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INTERNAL AUDIT AS A TOOL OF DETECTING CREATIVE ACCOUNTING AND FRAUD IN THE PROCESS OF EFFECTIVE MANAGEMENT IN ORGANIZATION

Abstract: The purpose of this article is to present the internal audit as a tool for minimalizing the risk of the creative accounting and the risk of fraud in business practice. There is shown audit process and own research in the field of audit sampling. The goal of the audit is to issue a fair opinion about the audited area, and the method of sampling is crucial in the process of detecting potential anomalies. The financial statements may contain some errors economic information may differ from the actual situation. The cause of irregularities in the financial statements may be committed errors, may be the use of creative accounting or in the worst case accounting fraud. Research conducted by the ACFE (Association of Certified Fraud Examiners) shows that the losses due to fraud and corruption are as much as 5% of revenues. The companies which are obliged to be audited in Poland - in accordance with the Accounting Act in Poland - the value of 5% of revenues will amount to not less than approximately 250'000 euros (5% of 5'000'000 euros) - the minimum annual loss due to fraud in these companies. Therefore it is important to properly build a system of "security", which may limit the potential loss of units.

The presented research shows that internal audit one of the the best way to detect and protect to fraud.

Key words: internal audit, fraud, creative accounting, audit sampling

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7.1. The audit process in the study and detection of symptoms of creative accounting

7.1.1. Internal audit process

Each audit will be most effective if there is a constructive cooperation between the "audit client" and the internal auditor. The objective of the internal auditor is to engage the "customer" at every stage of the internal audit. Despite the fact that each audit is different, the audit process is similar during performing audits and normally consists of four stages: an initial review, testing, reporting, follow-up audit.

At the initial review stage the auditor is going to know tested area, the internal regulations regarding the audited area - the procedures, instructions, decrees etc. On the basis of initial review auditor is developing a audit program and then opening meeting is organized. During opening meeting the auditor presents the purpose and scope of the audit and consults the organizational matters. An important part of this step is a review of the internal control system. This step should answer the question whether the system of internal control in the test process is sufficient or not. If internal control system is weaker then internal auditor need to take more documents to examine. Where is better internal control system, e.g. there are internal regulations, and they are precise and accurate, the potential risk of irregularities is lower. In the case of a well-designed system of internal control internal auditor shall perform limited tests of compliance. The essence of the study is to confirm whether designed and described in the regulation of internal controls exist.

In the second stage of the audit, conducting the audit we are going to test transactions. We examine specific documents - invoices, cash reports, payroll, etc. - and the essence of the audit in this stage is not to examine the existence of control but testing of transactions - the importance of the monetary values. At this stage, we use sampling. A number of documents to be tested depends on previous stage - the assessment of the internal

control system. At this stage, the auditor agrees recommendations with the "client". It is important that the recommendations are based on identified problems and agreed criteria - for example internal regulations, standards, acts, etc. Recommendations are agreed with "audit client" and presented in the report, which is part of the third phase of the audit.

"Follow-up audit" is last stage of audit and in fact it is verification if recommended in the report recommendations have been implemented or not. Common practice is to send a letter to client with request to inform auditor what steps have been taken and all recommendations have been implemented.

Standard audit process can be adjusted if the risk of fraud appears. In such situation we should go according to fraud detection procedures – we should extract area with risk of frauds and lead as a separate proceeding.

7.1.2. Audit sampling – own research

Sampling during performing internal audit is a key attribute of auditor's risk - if the sample is too small, the auditor may issue an incorrect opinion, make mistake. The error can rely on a positive opinion of the process tested when in fact there are many errors. In this case we can say that this is "*auditor's risk*". The reverse situation, "*auditee's risk*" is the issue of a negative opinion of the process tested, when in fact we should evaluate the process positively. Let's see as an example this situation: auditor takes a small number of documents for testing – eg. 30 invoices - where the entire population includes 1,000 invoices. In a sample auditor has identified five errors, and thus in the sample at every sixth document there are some irregularity. On this basis, the auditor gives a negative opinion. If it turned out that these 5 mistakes that happen are all the errors in the whole population - 1,000 invoices - we see that the error rate is 0.5%. In this case we are talking about "*auditee's risk*".

To avoid or at least minimize, against the risk of making a mistake (improper opinion) when issuing an opinion, the auditor should take the right amount of the transaction to the test (appropriate sample).

The following figures illustrate the results of my research conducted among internal auditors of units of Ministry of Justice. In the questionnaire I asked auditors about methods of sampling they are using in conducted audits. The first figure shows the results of respondents' answers to the question of what methods are used to determine the selection of the sample. 52.8% of all auditors use non-statistical sampling method - based on the judgment.

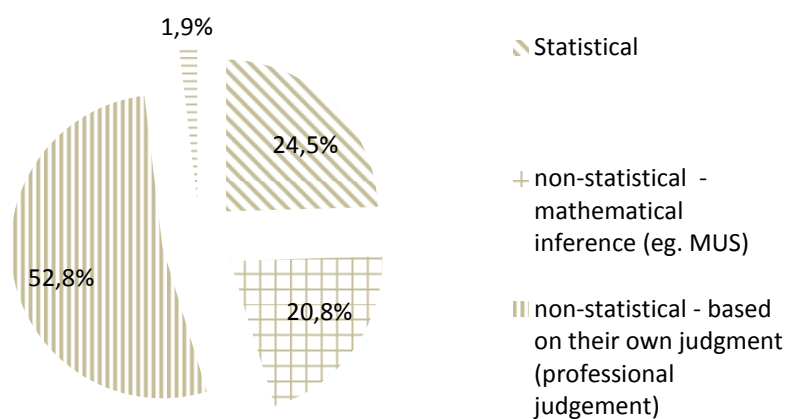


Fig. 7. 1. Sampling methods used by internal auditors

Source: own research

One of the next questions concerned the materiality used by auditors in the audit tasks. The question concerned whether the materiality is determined by the value, nature (eg. when the irregularity associated with fraud) or the context. Exactly half of the auditors applies a materiality threshold due to value, 25% due to the nature, 19.2% due to the context, and 5.8% in another way. Detailed data is shown in figure 2. The last issue is to answer the question of whether the materiality threshold is set

according to the value. Three-quarters of the auditors use materiality threshold on the basis of their own judgment. 17.2% of respondents sets a materiality threshold depending on the value of the population, 6.9% did not use a materiality threshold. Detailed data is shown in figure 3.

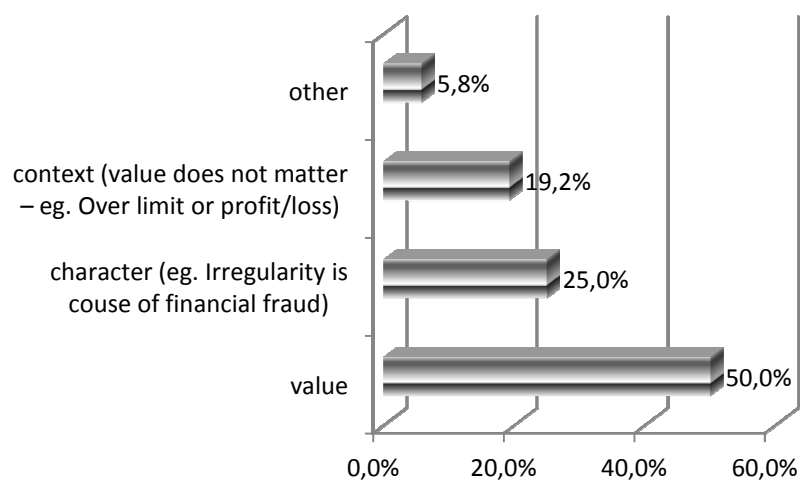


Fig. 7.2. Do you use materiality threshold?

Source: own research

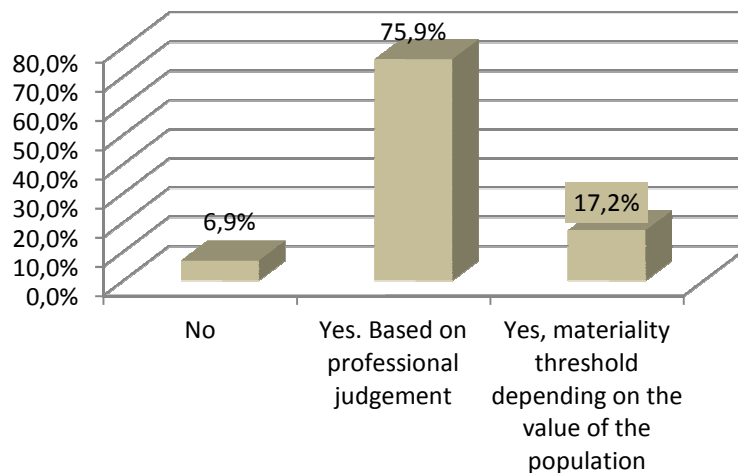


Fig. 7.3. Is the materiality threshold (in%) set according to the value?

Source: own research

7.2. Creative and fraud accounting and responsibility for accounting fraud

Entities, as indicated in the Accounting Act, are required to draw up financial statements and give it for auditing by the external auditor. The financial statements should be true and fair to show economic situation. Management is under pressure to show "appropriate" their financial situation depending on who is to be the "receiver" of the information. You would expect to "improve" their performance, but "coloring" of the financial statements is realized in both directions - for "a plus" and "minus". The situation of improving its image is more frequent - for example, in order to obtain a loan from the bank, increasing stock prices, obtain higher benefits by the management. However, there are situations where reality is showed in worse situation than it actually is, such as undervaluation the profits to reduce tax liabilities, "transfer" of profits for future period. For instance the situation at the end of accounting periods

if management will not receive bonus because not achieved goals (e.g. sales plan), transferred financial results (such as increasing sales) in future periods may affect the basis of the bonus for management paid in future periods.

Impact on the "coloring" of financial statements depends of unintended actions - making mistakes - or intentional actions such as creative activities (lawful) or fraud (unlawful). Based on the glossary of terms of auditing (International Federation of Accountants), issues related to fraud can be defined as:

- ***fraud*** - intentional action of one or more persons from the management, managing and supervising entity, employees or third parties using lies, in order to obtain an unfair or illegal advantage. For external auditor there are two types of intentional action: *resulting from fraudulent financial reporting* and *resulting from the appropriation of assets*;
- ***from fraudulent financial reporting*** - is associated with the intended irregularities, including those caused by omitting amounts, or disclosures in the financial statements in order to deceiving their users;
- ***appropriation of assets*** - applies to theft of assets of the entity and is usually perpetrated by employees in relatively small and insignificant amounts. It can also be caused by management, capable usually more to cover up or hide the appropriation of so difficult to detect.

The general rule is that financial statements should give a *true and fair view* of the situation. Sometimes accountants and managers are motivated to present the results, which do not show a true and fair view. Based on the definition of dr. prof. U.S. Dariusz Zarzecki, *creative accounting* (POLSKA AKADEMIA RACHUNKOWOŚCI, 2005) we have if the authorized statutory rules, customs and accounting policies are selected to present desirable, in the circumstances, the most expected company image, but not representing a reliable reflection of reality.

We can say that *accounting fraud* is an illegal, intentional and hidden, made in order to mislead the recipient financial information. As a *creative accounting* we can specify the action in accordance with the law, intentional and disclosed, made to achieve the objectives by “producers” of economic information.

Polish Language Dictionary defines fraud (SŁOWNIK JEZYKA POLSKIEGO PWN ON-LINE) as aware of the introduction of someone in mistake, or exploitation of one's fault for their own benefit. Expropriation is determined as taking over something or the granting of a rights to something.

The Polish Penal Code fraud is defined in the art. 297, and the consequence of such an act is imprisonment from 3 months to 5 years. The Penal Code dealing with yet another fraud that may be linked to economic activity - computer fraud or insurance fraud. Another example of crime against business is thwarting or impedes a public tender which is punishable by imprisonment up to three years (ART. 305 PENAL CODE).

In international regulations, we can find the definitions of fraud and corruption. Corruption (D. KAUFMANN, P. C. VICENTE, 2005) is defined abuse of public power for private gain. Another definition of corruption (World Bank) is the abuse of in the public or private sector in order to achieve personal gain.

7.3 Examples of fraud in the Polish economic practice

There are three examples of fraud committed by employees testify the scale of the problem occurring also in the Polish economic practice. Described below situations are quiet recent, and the common denominator is the position of the perpetrator - the chief accountant (an accountant) of company.

7.3.1. Half a million zł for private shopping and accommodation in hotels (interia.pl, 2012)

In the Lodz branch office of the General Directorate for National Roads and Motorways 34 years old employee for about 2.5 years extorted more than half a million zlotys, and extorted money spent among others on expensive shopping and accommodation in hotels. Perpetrator was employed in the Lodz branch GDDKiA as an inspector. Her tasks included, among others issues related to the fees provided by Public Roads law: the lease (use of part) of roadway, and the journeys oversized. The practice continued in the period from August 2010 to February 2012, and part of the duty charges do not affect the account of the Lodz branch, but on her private account. In total it was 10 transfers to the amount of at least 9 thousand zlotys to over 183 thousand zlotys. To make it more difficult to detect fraud, the woman did not show these revenues, which were transferred to her account. According to the prosecution she extorted in this way a total of over 505 thousand zlotys and tried to extort another 34 thousand zł. The prosecution accused her of abuse of power, fraud and falsification of accounting records. The indictment in this case already went to the District Court in Łódź. The woman is punishable by up to 10 years in prison.

7.3.2. Chef Accountant appropriates 1.6 million zł (serwisprawa.pl, 2011)

Chief accountant of a construction company within three years appropriated 1 600 000 zlotys. In addition to phishing she will be charged for crimes in the field of accounting and using a false document. She was responsible for whole financial matters, she have any possible authorization. As it turned out, for 3 years she led a double accounting. When business owners have figured out what she was doing, filed a notice of frauds. The police immediately took up the case, and after obtaining the relevant expertise of accounting 37-year-old heard the

prosecution allegations. She will be charged for an inappropriate conduct of accounting records and using a false document.

7.3.3. Chief Accountant municipal office defaulter of 2.2 million zł (onet.pl, 2012)

City of Ruda Slaska lost 2.2 million zlotys by its staff - city Treasurer. Lucy M. was the treasurer in municipal office in Ruda Slaska and at the same time and since the early 90's treasurer of the Workers' Grant&Loan Fund which associates 500 of the 581 employees in municipal office. Lucyna M. took decisions on loans till 2011 year. Woman, probably since 2001, transferred from a deposit ban account over 7.7 million zł. On this bank account there were deposits paid by companies participating in tenders organized by City of Ruda Slaska. Notification of suspected crime was submitted by President of Ruda Slaska, when it was detected that from deposit bank account disappeared 1,3 milion zł. Later turned out, this amount was higher, missing 2.2 million zł. Lucy M. died just after detection of irregularities. After the death of treasurer investigation was discontinued.

7.4. Summary

The purpose of this article is to present the internal audit as a tool for reducing the risk of creative accounting and fraud risks in business practice. In the article the audit process was presented and additionally presentation of research in the field of practice used by auditors in the sample selection. The research conducted by the ACFE (Association of Certified Fraud Examiners) shows us that losses from fraud and corruption are as much as 5% of revenues. The presented research shows that in some areas the best way to detect fraud is internal audit.

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