positions, key-positions, are held by employees

¹² **Source:** ACFE (Association of Certified Fraud Examiners) 2013, Report to the Nation on Occupational Fraud & Abuse.

with large experience, which means that elder persons have key-positions and gained access to the resources of the entity. This is the explanation why 50 years old persons represent the mean of age and why in our study, the age of the fraud author has raised. Frauds committed by 50 years old persons have produced mean losses of 500,000\$, two times more than the ones caused by younger fraud authors.

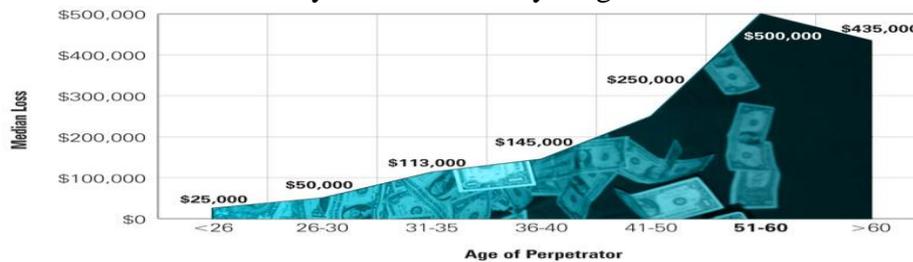


Figure no. 5– Age of fraud authors reported to earnings¹³

Bibliography

1. Ramos, M., *Risk-based audit best practices*. Journal of Accountancy, December, pp. 32-38, 2012;
 2. Riley, M. E., W. R. Pasewark, *Assessing the Allowance for Doubtful Accounts*. Journal of Accountancy September, pp. 40-46, 2011;
 3. Rotaru Viorel Horatiu - *Audit Risk and Materiality Threshold - towards Economic Risk and Audit Failure*, 5th WSEAS International Conference on Applied Economics, Business and Development (AEBD '13), Crete, 2013;
 4. Sanchez, M. H., K. F. Brown C. P. Agolia, *Consideration of Control Environment and Fraud Risk: A Set of Instructional Exercises*. Journal of Accounting Education no. 25, pp. 207-221, 2011;
 5. Sharman, P., *External Audit Failure*. Cost Management, 2011;
 6. Stolowy H., Breton G., *A Review of Research on Accounts Manipulation, Paper for the Annual Congress of European Accounting Association*, 2012;
 7. Wells, J. T., J. D. Gill, *Assessing Fraud Risk*. Journal of Accountancy, 2011;
- ***ACFE (Association of Certified Fraud Examiners) 2013 Report to the Nation on Occupational Fraud & Abuse;
- ***KPMG Fraud Survey 2013;
- ***OMFP 3055/2009 for approving simplified accounting standards according to European standards, applied since 01.01.2010.

¹³ Source: ACFE (Association of Certified Fraud Examiners) 20012, Report to the Nation on Occupational Fraud & Abuse.