FINANCIAL REPORTING AS A FACTOR OF CORPORATE CRIME

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Abstract

Corporate crime is a phenomenon that marked the XX century. The first half was marked with two major world economic crises (The Great Depression) and the second with an increasing number of massive corporate scandals..

Corporate crime stems from business activities and although there were financial scandals in previous centuries, corporate crime was in full swing in the last two decades. Modern business has significantly dematerialized and transformed into virtual reality, which on one hand represents a significant breakthrough, but on the other hand it opens a wide space and offers modalities for perpetrating crimes in the field of finance. Nevertheless, regardless of the conditions of modern business, the basic reason for corporate crime derives from human greed, namely, the wish to acquire resources which are limited by nature. What is significant is the fact that this type of fraud is spreading, and as a consequence there has emerged a need to study this concept from the scientific and professional perspectives, so as to find a solution and enable corporate crime prevention.

This paper will analyse corporate crime, errors, victims and financial statements as possible key points in meaning corporate crime. So, to point the corporate crime we also point out need of knowledge of accounting and rules for making financial statements, sufficient experience in coping with corporate crime incidents, the protection of interests in business is still not perfectly clear, starting from the fact that it is hard for creditors to protect their interest and collect their receivables to the fact that the interest of a certain party prevails over the common interest, management or owners, often establish a big number of small companies, directly or indirectly connected and thus break their business into pieces with an aim to avoid the audit of financial reports and overall fraudulent financial statements cause substantial damage to economy. Further will be offered the essentials that fraud examiners who investigate should be good and experienced experts in this field who will recognize the symptoms of modified financial statements.

Key words: corporate crime, fraud, victims, financial statement, mistakes.

INTRODUCTION

Corporate crime is a phenomenon that marked the XX century. The first half was marked with two major world economic crises (The Great Depression) and the second with an increasing number of massive corporate scandals. What is significant is the fact that this type of fraud is spreading, and as a consequence there has emerged a need to study this concept from the scientific and professional perspectives, so as to find a solution and enable corporate crime prevention.

Corporate crime stems from business activities and although there were financial scandals in previous centuries, corporate crime was in full swing in the last two decades. Modern business has significantly dematerialized and transformed into virtual reality, which on one hand represents a significant breakthrough, but on the other hand it opens a wide space and offers modalities for perpetrating crimes in the field of finance. Nevertheless, regardless of the conditions of modern business, the basic reason for corporate crime derives from human greed, namely, the wish to acquire resources which are limited by nature.

A big number of professionals studied and have been studying this field, but since it is very dynamic, a number of diverse and more complex business combinations have appeared with the aim of concealing corporate crime. For this reason, numerous experts from different fields (accounting, auditing, tax advisors, lawyers) have been engaged to implement their knowledge in order to present certain business changes, which are a part of a criminal scheme, in the most regular way. The essence is to present the overall business of a company in business records and summarize it in financial statements, so they have become the tools with which corporate crime is committed.

CORPORATE CRIME

Corporate crime is a rather broad concept and it refers to different types of frauds and abuses related to business. The concept of corporate crime refers to acts committed to harm or benefit a company and includes criminal acts ranging from different types of frauds, misuse of assets, corruption, money laundering, tax evasion, forgeries, to fraudulent financial reporting. Corporate crime refers to acts perpetrated by individuals or companies which enable them to obtain certain benefits which they would not be able to obtain otherwise in regular business circumstances. Therefore, companies resort to different types of corporate crime in order to reach their goals, or to enable individuals who are creators of such acts and who are involved in them to reach their aims.

Generally speaking, the original form of corporate crime and occupational crime is white collar crime. Corporate crime is an activity carried out “on behalf of and for the benefit of the company” by individuals who in that way promote their personal interests, so in that situation the company interests and individual interests are integrated. However, when personal interests overpower the company interests and when individuals strive to fulfil only their personal interests which may cause damage to the company, so in that situation the company is seen as a victim and the damaged party. Therefore, corporate crime acts are a creation of an individual or a group of people who can use their professional competencies to reach the goals of the company, hereby they appear as perpetrators and beneficiaries of the fraud. However, we should not neglect the fact that persons who are creators and perpetrators can equally use their abilities to harm the company and for their personal benefit.

Corporate crime as an activity which happens in the field of business is an act which can inflict considerable damage to the economy, so it is necessary to make significant efforts for its prevention and timely identification. Damage caused by corporate crime can be enormous in financial terms, and its amount and influence are often hard to establish.

An international survey which has been conducted by ACFE[1] for several years and which is published in the Report to the Nations[2] indicates that the criminal act of assets misuse inflicts a considerably smaller damage than fraudulent financial statements[3]. The study implements a certain framework for corporate crime acts and occupational crime based on a division given by ACFE which refers to: assets misuse, corruption and fraudulent financial statements. This study is focused on the interests of shareholders and stakeholders, so a criminal act perpetrated to inflict damage to the state, such as different forms of tax evasion or money laundering is not included. This study is limited by the fact that the sample from the region countries is insufficient to make relevant and applicable conclusions since the study does not take into account specific features of certain countries and economies. Therefore, business models which are practiced in modern developed countries, cannot apply directly in the region. Some of the reasons lay in the fact that former socialist countries are overloaded with the remains of the socialistic past, unsuccessful or unfinished privatization, transition period, process of adaptation to new economic conditions and eventually affected by the current economic situation.

Error or fraud

Business activities are dynamic and varied by nature, and since all business activities have to be presented in business records and financial statements, there can often appear errors and omissions in the process of their presentation. Therefore, it is important to recognize the essence of the business transaction and the way in which it has been presented and afterwards identify if it was an error or a fraud.

What is specific about corporate crime is the fact that frauds often look formally regular and sometimes they are not classified as frauds by the criminal law, or by any other law. Business

[1] Association of Certified Fraud Examiners http://www.acfe.com/
[2] Association of Certified Fraud Examiners – Report to the Nations Archive http://www.acfe.com/rttn-archive.aspx
[3] Ibidem, Page 12

activities which are in integral part of some criminal scheme are well backed up by documentation which confirms a certain business activity, but it is also the weakest link because certain documents are created to confirm the correctness of a certain business transaction.

Errors do occur often and are not uncommon in business, especially in a situation when there are frequent changes in legal and professional regulations, as it is in the countries in the region which are in the process of EU accession. It is also common that persons who participate in business are not sufficiently competent and trained which can result in a large number of errors.

What errors and frauds have in common is the fact that certain business transactions are not presented in the right way and consequently the information presented in the financial statements are incorrect, so in the process of investigation it should be established if you are dealing with an error or a fraud.

It is an intention to present specific business activities in a certain way which differentiates an error from a fraud. On one hand, frauds are deliberate acts perpetrated by one or more persons from different positions such as, executives, employees or third parties with an aim to reap certain benefits. On the other hand, an error is an unintentional act caused by a failure to present certain data or by a misstatement of facts connected to some business activity.

On the basis of the above mentioned, we can conclude that the same statement can be interpreted in two completely different ways in business records and financial statements, namely the same business activity can be either an error or a criminal cat. Since it is an intention which separates an error from a fraud, it can be observed that the very absence of intention to present the information incorrectly in financial statements is a differentiating factor between these two acts. However, if there is an intention to modify information and present fraudulent financial statements, then it will be a pervasive phenomenon in business records and financial statements. It rarely happens that a fraud appears in only one place in financial statements, actually the entire business records and financial statements will contain several different business changes which have the same purpose, to modify the information in financial statements so as to present a desired image and lead to a certain conclusion. On the other hand, errors can be unintentional and sporadic caused by oversights or the lack of understanding of the business activity or they can be unintentional but systematic, which points to inadequate competence and training to accomplish tasks. Consequently, differentiating between errors and frauds in financial statements requires profound knowledge of accounting and rules for making financial statements.

Victims of corporate crime

Corporate crime in the broadest sense of the word is an act which provides certain benefits to the perpetrators, but it also has its victims and damage which can be bigger than the benefits obtained.

Victims of the corporate crime can be:

- The company;
- Business partners;
- Employees;
- The state.

When speaking about corporate crime, the company can be the perpetrator, but also a victim of a fraud. Corporate crime is committed by a certain group of managers or employees, possibly in cooperation with third parties, with an aim to get certain benefits for the company, and in that way obtain certain benefits for themselves. However, other people from the company are not included in these activities, as well as the state and business partners, so they appear as potential victims. According to the study[4] the biggest number of companies involved in corporate crime do not manage to recover afterwards, whereas a smaller number of companies manage to recover to a lesser or greater extent. The mildest consequence of corporate crime will be a reduction of disposable resources and depreciation of the company value; whereas the most severe consequence will be the company bankruptcy, hereby both options leave consequences on other participants in business.

Bankruptcy of the company is not a desirable outcome from the economic aspect because in that way the scope of business activities is reduced, which can have numerous consequences. With bankruptcy the company ceases to exist, which causes employees to be left without their jobs and earnings, which except for personal consequences has influence on the economy by reducing the purchasing power of individuals. Business partners, banks and other creditors are left without their receivables which cannot be collected from a bankrupt company, whereas buyers cannot receive their goods, so their business activities are reduced until they find a solution. There is multiple damage inflicted to the state, which above all, refers to the lack of regular tax revenue from VAT, profit tax, social welfare and other public revenues. Furthermore, apart from having a reduced revenue, the state has to shoulder the burden of the unemployed who were made redundant because of the bankruptcy caused by corporate crime which increases its social expenditures. A collateral damage which is a consequence of all the above mentioned is a reduced tax revenue, because of the reduced income of the citizens who were left without their earnings and creditors who had to reduce their profit after writing off the receivables form the company which had bankrupted.

Except for the above mentioned damage which stems from corporate crime, there is another form of intangible damage which can have serious consequences on the level of national economy – it is the country risk which refers to reputation and susceptibility of the country to corporate crime. When an economic system is in order, corporate crime is less common, and as long as the economy is not so well-organized, especially when it is under the influence of specific circumstances (crisis, transition), corporate crime is far more common. Every national economy is interested in attracting as

[4] Ibidem, Page 67

many investments as possible in order to start and maintain economic activity. In regular circumstances investors are interested in investing their funds wishing to maximize their profit with minimal risk. Moreover, investors who earned money in "gray economy"[5] are also interested in laundering that money and investing it with minimal risk, so not even they are ready to accept an excessive risk of a disorganized economic system. Nevertheless, there are investors who do not mind disorganized economy, because in that way their profit made in "gray economy" is increased, and on the other hand the process of money laundering is facilitated. Yet, it often happens that investment in unstable economies is made within the process of money laundering in order to withdraw or transfer those funds in the next phase to some more stable economy, so this refers to one-off investments with no intention of continuity. If corporate crime becomes a common phenomenon in a certain economy, there will be no quality long-term investments and suspicious short-term investments will increase, which will not contribute to the stability and growth of the economy.

It is evident that corporate crime causes enormous damage, the most severe one deriving from fraudulent financial statements. Because of that the state needs to establish a regulatory system which will protect all the participants in business without favoring any of them. However, practice shows that this is still barely feasible which is confirmed by the practice of developed countries. Namely, the American system is primarily focused on the protection of shareholders' and stakeholders' interests, whereas the European system is more focused on the creditors' interests, which means that meeting creditors' requirements is a priority in case of a crisis or bankruptcy. Nevertheless, one must bear in mind that according to legal regulations and by pure logic the requirements of owners are the last ones to be met and creditors' interests come before them. However, both concepts neglect the fact that the utmost interest of all companies is to keep and continue business activities because in that way they will successfully settle all the liabilities to creditors and owners. It must be emphasized that the state in this situation has the biggest interest to keep the company and business, since it will still have tax revenue, a smaller burden of social welfare contributions, and higher social stability.

It must be stressed that countries in the region, especially the ex-socialist ones, still lack sufficient experience in coping with corporate crime incidents. The basic problem lies in the fact that the concept of private property in these countries was created through the procedure of ownership transformation and privatization. In these countries, which are undergoing the process of transformation, the protection of interests in business is still not perfectly clear, starting from the fact that it is hard for creditors to protect their interest and collect their receivables to the fact that the interest of a certain party prevails over the common interest. In business all participants have their interests and of course a short-term interest of one party should not be put in the foreground to cause

[5] Gray (informal) economy – a part of economy characterised by irregular and illegal business practices. It can be observed as gray economy, namely business operations which can be legalised by undertaking certain measures (for example by paying tax) and black economy, which cannot be legalised (for exampple drug dealing). It is characteristic of undeveloped and developed countries, but with economic development its share in GDP is reduced. All countries take measures to supress it in order to increase tax revenue. Ekonomski rečnik, (2006) Belgrade University, The Faculty of Economics, page 463

damage to all the others. It is common to put the short-term interest of the state in the foreground. It can be the collection of the current tax liability which can lead the company to bankruptcy, without taking care of the long-term interests of the state based on maintaining and increasing economic activity, by keeping the company so it can continue to operate. The state as a creditor should collect its receivables, but if this collection leads to a company bankruptcy, then it should put long-term interests before the short-term ones because after bankruptcy the state will have to shoulder the greatest burden. If long –term business activities of a company are protected, the tax revenue from it is maintained, interests of all other participants in business are protected and the burden of social welfare is reduced.

In ex-socialist countries, corporate crime investigations start from the state interests and tax evasion, and they are not sufficiently focused on the interest of other participants in business and the public. The investigation strategy should focus on collecting evidence, establishing facts and liability, as well as proving everything in court, with an aim to take care of long-term interests of the state and the company, to let the company maintain its business activity. Not every company whose management has committed corporate crime should go bankrupt, because it is not in anybody's interest – the interest of the state, creditors, buyers, employees and others is to keep the company, make it continue its business activities and thus settle its liabilities regularly.

FINANCIAL STATEMENTS AS A CORPORATE CRIME FACTOR

The purpose of financial reporting is to provide information on the basis of which decisions of financial nature will be made. Because of that, financial statements have been recognized as a useful tool to win certain benefits which could not be obtained otherwise, without modifying financial statements, so they have become an important factor of corporate crime.

Financial statements comprise information about the business activities of a company and they show different forms of assets, liabilities, capital, as well as income and expenditure, with plenty of additional information which helps to increase the understanding of financial statements themselves. All the information in financial statements is official and public statements regarding the company business, so this information bears a great importance. Financial statements of some companies are audited and auditors express their opinions with a reasonable level of conviction[6] regarding the correctness of financial statements. However, a great majority of financial statements are not audited, which decreases their reliability.

[6] „As the basis for the auditor's opinion, ISAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. ... However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.“ – International Standard on Auditing 200 – Overall Objectives Of The Independent Auditor And The Conduct Of An Audit In Accordance With International Standards on Auditing, Međunarodni standardi i saopštenja revizije, kontrole kvaliteta, pregleda, ostalih uveravanja i srodnih usluga 2013 (2015), Savez računovođa i revizora Srbije, Beograd, Page 85

The obligation of audit of financial statements is regulated by the law most commonly according to certain criteria which a company has to meet (the size of the company, value of assets, revenue, or type of organization – for instance, a shareholding company or a limited liability company), although any company can decide to have its reports audited as a part of the company business policy. Companies today, namely the management or owners, often establish a big number of small companies, directly or indirectly connected and thus break their business into pieces with an aim to avoid the audit of financial reports.

Users of financial statements

Users of financial statements are different legal entities and individuals who obtain the information for making business decisions from financial statements of a certain company. Users of financial statements can be:

- External
  a) *The state and its organs;*
  b) *Creditors (banks and other financial institutions, as well as other companies);*
  c) *Business partners (suppliers and buyers);*
  d) *Potential investors, and*
  e) *Public.*
- Internal
  a) *Shareholders;*
  b) *Company management;*
  c) *Professional departments within a company, and*
  d) *Employees.*

Since there are numerous users of financial statements, each of them needs different information, depending on their business goals and decisions which they need to make. Investors' goal is to make as much return on investment as possible, whereas creditors need information about the company leverage and the capability of the debtor to pay back loan installments and interest.

Suppliers and other creditors want to make sure that the company will be able to settle its liabilities on time, whereas buyers want to make sure that the company will be able to deliver goods or services. The state and its organs need the information about the business activities of a company as a basis for establishing liabilities for public revenues and tax policy, as well as for generating statistical data and analyses. The public is also interested in financial information, whether as a potential investor or to follow economic trends, company development and the influence on the local economy.

Except for external interested parties there are internally interested parties who also make business decisions on the basis of the information from financial statements. On the basis of financial statements, shareholders obtain information about the profit rating of the company and potential dividend. The management, employees and professional departments can have a more complete insight into company trends and developments, whereas if they are in the capacity of shareholders they also have inside information at their disposal, on the basis of which they make decisions about further investment or disinvestment in the company.

All of the above mentioned groups use financial statements in order to obtain relevant information on the basis of which they could make financial decisions and that very fact is the reason for making modifications of financial information which result in fraudulent financial statements.

Modification of financial statements

Modification of information in financial statements depends on the goal which we want to achieve, or what kind of conclusions we would like to lead the users of financial statements to. In line with that, fraudulent financial statements are by rule a decision made by top management and company owner. The modification of information which eventually results in fraudulent financial statements will be carried out depending on who they want to mislead.

Techniques which present the general framework for making modifications in financial statements are the following:

Overestimating	**Underestimating**
Assets	Assets
Liabilities	Liabilities
Accruals and deferrals	Accruals and deferrals
Income/profit	Income/profit
Expenditure/loss	Expenditure/loss

The process of preparing financial statements is based on business transactions which provide financial information on the basis of which financial statements are made as a reflection of a company's business activity for a certain period. On the basis of financial statements made in this way the users make further decisions regarding the approval of loans, investing, taxing, etc. However, in the process of making fraudulent financial statements techniques are implemented using a reverse process. In the reverse process you start from a desired image of financial statements and information is modified in the way to accomplish that.

The reverse process means that you start from the final goal, which means presenting the desired picture in financial statements of a company which will result in making a certain favorable decision, for example getting a bank to grant a loan under favorable conditions. In order for such a decision to be made it is necessary to present the information in the financial statements that the user wants to see. For the purpose of getting a convenient loan financial statements will be modified to show small leverage with banks and other creditors, low interest expenses, substantial assets and receivables, as well as a significant profit rating of the company. This can be achieved by underestimating liabilities and interest expenses, as well as by overestimating assets and revenues, or profit. In this way the company can show that it is not indebted by underestimating liabilities or not presenting them at all. It can also underestimate or hide interest expenses for which purpose positions of accruals and deferrals can be used. By overestimating its assets the company will show that it has assets of great value so it can guarantee settling its debts, whereas overstating revenues and profit will confirm that the company is doing fine which could put it in the group of low-risk companies which can get a loan under more favorable conditions.

If the company aims to present a favorable picture of the company business activity or to attract investors for a new emission of shares, then profitability, as well as payment of dividend will be very important indicators. In order to reach this goal, profit and receivables in financial statements can be overestimated and payables and expenses underestimated, which can result in increased profit. Investors who rely on such financial statements run a special risk because a long-term implementation of such a policy can create an illusion of stability, growth and profitability of the company, and that is all based on misstatements.

Techniques applied in making fraudulent financial statements can be very perfidious, especially when there is a certain aim, or an intention to influence the users of financial statements to make certain decisions. The application of these techniques is a work of experts from the fields of accounting, auditing and taxation. What’s more, excellent professionals with a profound knowledge of accounting can use these techniques to modify financial statements in such a way that not even experienced investors and bankers can recognize them on time. Since fraudulent financial statements cause substantial damage to economy it is essential that fraud examiners who investigate be good and experienced experts in this field who will recognize the symptoms of modified financial statements.

CONCLUSION

Business activities of every company are presented in financial statements made by the management and which are used to present the company in public. On the basis of financial statements very important financial decisions are made; creditors decide whether to approve loans, investors decide whether to invest, and the state established the amount of tax liability, etc. Owing to techniques and reverse process in creating financial statements the information presented in them can be modified in order to present the company in the way that the management or owners have planned and gain a certain benefit by misleading the users of this information. In this way, goals of a certain group of people, often owners and management are accomplished, while jeopardizing the goals of other participants in business. This type of corporate crime is the most detrimental one for the economy and the state, because it can demotivate investors and decrease investment activity in economy, which again has very serious long-term consequences on the national economy. To sum up, the number of victims and damage of the corporate crime are big, and the biggest victim can be the state itself if it does not organize the economic system in the right way and establish the economic climate which will prevent corporate crime.

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