FRAUDS AND UNINTENTIONAL ERRORS IN FINANCIAL STATEMENTS

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Abstract: *Financial statements, as the end product of accounting, aim to provide reliable, relevant, objective and true financial information. However, in dynamic and uncertain business conditions, there are numerous forms of financial frauds, such as false financial statements, corruption and alienation of property that impair the quality of financial reporting. The aim of this research is to point out the distinction between criminal actions (frauds) and errors in financial reports, with special reference to unintentional errors and the problem of defining the materiality threshold, and the impact of the threshold level of materiality to them. The research will be performed on the basis of available and current scientific and professional literature, with the application of comparative methods, methods of induction, deduction, analysis and synthesis. The results of the research show that reliable and transparent financial reporting is an important determinant of the stability of the financial system. Presentation and findings in research work can be of great importance for investors, creditors and other stakeholders, which will serve as a basis for them to make decisions on resource allocation.*

Keywords*: financial statements, criminal acts, fraud, errors, international financial reporting standards*

INTRODUCTION

If we start from the fact that the financial statements of all countries of the world aim to provide understandable, reliable, clear and comparable information about the business of economic entities, as well as that the audit of financial statements serves to confirm their truthfulness and objectivity, while respecting International Financial Reporting Standards, International Standards on Auditing and the Code of Ethics, it could be concluded that in the domain of financial statements there is no possibility of criminal acts and fraud. However, practice has shown quite the opposite. That is, in this domain, there are possibilities of various abuses that violate the interests of capital owners and that provide inaccurate information to investors, creditors and other stakeholders. Information about the financial position and performance of companies presented in their financial statements is of great importance to users, as they are the basis for making decisions about the allocation of resources. Therefore, reliable and transparent financial reporting based on true information is an important determinant of the reliability and stability of the financial system. At the end of the last and the beginning of this century, numerous financial frauds occurred, which indicated the existence of danger of losing confidence in the reliability of the financial information provided by the financial statements. The ability of financial statements to provide relevant information, especially to external users, has made them an important factor in the stability of financial markets. However, modern tendencies, the appearance of illegal activities of certain companies and the bankruptcy of large financial systems have led to a loss of confidence and doubt in the reliability of the information provided by the financial statements. Numerous frauds from the end of the previous and the beginning of this century have highlighted the problem of the quality of financial reporting. The fact that most of these frauds were accompanied by manipulations in the financial statements indicated the importance of achieving and maintaining the quality of financial reporting and the need for more adequate legislation in this area. In order to ensure the highest quality and safest financial reporting, it is necessary to unite the accounting profession, legislation and the state in one strong mechanism, which will formulate rules for controlling compliance with financial reporting standards. In addition to the fact that the international accounting and auditing profession, as well as state legislation, have taken preventive measures and mechanisms to combat criminal acts and fraud in financial statements, they often occur today. For this reason, a meaningful and thorough study of financial fraud is necessary.

Based on the above, the subject of the paper will be focused on defining and classifying the most common criminal acts in the financial statements, as well as on the ways of detecting them, while presenting and classifying the most significant errors in the financial statements. The aim of the research is to point out the distinction between criminal actionss (frauds) and errors in financial statements, with special reference to unintentional errors and the problem of defining the materiality threshold, as well as the impact of the threshold height on them. The paper will be structured in three parts. The first part will deal with the concept and classification of frauds in the financial statements, the second part will be dedicated to the

methods of detecting frauds in the financial statements, while the third part will focus on the classification of errors in financial statements and defining the materiality threshold.

1. CONCEPT AND CLASSIFICATION OF FRAUDS IN FINANCIAL STATEMENTS

The concept of frauds (criminal actions) in the financial statements is not precisely defined. When defining this term, the most common starting point is deception, forgery, theft, corruption, embezzlement, illegal appropriation, concealment of important and inaccurate financial data. Criminal action (fraud) in the financial statements is interpreted differently in different laws of the countries. That is, one country can interpret a certain action as criminal, while the legislation of another country interprets such action as a regular occurrence. Criminal action, ie fraud and embezzlement, is defined in the financial statements as an intentional act committed by one or more persons, who are in managerial positions, responsible for management, employees or third parties, all with the aim of gaining unfair or illegal benefit.[1]
A significant problem in determining criminal actions in the financial statements is the lack of a uniform classification. Fraud in financial statements typically involves:[2]

- falsification, alteration and manipulation of financial data, documents and business transactions;
- intentionally omitting or misrepresenting information about transactions or business events;
- intentional misapplication of accounting principles;
- overstatement of income;
- overestimation of assets;
- underestimation of costs;
- underestimation of obligations;
- incorrect disclosures.

According to the Association of Certified Fraud Examiners (ACFE), it is common for criminal actions to be classified into three groups, as follows:

1. False financial reporting,
2. Corruption and
3. Alienation and misappropriation of property.

False financial reporting is such a criminal act that deceives the users of financial statements in order to make financial decisions in favor of the legal entity that prepared the financial report. False financial reporting can also be defined as intentional misrepresentation of material facts or accounting data that causes the user of financial information, presented in the financial statements, to make wrong decisions.[3] Also, false financial reporting can be defined as intentional omission of amounts or disclosures in the financial statements, in order to mislead the users of the financial statements.[4]
False financial reporting can take the following forms:[5]

- Incorrect recognition of income, through: exaggeration of income (recording of fictitious and false sales), early recognition of income and recognition of conditional sales (transactions that are not yet completed due to unforeseen circumstances are recorded), abuse of the deadline for recording sales in financial statements, incorrect presentation of execution estimates, unauthorized deliveries or accumulation of deliveries, consignment sales (goods are delivered to customers on the basis of shipment, but are recorded as ordinary sales);
- Exaggeration of assets through exaggeration of final inventories, exaggeration of account receivables, exaggeration of property, plant and equipment (depreciation is not carried out when it should be);
- Incomplete expression or reduction of costs and liabilities through underestimation and reduction of costs and loans, exaggeration of receivables from suppliers, etc.;
- Misuse of funds through the recording of fraudulent transactions in order to create a fraudulent account balance;
- Inadequate disclosure of data using inadequate accounting treatment, e.g. recording assets at market or some other value than by price, inadequate recording of transfers of goods, non-recording of debts, omission of contingent liabilities from financial statements, etc.;
- Other miscellaneous techniques, such as direct falsification of financial statements.

According to the definition of the United Nations Convention against Corruption, corruption can be defined as the direct or indirect extortion, demand, receipt and acceptance of any amount of money, gifts or other valuables by officials for the purpose of illegal performance of their duties. Corruption undermines democracy and the rule of law, leading to violations of human rights law.[6] Corruption includes bribery, conflict of interest and other forms of corruption (such as takeovers, illegal rewards, economic blackmail). Bribery can be defined as offering, receiving or seeking some value for the purpose of illegally influencing the performance of a certain official action.[7] Conflict of interest implies a criminal act in which the perpetrator of fraud has a hidden personal interest in a business transaction that adversely affects the company.
The alienation of property in the company refers to the "theft" of property by employees that they will use for personal purposes. Unlawful misappropriation of funds is a criminal action in the financial statement by which the perpetrator takes, appropriates and uses the material assets of a legal entity. Practice has shown that misappropriation occurs most often as misappropriation of cash and supplies, while misappropriation of buildings, machinery, equipment and other tangible assets occurs much less frequently.[8]

2. METHODS OF DETECTING FRAUDS IN FINANCIAL STATEMENTS

When detecting fraud and embezzlement in the financial statements, it is necessary to investigate the reasons for the same. Some of the motives for committing fraud in the financial statements are:[9]

- Low level of income - most frauds in the financial statements are due to the need for the income statement to perform better than it actually is. Poor business performance can lead to management losing jobs or benefits;
- Decreased ability to raise capital - governing bodies provide false financial statements to encourage the acquisition of capital. Poor financial performance may impair a company's ability to increase capital through financing and other forms of action offers;
- General business opportunities - management sometimes cheats in the financial statements to make their company look better than it actually is, in order to have greater access to business opportunities;
- Compliance with bond clauses - fraud occurs to disguise the company's inability to meet the requirements of bond clauses;
- General greed - management issues false financial statements in order to advance or maintain existing positions;
- Theft, bribery and other illegal activities - management must cover up the embezzlement of large amounts of money by issuing false financial reports;
- Product placement - management seeks to cover up financial problems in order to retain customers, because customers are often afraid to enter into longer cooperation with companies that are in danger of failure;

Criminal action in the financial statements can occur if there are no internal controls that can detect or prevent fraud or embezzlement, if management is unable to assess the quality of contracted and performed work, if there are no mechanisms to punish the perpetrator, if the injured party does not have access to information; if there are a lot of potential injured persons who are ignorant, or have any barriers that will prevent them from detecting criminal activity and if the perpetrator is aware that he will not leave a trace.[10]

One way to detect criminal activity in financial statements is to own and use appropriate computer software. This software is based on sophisticated technologies and has the ability to monitor and record all illogical postings, employee actions, as well as the use of inadequate documentation. The software works by reporting all suspicious and unusual activities to controllers. In this way, the software can detect certain signals that indicate fraud, such as: similar names and data of customers or suppliers, a high level of activity of an existing or new business partner, transactions with business partners on accounts that do not match the given data, suspicious transactions related to checks, the frequency of refunds made to business partners by employees.

The most effective methods of detecting fraud are the so-called warning signs ("red flags"). Warning signs indicate when something is wrong in the business of the company, ie when there are certain deviations and irregularities, but they do not necessarily indicate the existence of a certain criminal act. The most common warning signs when creating false financial statements include: threats to financial stability or profitability due to economic, business or internal business conditions, too much pressure on management to fulfill the high set financial objectives, evidence that executive managers are financially dependent on the performance of the legal entity, very complex transactions or relationships with third parties, inefficient supervision of executive managers, unstable organizational structure, inefficient internal controls, inefficient reporting process, negative cash flows, unusual profits or sudden profit growth, sudden revenue and / or business growth, unusual and very complex transactions at the end of the reporting period, etc.

Warning signs that can be recognized in employees who illegally appropriate and alienate property are: avoidance of direct gaze, increased irritability, constant anger, tendencies to blame others, changes in lifestyle, etc. Another technique used to detect criminal acts is to interrogate employees, i.e. to interview employees, both those who committed fraud and other employees who may witness the investigation. The examination is conducted starting from the highest level (management), through the examination of members of the management and supervisory board and members of the internal audit, to the examination of other employees (staff at the operational level, managers, representatives ...).

Criminal actions in the financial statements, such as false financial reporting, can have different effects on certain positions in the financial statements. These are mainly the presentation of a better or worse property-financial position (in the balance sheet) and a greater or lesser financial result (in the income statement). Expression of a higher financial result can be achieved either by underestimating expenses or overestimating income. Expressing a higher financial result for the effect has an increase in stock prices, attracting new investors and maintaining the confidence of existing investors, payment of higher dividends, maintaining the existing position of manager, as well as more favorable conditions for new borrowings or loans. To express a higher financial result, in practice, more use is made of manipulations with the amount of income, because the benefits of manipulating revenues are greater than expenditures, in terms of improving the creditworthiness of companies or improving certain indicators used in financial analysis. Expressing a higher financial result by overestimating income leads to an increase in net assets and showing a better property and financial position of the company. Expressing a lower financial result can be achieved either by overestimating expenditures or underestimating revenues, which has the effect of: delaying the payment of taxes, or tax evasion, which will lead to a poorer financial position of the organization. All this will result in lower property tax, lower profit tax and lower value added tax, then, hiding high profitability from competition, not attracting attention from regulatory authorities and saving profits for years when business profits will be reduced.

3. CONCEPT AND CLASSIFICATION OF ERRORS IN FINANCIAL STATEMENTS

During the analysis of errors, in this part, the concept of errors in the financial statements will be given first, and then the classification of the same, as well as the period when they may occur, with emphasis on regulations that are valid in the observed period. When formulating the notion of mistakes, the notion of criminal action (fraud) and mistake is often equated, which is completely wrong. Fraud or criminal activity is characterized by the existence of a conscious intention of the persons responsible for compiling financial statements to present false information in order to achieve some specific goals (e.g. showing increased profit or concealing the realized loss). In the accounting literature, errors caused by the following are considered common:

1. Incorrect methodologies in the collection or processing of data used in the preparation of financial statements,
2. Erroneous accounting judgments arising from omissions or misstatements of facts and
3. Inadequate application of accounting principles relating to the amount, measurement, recognition, classification, presentation or disclosure.[11]

In the given classification of errors, the following table lists the most important divisions of interest to accountants.

Table 1 Distribution of errors [12,13,14,15,16]

Criterion	Type of error
Accounting basis applicable in Serbia	• **Material errors** are errors that are corrected over the initial balance of the current year and thus correct the balance and result of the previous year. • **Materially insignificant errors** are errors that are corrected in the current reporting period, ie those correct the condition and result of the current period.
The intent of the person who made the mistake	• **Intentional errors** are errors behind which the intention for the acquisition of benefits or uses is hidden. • **Unintentional errors** are errors that occur by accident without clear intentions and motives of the perpetrator.
Impact of error correction on balance sheet and / or income statement	• **Errors whose correction affects the balance sheet** represent errors whose corrections are visible in the balance sheet. • **Errors whose correction affects the income statement** represent errors whose corrections are visible in the income statement. • **Errors whose correction affects the balance sheet and income statement** are errors whose corrections are visible in the balance sheet and income statement
The way a mistake can be made	• **Errors caused by omitting** an item from the financial reports. • **Errors caused by reporting** the wrong amount, greater than or smaller. • **Errors caused by incorrect recognition of items** e.g. expenditure instead of funds, income instead of liabilities, funds instead expenditures, liabilities instead of revenues and the like.
Influence of regulations when defining error	• **Errors known by law** - a typical example of this error was present in Serbia concluding with the compilation financial report under December 31st in 2009 and this error is also called a fundamental error. Considering the fact that the professional regulations in Serbia have grown partly into legal ones, these mistakes can include materially significant and insignificant mistakes. • **Errors that are known by internal regulations** through the internal act and that may occur in connection with the recognition, measurement, presentation of elements of financial statements as well as through the disclosure of certain information in the notes to the financial statements.

It is a well-known fact that one of the three accounting bases is used in the accounting of Serbian companies: International Accounting Standards / International Financial Reporting Standards (IAS / IFRS), International Financial Reporting Standards for Small and Medium Enterprises (IFRS for SMEs), Ordinance on the manner of recognition, valuation, presentation and disclosure of positions in individual financial statements of micro and other legal entities (Rulebook for micro and other legal entities). Regardless of which of these bases the entities apply, it is the same way of accounting for significant and insignificant errors. In clarifying the errors in this article, we will use the most comprehensive basis, which is IAS / IFRS.

In International Standard 8 - Accounting Policies, Changes in Accounting Estimates and Errors[17], among other facts, in order to understand non-material errors, it is necessary to keep in mind the following statements:"

• Previous period errors are omitted or misrepresented data from the entity's financial statements for one or more periods resulting from the non-use or misuse of reliable information that:

(a) was available when the financial statements for the periods were authorized for issue; and (b) could reasonably be expected to be obtained and taken into account in the preparation and presentation of those financial statements. (Such errors include the effects of mathematical errors, errors in the application of accounting policies, misinterpretation of facts, fraud or oversight).

• Material misstatements or misstatements of items are materially significant if they, individually or jointly, could affect the economic decisions of users made on the basis of the financial statements. Material significance depends on the size and nature of the omitted or misrepresented item being assessed in the particular circumstances. The size and nature of the item, or a combination of both, can be a deciding factor.

• Errors may arise in recognizing, measuring, presenting or disclosing elements of financial statements. Financial statements are not in accordance with IFRS if they contain either materially significant errors or insignificant / immaterial errors that were made intentionally, in order to achieve a certain presentation of the financial position, financial performance and cash flows of the entity. Potential errors of the current period detected in that period are corrected before the financial statements are authorized for issue. However, materially significant errors are sometimes detected only at a later period, and those errors from the previous period are corrected in the comparative information presented in the financial statements for that later period.

• An error from a previous period is corrected by retrospective recalculation of the data unless it is impracticable to determine either the effects relating to a particular period or the cumulative effect of the error.

• When it is impracticable to determine the effects of an error from a particular period on comparative information for one or more presented prior periods, the entity recalculates the opening balances of assets, liabilities and equity for the earliest period for which retrospective recalculation is feasible (which may be the current period).

• When it is impracticable to determine the cumulative effect of an error on all prior periods at the beginning of the current period, the entity recalculates the comparative information to correct the error in advance from the earliest date for which it is practicable.

• The error correction from the previous period is excluded from the gain or loss for the period in which the error was detected. All presented information from previous periods, including any summary reviews of financial data from the past, is recalculated as retrospectively as practicable.

• When it is impracticable to determine the amount of an error (e.g., an error in the application of an accounting policy) for all prior periods, the entity shall restate the comparative information in advance beginning at the earliest date for which it is practicable. It therefore disregards part of the cumulative recalculation of the amounts of assets, liabilities and equity that existed before that date. Certain paragraphs in the standard provide guidance on when error corrections for one or more periods are considered impracticable."

When correcting errors, it is necessary to keep in mind the fact when the error was discovered and which part of the accounting basis should be applied. The answer to this question is best given by the following overview, which is given in the form of a table.

Table 2 Application of appropriate regulations depending on when the error was detected

Financial statements approved and submitted	The period in which the error was detected	The period to which the error relates	Applicable accounting regulations		
			IAS / IFRS	IFRS for SMEs	Rulebook for micro and other legal entities
June 30th, 2021	From January 1st to June 29th, 2021	From January 1st, 2020 to December 31st, 2020	IAS 10 – Events after the reporting period	Section 32- Events after the reporting period	Article 11 Events after the balance sheet date
April 30th, 2021	From May 1st, 2021 and in the future	From January 1st 2020 to December 31st, 2020	IAS 8 – Accounting policies, changes in accounting estimates and errors	Section 10 - Accounting Policies for Estimates and Errors	Article 10 Corrections of accounting errors
June 30th, 2021	From January 1st to December 31st, 2020	From January 1st 2020 to December 31st, 2020	The error is corrected in accordance with the regulations from the accounting basis that is applied.		

Based on the given table, the following conclusions can be drawn:

- That in case the error is discovered in the period before the financial statements have been approved, the correction of the error is made in the period for which the financial statements are prepared.
- In case the error is discovered in the period to which the error refers, it is corrected in that period, e.g. if an amount has been posted in error, it is corrected by cancellation.

From the above work it can be seen that the materiality threshold can be defined in different ways. The following table shows the modalities for defining the materiality threshold in the internal acts of the entities, i.e. in the Rulebook on Accounting and Accounting Policies.

Table 3 Defining the materiality threshold in the internal accounting act

Internal accounting act	Defining, describing the threshold of materiality
Modalities from the Rulebook on Accounting and Accounting Policies	Materiality threshold for the reporting period is obtained as **a product of operating income** from the balance sheet and 2%
	Materiality threshold for the reporting period is obtained as **a product of total revenues** from the balance sheet and 2%
	Materiality threshold for the reporting period is obtained as **a product of business assets** from the balance sheet and 2%
	Materiality threshold for the reporting period is obtained as **a product of total assets** from the balance sheet and 2%
	Materiality threshold for the reporting period is obtained as **a product of profit or loss** from the balance sheet and 2%
	Materiality threshold for the reporting period was obtained as a product of **100,000** € and 2%
	Materiality threshold for the reporting period was obtained as a product of **$ 100,000** and 2%
	The materiality threshold for the reporting period was obtained as a product of **$ 10,000,000** and 2%

These are just some of the modalities of defining the materiality threshold, and which of them is appropriate for the company depends on several factors. Certainly crucial is the one that will contribute to objective financial reporting and disclosure of a more realistic financial situation and success of a particular company.

4. CONCLUSION

Good financial reporting should be based on reliable, relevant, objective and true financial information. Only such information will provide quality financial reports, which will provide a high degree of security and trust, both for internal and external users. Reliable financial statements will be the basis for making business and financial decisions.

Previous analysis has shown that financial reporting is subject to criminal actions and fraud, i.e. illegal actions, which results in false financial reporting. False financial statements are compiled with the aim of manipulating the financial position and business results of the company, all with the intention of deceiving the users of financial statements and leading them to make wrong decisions. False financial reports mislead not only investors, both existing and future, but also lead to serious problems in the financial market. On the other hand, errors are also present in the financial statements as a type of unintentional actions that result in inaccurate presentation of data. Whether it is criminal actions (as conscious and intentional acts) or unintentional mistakes, the goal of every company should be to prevent their occurrence. Adequate and ethical performance of activities by managers, auditors, accountants, as well as government and regulatory authorities will have the ultimate goal of quality financial reporting. Otherwise, the financial reports will be based on criminal actions and misinformation, the consequences of which will have a negative impact on both one organization and the economy of one country. When defining the materiality threshold, we are of the opinion that the threshold that has long-term stability, i.e. the one that does not change, is more acceptable. From our point of view, it is more acceptable to use as a materiality threshold assets and a defined fixed amount than income, expenses, profit and loss.

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