

## THE ROLE OF A COMPANY'S INTERNAL CONTROL SYSTEM IN FRAUD PREVENTION

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### Abstract

The emergence of internal control over specific segments of activities has been associated with management needs for evaluation of the consistency between the actual situation and development targets. Monitoring activities should enable detection and timely reaction to possible target-related deviations. While responding to complex market needs, companies are exposed to numerous internal and external influences, some of which may cause significant damage. Companies have realized that it is safer and cheaper to establish their own internal control systems in order to prevent such influences. The aim of this work is to show how the overall quality of control and company performance is improved through implementation of preventive methods by internal controls, and to indicate that a developed system of internal control represents a protective barrier against various kinds of data manipulation and fraud inside the companies. Special attention was paid to fraud in financial statements since it can cause the most serious damage leading to instability of the economic-financial environment.

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## INTRODUCTION

An efficient management system is a precondition for achieving company goals. Such a system indicates careful planning of long-term goals and coherence in realization. Since reaching targets is a complex and dynamic process which may go in the wrong direction, a management system therefore needs qualitative, well-timed and reliable information generated by continuous observation and control of all activities. Monitoring activities should enable detection and timely reaction to possible target-related deviations, without jeopardizing the process of activities.

Since partial, occasional and voluntary internal supervision could not respond to such information needs, it has gradually been transformed into a complete and permanent system of internal control of all important functions and processes. Although the function of supervision is a part of the management system and belongs to the exclusive competence of top management, it cannot be expected that management carries out the overall performance supervision. Even if we neglect the fact that management is mainly concentrated in strategy and the future, there still remain the problems of time needed for direct supervision as well as the specific knowledge to ensure qualitative and continuous monitoring of goods and cash flows within the company. However, management is considered responsible for setting up an adequate control environment and control activities to prevent undesirable events in business and reporting.

The aim of this work is to show how the overall quality of control and company performance is raised through implementation of preventive methods of internal control, and to indicate that a developed system of internal control represents a protective barrier against various kinds of data manipulation and fraud inside companies. Accordingly, the title was chosen to emphasize the role and significance of an internal control system, because internal control is the first step in the process of protection against fraud. The first part of this study examines the concept and importance of internal control, while the second concentrates on the essence and scope of fraud in financial statements, including also preventive internal control methods. Finally, the third part refers to the role and responsibility of management in organizing internal control.

## CONCEPT AND IMPORTANCE OF INTERNAL

The emergence of internal control over specific segments of activities was associated with management needs for information on business performance and its development. Thus, management was able to more precisely evaluate consistency between the actual situation and development targets. The original supervision was based on occasional, current and direct inspection of activities or additional inspection of documentation and information related to the work done. Although such an approach is still very important, the practice, however, has showed that management of a contemporary enterprise requires a different attitude toward supervision over processes and information. Modern business is characterized by complexity of goals and processes demanding qualitative, prompt and reliable information. Since occasional, partial and voluntary internal supervision could not meet such information requests, a complete and permanent system of internal controls of all important functions and processes in an enterprise has emerged.

### Essence and types of internal control

Among various definitions of internal control probably the most complete one was provided by the Committee of Sponsoring Organizations of the Treadway Commission: “Internal control is a process, effected by an entity’s board of directors, management and other personnel, designed to provide „reasonable assurance” regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations” (Rezaee, 2002, p. 212). International Standards on Auditing states that internal control system “means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information (Međunarodni standardi i saopštenja revizije: Značenje pojmovna, SRRS, Beograd, 2005, p. 144).

The essence of internal control is a comparison that enables evaluation of the current state in respect of an accepted base for comparison which may consist of tasks, regulations or instructions. The result of the control should be the confirmation that the current state is in compliance with established norms or detected deviations from such norms. Since internal control is not an event nor a circumstance but an array of activities that check a company's performance and since it is established and implemented by people, the board of directors and managers expect it to provide a reasonable, not absolute, assurance that the company's goals are achieved. But, constraints are imminent to human nature - management and employees are usually able to circumvent the system of internal control individually or by mutual agreement, making the internal control system useless.

Various types of internal control may be grouped into two main categories:

1) *administrative controls* – addressed to strengthen the successfulness and efficiency of performance, as well as the compliance with rules and management policies. Such controls are subject to business and compliance audit,

2) *accounting controls* – oriented towards the correctness of financial data and protection of a company's assets against unlawful conversion. As a result of increasing amount of fraud in financial reporting there is growing interest in control methods for protection of company assets. Accounting controls are considered by independent and internal audit.

Further distinction of internal control types could be carried out according to the following criteria (Kiziukiewicz & Sawicki, 2007, p. 269):

- 1) control executor,
- 2) control extent,
- 3) control period.

In regards to the first distinction criterion of control executor, there are:

1) institutional control, conducted by specialized units planned in the organizational structure specifically for this task,

2) functional control, related to duties of management in various positions in the company's organizational structure.

According to the control extent criterion we distinguish among:

1) complete control encompassing the whole range of questions,

2) problem control, concentrated on a specific question,

3) additional control, conducted in the case of selected issues,

4) follow-up control, carried out to see if post-control activities were conducted.

The control period criterion defines:

1) introductory control, oriented towards future operations,

2) current control, concentrated on operations during or after their fulfillment,

3) subsequent control, examining completed operations in order to determine whether business activity is performed in compliance with standards and to propose possible corrective measures. It includes periodic, formal and essential control.

We can expand the original set of criteria with an additional one – course of action – so as to define:

1) progressive control, which is directed from the first business transaction to the last one,

2) retrograde control, which is the opposite from progressive control, directed from the last business transaction toward the first one.

## INTERNAL CONTROL GOALS AND CONSTRAINTS

An internal control system should be the base for the development plan of each company. A successfully developed internal control system is a necessary but not sufficient condition for efficient management. Internal controls cannot resolve all of a company's problems. However, inefficient internal controls or their lack may cause serious problems for the company. Internal control becomes a part of the management process. Nevertheless, even the most effective internal control techniques are not remedies for bad solutions, inefficient management or external and unexpected events. On the other hand, good management and effective internal controls can limit the effects of unfavourable conditions through identification and quick response to such conditions.

Internal control consists of all mechanisms and procedures covering all the activities and ensuring efficient and safe functioning. It includes preventive actions which support achievement of the following **goals**:

1) consistent realization of business strategy and efficient use of available resources,

2) risk identification and handling on a regular basis, asset preservation, reliable and complete data needed to access the financial situation and prepare the financial statements on time,

3) compliance with laws and regulations as well as the internal codex and instructions.

With regard to these goals, each enterprise should have an internal control system. It is a hierarchical system of different control areas, methods, and means for its implementation in observing and registration, detection of deviations and their causes, as well as in presentation of results.

Understanding the nature and goal of internal control can be a challenge for many directors and members of management and supervisory boards. They oppose lengthy and often boring reports and other documents, as well as advice of numerous experts who present the subject in a much more complicated way than necessary. Therefore, directors usually understand internal control as “bureaucracy”. Indeed, too complex methods and procedures discourage initiative and lead to unnecessary spending of a company's resources. Internal control actually aims to help the company to achieve its goals. It is important to distinguish internal control from various types of external controls. Namely, internal control facilitates efficiency and effectiveness and is therefore a necessary condition for long-term survival of the company, while it may operate well without external control.

Efficiency of internal control may be constrained by management, employees and secret agreements. Management is sometimes a limiting factor due to possible omissions during the control process. Employees can make mistakes while processing orders and come up with wrong conclusions. Secret agreements among a few individuals may take place in order to usurp a company's assets, which can be prevented by clear division of tasks and responsibilities.

### **Instrument of internal control**

There are some factors common to each organization and specific instruments in building the system of internal control suitable for the majority of organizations. These are the following:

- 1) organizational system,
- 2) accounting system,
- 3) internal audit,
- 4) cadre,

5) balance sheet.

6) regulation of product and service quality.

**Organizational system** directly impacts the system of internal control. The organizational system needs to be established in such a way that the internal control system becomes an automatic process, resulting in a significant decrease of deviations in business. Internal organization, work positions and task systematization organizes work in distinct organizational units: departments, sectors, business functions, etc. Inside the units there is a task and work position determination. Detailed tasks are defined for each working position together with internal control practices. Therefore, responsibility for internal control is determined. It is important to emphasize the control of worker participation in business performance, and to ensure that the same person does not perform in all phases of the business process. Thus, control should be incorporated into organizational structure as an integral part and contribute to the improvement of business activities. Managers of all organizational levels are responsible for regular and complete functioning of business units, while internal units or departments are responsible for efficient functioning of its internal controls. Competence, authority, and responsibility should be defined through internal acts for long-term functioning without internal conflicts.

**Accounting system** represents the key instrument of internal control because of the amount and importance of the data it produces. With its segments (accounting, planning, analysis and supervision), it should develop accounting internal controls because the extent and depth of performance examination by external control depend mainly on the reliability of the accounting internal control. The accounting system is important and extensive and has its own internal control instruments as the following:

- 1) accounting standards,
- 2) chart of accounts,
- 3) accounting regulation,
- 4) business plans and programs, decisions and instructions,
- 5) cost accounting system,
- 6) documentation.

**Internal audit** is a separate unit in the organization which supervises the functioning of internal controls and estimates their efficiency. By collecting and testing the proofs internal audit provides a professional appraisal of the internal control system and gives recommendations if weaknesses are detected. If the organization does not have internal audit, it should more intensively use other

instruments of internal control, and organize a separate professional commission to conduct the analysis of its internal control system.

**Cadre** is a key factor for achieving the established business targets and carrying out the internal supervision. A qualitative professional cadre is a rare and constantly missing resource. Development and functioning of an internal control system depends on its structure and competence. Cadre strengthening improves the system of internal controls and therefore contributes to better business efficiency of the company.

The **Balance sheet** is a very complex control instrument. It is a legal obligation that must be met once a year, usually at the end of the year, and is incorporated into the annual financial statement. The aim is to determine the real state of assets and sources. Due to exceptional occasions (mergers, separation, division, handover, theft, etc.) the balance sheet may also be requested throughout the year. Usually, additional balance sheets are partial, while end period balance sheet need to be complete. It is a legal obligation, but is conducted upon a manager's order. There is a commission producing it and making the report which is forwarded to the management board for further consideration and acceptance. The management board approves the balance sheet.

**Regulation of product and service quality** is connected to standards as minimal quality requirements for goods and services. Increasing market demands, competition, ecology, globalization and other factors have contributed to the emergence and development of product quality management. The ISO 9000 series of standards appeared in Europe with a tendency of constant development and enlargement.

### **Internal control in detecting and preventing fraud**

Earlier internal control used to deal with fraud more directly than today. The situation started to change when the scope of internal control services expanded, so the accent was more on preventing than detecting fraud. It turned out that effects were greater if a good internal control system and management procedures were developed to reduce the possibilities of fraud. Such a transition from fraud detection to development of better systems and procedures for fraud prevention enabled internal auditors to provide more constructive services through the operational audit. However, internal auditors

should always be aware of their real responsibilities while providing help in fraud prevention and detection. Management bears the responsibility for fraud. Nevertheless, there always appears the question during the fraud investigation “When was the last audit conducted?” or “Where were the auditors?”. Once fraud takes place, auditors become responsible to explain why they failed to detect weaknesses that could lead to a fraud.

Internal control is expected to identify possibilities of better prevention which is more desirable than detection. The role of internal control is determined by the standards of professional practice. According to these standards internal auditors should be aware of intentional violations, mistakes and omissions, inefficiency, spoilage, ineffectiveness, and conflicts of interest. Internal control cannot provide absolute assurance in avoiding irregularities, but it can highlight the probability of faultiness. Standards do not place the responsibility for fraud detection on internal control. Yet these standards require internal auditors to expect potential conditions for fraud, identify the possibility for their existence, and to be aware that fraud might occur during the auditing process.

Numerous financial scandals have proven that many financial statement frauds were influenced intentionally or not by external auditors' advice and lack of warning when the risk of fraud existed. Therefore, companies have realized that it is safer and cheaper to establish their own internal control system in order to prevent fraud in the future.

### **ESSENCE AND SCOPE OF FRAUD IN FINANCIAL STATEMENTS**

Manipulation of financial statements may shake up even the most developed capital markets, disturb their functioning and lead to a less or more serious financial crisis. Decrease of investments, GDP, and employment also affect a national economy. It is widely known that the decrease in investment attractiveness resulting from uncertainty, higher risks and an inefficient capital market slow down economic activities. Therefore, financial statements can contribute to or threaten the stability of the economic-financial environment. High-quality financial statements do not only represent the interest of investors and accounting profession but also of the regulatory bodies and relevant state institutions.

## Nature of fraud in financial statements

Financial statements based on International Accounting Standards should present correct data as the basis for the decision making process. Without qualitative financial reporting it is not possible to manage the company adequately, attract potential investors, procure desired loans, influence share prices at stock exchanges, etc. Managers usually receive a fixed salary and a premium if owners expectations are achieved. There is a risk that managers might abuse their position by setting their own interests before the interests of their company, which may lead to undesirable consequences for the shareholders, investors, other stakeholders, the capital market and society in general. Almost all business scandals in the last years were the result of fraud in financial statements. A large number of financial scandals in the USA (Wordcom, Enron) and in Europe (Parmalat, Ahold) demonstrated that even in developed market economies scandals can negatively influence the status of employees, pensioners, business partners and other parties which are not protected from the risk of fraud. Globalized, financial markets detect frequent frauds at national as well as at the international level. Large disorders in regional capital markets caused by frauds in financial reports have initiated serious monetary shocks, especially in developing countries, since they are very sensitive to international financial frauds.

Frauds in financial statements could be defined as conscious violation of accounting standards while making financial reports and presenting false data. Such frauds exist as long as financial reporting is oriented toward the achievement of a manager's short-term goals. They are present not only in transition countries but also in countries with developed economies and traditional financial reporting. Frauds in financial reports in the recent past have caused devastating effects in developed countries leading to the emergence of global financial crises.

Pursuant to International Audit Standards (IAS) frauds in financial reports are considered criminal activities of intentional wrong data presentation (Međunarodni standardi i saopštenja revizije“, Savez računovođa i revizora Srbije, Beograd, 2005, p. 277) Association of Certified Fraud Examiners (ACFE) defines financial report frauds as “the intentional, deliberate, misstatement or omission of material facts, or accounting data which is misleading and, when considered with

all the information made available, would cause the reader to change or alter his/her judgment or decision“ (Zabihollah, 2002, p. 2). The American Institute of Certified Public Accountants (AICPA) defines financial statements fraud as “intentional mis-statements including omissions of amounts or disclosures in the financial report to deceive financial statement users”.

The consequences of financial statement fraud can be very unpleasant, sometimes even dramatic. The most common reasons for such fraud are managers' personal benefits. Those benefits are always gained at the cost of other interest groups, so managers are able to enjoy favourable results only in the short-run. In the long-term consequences are negative and mostly affect those who do not participate in the financial fraud. Damage can be direct and measurable in terms of realized loss or omitted gains, as well as indirect such as omitted dividends or capital gains. Opportunity costs in terms of omitted gains because the best investing alternative was rejected are good examples of certain damage which is not easily measurable. Financial statement fraud may be accomplished through:

- 1) falsification of material facts, documents or business transactions,
- 2) false presentation of events, transactions, accounts, and other important information which is included in a financial report,
- 3) deliberate wrong use of accounting principles, policies or procedures which serve to evaluate, recognize and record business transactions,
- 4) false presentation of financial information in financial reports. (Wells, 2005, p. 324).

Damage to the accounting profession due to financial statement fraud, although hardly measurable, is certainly significant. Despite enormous efforts this profession puts in establishing qualitative regulation, it is still impossible to develop perfect rules, and there is also creative interpretation of rules, as well as the unethical behavior of managers, accountants, and auditors. Lost trust in the quality of the financial reporting system and reliability of auditing opinion is an inevitable consequence. Since financial statements may have hidden losses, there is a huge risk for those who make decisions on the basis of such information. Consequently, information risk increases the costs of accounting information.

## Forms of financial statement fraud

According to International Accounting Standards or national regulations financial reports usually contain a Balance Sheet, Income Statement, Cash Flow and Comments on financial statements. Practice has shown that the majority of financial statement frauds were conducted through manipulation of revenues and expenses in the Income Statement and also of assets and obligations in the Balance Sheet. These financial statements are subject to manipulations, while some others are less likely to be subject to manipulation. The purpose of creating false financial reports is to impact the level of current profit through:

- 1) presenting greater profit by increasing revenues and/or decreasing costs and current period losses,
- 2) presenting lower profit by decreasing revenues and/or increasing costs and current period losses.

The majority of financial statement fraud is committed by manipulating revenues and expenses in the Income Statement. Manipulation of revenues can be classified into two main groups:

1) **False revenue increase** – aims to increase the periodic profit usually in order to hide losses or to bring bonuses. Accounting steps to obtain greater profit are:

- a. double booking of the same customer invoices,
- b. booking of fictitious invoices,
- c. recognizing revenue in advance,
- d. revenue swelling,
- e. converting reserves into revenue.

2) **False revenue decrease** – revenue decrease is displayed in order to avoid periodic “jumps” in revenues. Namely, “jumping” high in one year may cause the sense of a great fall in the next year and thus the stock prices may fall independently of realized profit. For such reasons managers tend to make the impression of stable revenue growth instead of big oscillations. Reduction techniques are various:

- a. not issuing invoices for continuous delivery at the end of period,
- b. postponement of revenue recognition,
- c. grey market trading,
- d. not issuing invoices for partial sales/work done,
- e. revenue carried forward to the next year, etc.

A direct impact on results alternatively may be obtained by cost manipulations, such as the following:

1) **False expense increase** – striving to reduce profit and company tax obligations. Accounting techniques

for false expense increase are:

- a. paying managers' private bills through the company,
- b. fictitious accounting,
- c. aggressive assets write-off (“Big-bath accounting”),
- d. avoiding deferred cost if necessary,
- e. invoices for services from other companies giving the impression of larger revenue in their bookkeeping activities,
- f. increase in depreciation expenses,
- g. planning costs above the usual level and costs related to non-existent risks.

2) **False expense decrease** – reasons are mainly to avoid losses, to hide losses or to increase profit in order to receive bonuses and other payments. Accounting techniques for the false expense decrease are:

- a. lowering depreciation expenses, removing current expenses from the Income Statement and its recapitulation,
- b. deferring of current costs,
- c. not booking suppliers' invoices,
- d. postponement of costs in the current year (not writing-off receivables and supplies or not planning risk costs although it should be done in the current year).

There are various schemes often used in financial statement frauds:

1) **Improper Revenue Recognition** – by recording sales to nonexistent clients (fictitious sale) or recording a sale even if its realization is questionable,

2) **Improper Capitalization of Costs** – excessive capitalization of expenses connected with internally built means, capitalization of means which do not bring future benefits, capitalization of R&D expenses, capitalization of administrative expenses, capitalization of expenses before the activity has started,

3) **Overstatement of Assets** – failure to pay off old suppliers and/or not making adequate deductions for non-collectable receivables, recording non-existent supplies or not taking into account depreciation of assets,

4) **Unrecorded Liabilities** – omission of a real cost increase in a given period or obligations at positions that rarely appear,

5) **Inadequate disclosures** – hiding the going-concern problem, guarantees for other's debt (Stefanović, p. 8).

Each type of financial statement fraud can be discussed in detail and all of them provide false and unreliable financial information that may be misleading to the users of financial statements. There are numerous motives for financial statement fraud, but the main reason is creation a false image of financial standing. Also, managers commit financial fraud to keep profit at a certain level and keep investors, postpone payment of income tax, and – which is not rare – they use such manipulations for their personal benefits.

### **Internal control in preventing financial statement fraud**

Generally, responsibility for internal control system functioning must be attached to the highest hierarchical level in the company. Companies should develop an internal control system able to fully protect both owners and resources. It includes procedures designed to lower the risk of criminal activities and obtain reliable and objective financial reports. Internal control officers are often considered exclusively responsible for preventing criminal activities. However, primary responsibility for the effectiveness of internal control still rests with the management system of the company. Firstly, internal control standards suggest making a list of potential criminal activities, i.e. :

1) investigating if there is a risk of criminal activities (jointly with the managing authority),

2) investigating (jointly with the external auditor) possible material errors in financial statements (Fraud Risk Management: A guide to good practice, 2009, CIMA, p. 9).

In order to achieve a successful performance of internal control in fraud detection it is necessary to:

1) acquire the knowledge of an internal control system – it is necessary for management to acquire the knowledge of key elements of internal control and the way they function. It means the estimation of control usefulness and applicability – whether the control, individually or in combination with other controls, effectively prevents, detects and corrects material errors. Understanding of an internal control system is achieved by:

- a. conducting the preliminary review,
- b. documenting the internal control system,
- c. identifying transaction cycles,
- d. conducting the procedure of “walking” through transactions,

e. designating control procedures which can be relied upon.

2) Estimate control risk – no matter how efficient an internal control system is, none can completely prevent false data due to errors, and especially due to secret agreements of employees and managers. It is therefore necessary to estimate the reliability of an internal control system before deciding upon the scope of further activities. This step helps to evaluate the purposefulness, successfulness and structure of internal control in detecting and preventing false material data in financial statements. During control risk assessment it is possible to notice whether possible errors or frauds may appear in financial reports. Control risk evaluation is forwarded to the management and auditing committee if there are significant omissions in the internal control system. Accordingly, while evaluating control risk it is necessary to:

a. consider potential fraud or errors that may appear in financial statements,

b. consider necessary control steps for fraud and error prevention,

c. conduct control tests and evaluate control risk,

d. inform the responsible bodies about the internal control omissions observed (Petković, 2010, p. 156).

3) Determine the effect of control risk assessment on essential tests – after assessing the internal control usefulness, and if it is estimated that fraud may appear and alter significantly the data in financial statements, it is necessary to determine the overall response for financial statements and further procedures whose nature, time and scope are adequate for the estimated risks. It is reflected through the essential tests affected by control risk evaluation. If control tests reveal favourable data about the successfulness of the internal control system and control risk level, then the size of the essential tests may be reduced. Usually, the estimated control risk level is not low enough to completely eliminate the need for essential testing. That is why the relevant balances as well as transaction types should be submitted to essential testing. On the other hand, if it is estimated that internal controls are weak and unsuccessful, which means that the risk of fraud is greater, it is necessary to conduct wider essential testing.

Internal controls must be correctly evaluated in order to be useful, and to reveal financial statement fraud in time.

## INTERNAL CONTROL TECHNIQUES IN FINANCIAL STATEMENT FRAUD PREVENTION

Internal control and other types of control (external auditing and forensic accounting) should develop and describe techniques for dealing with criminal activities. It is very important in fraud prevention because all participating subjects are informed about how to handle fraud. Documenting will support the supervision of preventive controls or suggest that such controls are ineffective. Testing of the procedures which ensure adequate operations of preventive controls and their results have to be documented in detail. The most important is that documentation contains a detailed description of elements used to prevent financial statement fraud, emphasizing the roles and responsibilities of all participating parties. When companies evaluate management programs to fight fraud, or try to improve such programs, they should also evaluate techniques for fraud prevention. Therefore, a company should, with the help of internal and external auditors, periodically evaluate preventive techniques in order to make sure that none of the preventive control elements has been warped. Internal control enables an additional evaluation process and preventive techniques by external auditors and forensic accountants who analyze them in detail and report in the case where specific programs are not as supposed or their consistent implementation will cause more damage than benefit. One of the best ways for prevention of financial statement fraud is in providing a control environment which encompasses:

- 1) a codex of behavior, an ethical policy in order to establish a proper attitude towards fraud prevention at the highest level of organizational structure,
- 2) ethical and warning programs of communication for alerting and reporting the noted deviations,
- 3) instructions, practice and rewards for employees,
- 4) supervision by audit committee and managing board,
- 5) investigation of reported cases and elimination of any confirmed fraud.

The plan, approach and scope of monitoring fraud in financial statements should be documented and upgraded in every company. Taking into account all parties which participate in risk process evaluation and subsequently designed control activities, it is very inconvenient to require that an independent body regularly monitor

the fraud preventive measurements. Additional revision should be conducted separately from any routine or planned audit. Forensic accountants, as a special kind of controller, should deal with the implementation of continuous internal control, and a positive result may be guaranteed. Before any program revision, problems such as significant changes in organization and their risks, changes in responsibilities for activities implementation, as well as the result from the previous investigation, will determine the extent to which the current investigation scope has to be changed. Each evaluation should contain proofs that the management are actively involved in the management risk of fraud, and that the corrective measures were undertaken in time.

## ROLE AND RESPONSIBILITY OF MANAGEMENT IN ORGANIZING INTERNAL CONTROL

Management is responsible for the establishment, maintenance, and monitoring of internal control structure to ensure the achievement of company's goals. Its tasks are as follows:

1) **creating the culture of ethical behavior** – management is responsible to clearly explain to all employees how they are expected to behave. The basis of a business environment in which the company can successfully deal with fraud is a strong system of values formed through various codes of conduct, an ethical codex, etc. At the same time they make grounds for creating the culture of ethical behavior which consists of:

- a. personal example,
- b. creating a favourable working environment,
- c. adequate recruitment,
- d. employee training and development,
- e. accepting responsibility and norms of behavior,
- f. punishing (<http://www.aicpa.org/download/antifraud/SAS-99-Exhibit.pdf>, accessed 08.07.2012).

2) **estimating reliability of an internal control system** – none of the financial statement frauds could be conducted without the identified possibilities for their performance and camouflage. A weak internal control system increases such chances. That is why management has responsibility to periodically estimate the effectiveness of internal controls in preventing fraud by:

- a. evaluating and measuring risk factors of financial statement fraud,
- b. considering possible ways of fulfillment,

- c. putting emphasis on detected risk factors,
- d. assessing the successfulness of internal controls which ease the risk factors.

3) **designing and implementing internal controls directed against financial statement fraud** – although internal controls reduce the possibility of financial statement fraud, there is always a certain degree of risk that they will not perform the way they were supposed to. None of the internal control systems is immune to fraud, especially in the case of secret agreements between employees. However, there is a dilemma related to special control steps designed for fraud prevention. Contemporary management and control theory and practice imply that there are *fraud specific internal controls* which represent a “system of special control procedures designed and derived for the basic, if not exclusive aim of fraud prevention and discouragement” (Davia, Coggins, Wideman & Kastantin, 2000, p. 102). Correct design and implementation of those controls enable a company to achieve its goals for property protection against illegal action,

4) **supervision of internal control performance** – an internal control system must be supervised in order to estimate if controls still function and whether changed risks have imposed the need for implementation of new control procedures. Management together with other bodies (such as an auditing committee) should be strongly involved in supervision of internal controls. Monitoring could start with “self-assessment” among persons responsible for important accounts, procedures and operations including the non-management staff. Management and the auditing committee should analyze the results. Management should also evaluate the purposefulness and effectiveness of supervisory activities over internal controls, and document their estimation and conclusions. The aim of documenting is collection of proof in favour of management’s supervisory program and activities. Documentation should be sufficient for auditors to understand how the management has conducted the program and conclusions regarding design and operational effectiveness of supervisory activities. Documentation following the supervision over internal controls for detecting criminal activities might include:

- a. management and auditing committee’s estimations regarding the supervision and assessment of internal control successfulness in preventing financial statement fraud,

- b. omissions and weaknesses of internal control which should be considered at the responsible organizational level of the company,

- c. internal controls which are “refreshed” and changed as a result of internal control activities in fraud prevention (<http://www.deloitte.com/dtt/cda/dc/content>, accessed 08.07.2012).

## CONCLUSION

Dynamic market growth has contributed to increasing competition, forcing companies to adapt to changing demands. While responding to complex market needs, companies are exposed to numerous internal and external influences, some of which may cause significant damage. In order to avoid this, companies tend to establish an effective internal control system. The primary task of internal control is not finding the cause of fraud, but rather detecting and stopping further fraud expansion. An internal control system, if well designed and functioning, ensures that it will be successful in all segments. However, even then it happens that internal control is not able to find the solution to fraud. To overcome such problems internal control should cooperate with other controls (external auditing and forensic accounting) and, as far as it is capable, implement new methods and techniques for fraud prevention. Preventive techniques used by internal control ease the job of detecting frauds. These techniques are a necessary part of the overall process, because if used correctly, the chances of fraud detection increase. Preventive methods are not new, they have always been present inside the company, but in different form. They should be treated with much attention, because their adequate implementation increases the quality of business performance and control. Internal control should gradually implement new methods for fraud prevention. Nevertheless, internal control should at least consult other controls while handling fraud in order to increase the quality of a company’s defense mechanisms. The considered internal control techniques for fraud prevention may be practically implemented only when a company has a developed system of internal control which regularly performs the process of control. Many companies do have internal control but its role in fraud prevention is marginalized, especially when managers are personally involved in fraud.

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