http://journals.uonbi.ac.ke/index.php/adfj
ISSN 2522-3186

ADFJ ISSN 2522 – 3186.

African Development Finance Journal

VOLUME 8 (II)

Techniques used to Prevent and Detect Fraudulent Financial Reporting: An Aspect of Financial Statement Misrepresentations

James Daniel Chindengwike

Date Received: November, 25, 2024
Date Published: December,30,2024

African Development Finance Journal http://journals.uonbi.ac.ke/index.php/adfj
December Vol 8 No.2, 2024 PP 86-95 ISSN 2522-3186

Techniques used to Prevent and Detect Fraudulent Financial Reporting: An Aspect of Financial Statement Misrepresentations

By: James Daniel Chindengwike [1]

Abstract
Techniques used to detect and prevent fraudulent reporting of financial statements are very important in the effective operation of any company. The aim of this paper is to assess the aspect of financial statement misrepresentations and how we can apply the techniques to detect and prevent fraudulent reporting of financial statements. This paper opted for a for a qualitative research approach. This study used different research books (6) as a source of the data (documentary reviews as the tool of data collection). The study found that techniques to detect and prevent fraudulent reporting of financial statements are very crucial in aspects of financial statement misrepresentations. Also, the study observed that techniques used to detect and prevent fraudulent reporting of financial statements are liabilities versus assets, cost of goods sold versus sales, accounts receivable versus sales, gross, inventory a company's inventory, operating versus sales, net profit margins, and analytical procedures for fraud examiners. The study concluded that the techniques used to detect and prevent fraudulent reporting of financial statements are very imperative to enhance the operation of the organization. The study recommended that the fraud inspectors should apply the ratios to examine debtors for possible larceny schemes. Buying and getting inventory structures can upset the ratios. Minimizing the COGS consequences in a rise in the ratios as well. Significant changes in the inventory turnover ratio are good signs of likely fraudulent inventory action. Also the management should commit to aiding all employees in building internal control systems through interaction and training in order to educate them on issues surrounding the effective application of accounting laws and processes, thereby enhancing their professional skills and competence. There is a need to take legal action against those who misuse local government funds, and recovery must be obtained. This study looked at how internal control systems affect the performance of Tanzanian local government authorities. The paper calls for greater research into the problems of building organizational internal control systems, as well as the impact of information and communication technologies on these systems. The effects of information and communication technology on internal control systems.

Keywords: *Fraudulent Financial Reporting, Financial Statement, Misrepresentation*

1. Introduction

Any organization needs to be able to detect and prevent fraudulent financial reporting in order to function efficiently (Crain et al., 2015). A company's financial health is communicated through three different types of financial statements: the cash flow statement, which displays the sources and uses of cash; the income statement, which displays the company's profit or loss; and the balance sheet, which displays the company's assets, liabilities, and owners' equity (Hopwood et

[1]*Lecturer, St. John's University of Tanzania, Dodoma, Tanzania, Faculty of Commerce and Business Studies, Finance, Accounting and Economics Department, Email: chindengwikejames@gmail.com*

al., 2008). Unexpected connections, the fraud examiner must investigate any strange correlations between financial data that are discovered by analytical methods. Additional procedures and research should be a part of the outcome evaluation process (Skalak et al., 2015). The fraud examiner should determine the anticipated causes of the deviations before questioning the organization’s management and employees. When speaking with business staff, the fraud examiner will be more equipped to pose intelligent, logical enquiries. Examining the supplementary materials is a good idea if you want to confirm the workers' justifications (Hopwood et al., 2008). For example, if the sales manager says the new campaign is driving up sales, check the advertising expense account to be sure the campaign really happened. If the advertising budget was the same as it was the year before, there may have been fraud and an unfair partnership.

Financial data is frequently given to provide insight and direction about a company's financial health, performance, and cash flows. Financial statements are utilized by management to make business decisions. Its data is gathered to investigate the organization's functioning. It allows for the identification of the causes of deviations from previously set standards, as well as the finding of undiscovered production resources. Statistical authorities frequently utilize business annual reports to assess the direction and breadth of product development. Nonetheless, some parties intentionally engage in dishonest activity when reporting financial data. Whether committed for personal gain or for other motives, fraud is defined as an intentional conduct that causes a loss to certain persons or institutions. A violation of widely recognized accounting rules is referred to as fraud. Fraud is defined as unlawful activities that are purposefully committed, concealed, and profited from by turning them into money or other goods. This deliberate, covert action is carried out both within and outside. Fraud occurs when someone intentionally misrepresents the truth or conceals or hides a material fact in order to persuade someone else to do something against their will.

A deliberate act of fraud by one or more management, governance, employees, or outside parties that results in the fabrication of financial statements that are the subject of an audit is referred to as a fraudulent act in the context of financial reporting. (AICPA, 2020). Fraudulent financial reporting, according to the Association of Certified Fraud Examiners (ACFE), is the deliberate reduction or elimination of disclosures in financial statements with the intent to mislead financial statement readers about a company's financial status. The purpose of false statements in fraudulent financial reports is to deceive their users.

Indonesian businesses, both state-owned and privately held, have significant rates of accounting fraud. In terms of corruption, Indonesia ranks 102nd out of 180 nations in 2020 with a score of 37 on the Corruption Perception Index (CPI) (2020, Transparency International). The quantity of instances involving fraud and corruption, including tax manipulation, state-owned and private company management filing lawsuits, various bank liquidations, and financial crime cases (Wilopo, 2006). The financial reporting process may suffer negative consequences and flaws if undiscovered fraud occurs.

2. Literature Review

This section explained the related literature Review.

2.1 Theoretical Literature Review

2.1.1 Agency Theory

Agency Theory outlines the contractual connection between a principal and an agent, both of whom are business members. According to Musfi, and Soemantri (2024), the principle maintains the relationship by choosing an agent to make the best judgments while prioritizing the company's profits to save money. Agency theory seeks to improve people's ability to assess the environment in which they must make decisions (as both principles and agents) through belief revision role). The latter evaluates the consequences of earlier decisions in order to increase the efficiency and consistency with which results are divided between principle and agent.

2.1.2 Fraud Hexagon Theory

The fraud hexagon concept is based on Cressey's fraud triangle (1953). Vousinas (2019) developed the fraud hexagon theory, which is now widely utilized by practitioners to identify fraud. According to Vousinas, six elements inspire people to commit fraud: financial concerns (stimulus), the perpetrator's ability to commit fraud without being caught (capability), the opportunity to commit fraud (opportunity), and those who believe that internal control does not apply to them

http://journals.uonbi.ac.ke/index.php/adfj
ISSN 2522-3186

and have a superiority complex that leads to avarice (ego). An agreement between two or more individuals to commit or justify fraud. Stimulus occurs when a company's performance falls short of the industry average (Tragouda *et al.,* 2024). In general, it stems from financial needs and situational constraints caused by financial promises that management cannot yet provide. SAS 99 distinguishes four types of stress that may contribute to financial statement fraud: financial stability, external pressure, personal financial need, and financial targets. The phrase capacity refers to a person's ability to commit fraud in a business situation. One successful implementation of this concept is a change in the board of directors, which causes a conflict of interest (Narulita, et al., 2024). An opportunity is a situation or setting in which an event can occur.

The perpetrator seeks an explanation for his actions; rationalization plays an important role in the occurrence of fraud. This reasoning might occur when the culprit believes they are entitled to something more (a job, money, or a promotion). The change in the auditor variable acts as a surrogate for the rationalization aspect. The hubris portrayed here is that of someone who believes that internal controls and business wisdom do not apply, and that he is not obligated by them, therefore he does not believe he has committed fraud.

2.2 Empirical Literature Review

Some frauds in organizations are the consequence of a system failure, such as a lack of effective control over purchase order placement. Other frauds are the result of a failure to follow proper control measures. It could be negligence in doing a check (Chindengwike, 2024). It's likely that too much faith has been placed in one individual, with no clear separation of responsibilities. Frauds performed in partnership may be more difficult to detect. Because there is no human verification of transactions, a computer can be used to commit fraud. The lack of human participation may allow transactions to be completed that would not have been possible in a manual system (Yousefi Nejad *et al.*, 2024). Organizations should offer a summary of data disclosures.

Chindengwike (2024) employed an analytical technique in his study of monitoring and control activities to investigate the effects of penalties and other types of internal controls on the possibility of employees participating in fraudulent activity. Data was collected by both managerial and non-managerial employees. The study's findings demonstrated that separating responsibilities and having control actions raises the cost of committing fraud. This means that the benefits of committing fraud must outweigh the environmental costs of carrying out the various actions that lead to an employee committing fraud. It was also discovered that separation of jobs serves as a cost-cutting deterrent. According to Dashkevich et al., (2024), internal controls are critical in guaranteeing effective revenue collection.

The majority of the firms studied lacked the following internal control components: risk analysis and inefficient information flow. The study also found that the sample population was unaware of the components of an effective internal control system. The study also discovered a negative association between enterprise size and the effectiveness of internal control systems, as well as a negative correlation between enterprise-owned resources and internal control system defects.

According to Bamhdi (2024), study on the effectiveness of internal control in Kenya's public sector, risk is regarded as critical to corporate governance and has become synonymous with the concept of internal audit. However, the importance has shifted. Internal control was highlighted as a result of documenting business concerns and professionalizing the internal audit function. Ginting et al., (2024) investigated the internal control system and financial accountability in Nigeria's south-west public sector. The study emphasized the need of assessing the efficacy of internal control systems in government ministries (units).

3. Research Methodology

This paper opted for a for a qualitative research approach. Descriptive research design used in this study because is easy to connect the data from different scholars. This study used different research books (6) as a source of the data and materials. Documentary reviews are used as the tool of data collection. Various inputs are used from literatures, such as journals, research papers and working papers was used.

4. Results and Discussions

4.1 Insights of the Techniques used to Prevent and Detect Fraudulent Financial Reporting

Although specific circumstances may result in different outcomes, the basic connections between financial accounts that are displayed below are generally true. The following comparison of items is used as a method to identify and prevent fake financial reporting:

Assets Versus Liabilities; A company that manages its finances well aims to maintain a healthy ratio of assets to liabilities. By keeping a certain amount of balance, the business may save money on borrowing and show lenders and equity investors that it is dependable. A sudden divergence from normal operating procedures might be a sign that management has a different understanding of how the business is run. It could also imply that there is anything the management is hiding. A notable rise in the percentage might suggest that off-balance sheet companies are hiding long-term debt and other obligations. According to Skalak et al. (2015), a significant drop in the ratio and a rise in liabilities might suggest that the company extensively depends on borrowing to support its operations, which would increase the risk (Chindengwike, 2024; Lokanan et al., 2024).

Sales Versus Cost of Goods Sold; Revenue is generated for the firm by the sales of its products. This product must be manufactured, purchased, or both; labour, materials, and other costs must be paid for. As such, there must always be a cost associated with a transaction. In general, the cost of things sold increases along with sales. Well, there are instances in which a business has reduced expenses by using a more effective production technique, but, in those circumstances, sales-related expenses are still disclosed at the time the product is sold (Crain et al., 2015; Shbeilat, 2024).

Sales Versus Accounts Receivable; when a business closes a transaction with a client and frequently delivers the goods before the client pays, an account receivable is generated (Skalak et al., 2015).

Sales Versus Inventory A company's inventory; A product that is prepared for sale. Projecting future sales is an organization's main objective, and in the process, it tries to match these requests by maintaining a sufficient level of inventory. Therefore, inventory often signals a rise in sales. Inventory must rise in proportion to sales growth in order to satisfy demand. Inventory that increases more quickly than sales may be the result of overstock or outdated, slow-moving commodities. Profit Margin Businesses might decide to sell goods or offer services in order to generate revenue. In a similar vein, businesses must pay both directly and indirectly for the goods and services they provide for clients (Hopwood et al., 2008).

Gross, operating, and net profit margins are shown on the income statement; Profit margins should gradually level out since the business has to generate a profit in order to stay in business. The business needs to find methods to cut costs if it faces more competition and is forced to lower the price of its goods. Continuous pressure on profit margins is a sign of managerial stress, and this might eventually result in financial reporting fraud (Kranacher and Riley, 2019).

Analytical Procedures Fraud Examiners: To assess the company's financial status, apply a variety of methods to transform data that could otherwise seem random and illogical into precise and insightful insights. An organization’s financial health may be accurately assessed by looking at the correlations between the data. An investigator investigating fraud can determine what constitutes persuasive evidence and have a better understanding of the organization’s financial position by comparing these relationships with those of other industries or organizations operating in the same sector.

5. Conclusions and Recommendations

The study came to the conclusion that improving an organization’s operational efficiency depends critically on the methods employed to identify and stop financial statement fraud. The study suggested that in order to screen debtors for potential theft schemes, fraud inspectors could use the ratios. Inventory structure purchases and acquisitions might throw off the ratios. Minimizing the effects of COGS on ratio increases as well. The inventory turnover ratio changing significantly is a strong indicator of possibly fraudulent inventory activity.

Also; According to the study, management should commit to aiding all employees in building internal control systems through interaction and training in order to educate them on issues surrounding the effective application of accounting laws and processes, thereby enhancing their professional skills and competence. There is a need to take legal action against those who misuse local government funds, and recovery must be obtained. This study looked at how internal control systems affect the performance of Tanzanian local government authorities. The paper calls for greater research into the problems of building organizational internal control systems, as well as the impact of information and communication technologies on these systems. The effects of information and communication technology on internal control systems.

References

Chindengwike, J. D. (2024). Application to Various Types of Computer Crimes and Digital Forensics: A Case of Mccartney's Net worth and Settle. *Journal of Digital Security and Forensics*, *1*(1), 30-33.

Chindengwike, J. D. (2024). Effects of taxpayer's attitudes on tax evasion among SMEs in Tanzania: A case of Singida Tax. *African Journal of Economics and Business Research*, *3*(2).

Chindengwike, J. D. (2024). Influence of Dividend Pay-Out On the Share Price Volatility from Manufacturing Companies Listed at Dar Es Salaam Stock Exchange. *African Banking and Finance Review Journal*, *15*(15), 242-256.

Chindengwike, J. D. (2024). Influence of inventory turnover on the profitability of listed manufacturing firms in Dar Es Salaam stock exchange, Tanzania. *African Journal of Economic and Sustainable Development*, *9*(4), 273-283.

Chindengwike, J. D. (2024). Nexus between foreign assistance and economic growth in Tanzania. *Sustainable Economies*, *2*(3), 163-163.

Chindengwike, J. D. (2024). Relationship between Bank Balance Inquiry and Customer Satisfaction in Tanzanian Commercial Banks: A Case Study of CRDB Bank, Singida. *African Journal of Entrepreneurship and Innovations (AJeIN)*, *3*(3), 17-27.

Chindengwike, J. D. (2024). Relationship between Bank Balance Inquiry and Customer Satisfaction in Tanzanian Commercial Banks: A Case Study of CRDB Bank, Singida. *African Journal of Entrepreneurship and Innovations (AJeIN)*, *3*(3), 17-27.

Crain, M. A., Hopwood, W. S., Pacini, C., & Young, G. R. (2015). Essentials Of.

Hopwood, W. S., Leiner, J. J., & Young, G. R. (2008). Forensic accounting. *(No Title)*.

Kass-Shraibman, F., & Sampath, V. S. (2011). *Forensic accounting for dummies*. John Wiley & Sons.

Kranacher, M. J., & Riley, R. (2019). *Forensic accounting and fraud examination*. John Wiley & Sons.

Rufus, Robert J.; Miller, Laura Savory; Hahn, William Forensic Accounting: Global Edition

Skalak, S. L., Golden, T. W., Clayton, M. M., & Pill, J. S. (2015). *A guide to forensic accounting investigation*. John Wiley & Sons.

Tragouda, M., Doumpos, M., & Zopounidis, C. (2024). Identification of fraudulent financial statements through a multi-label classification approach. *Intelligent Systems in Accounting, Finance and Management*, *31*(2), e1564.

Musfi, P. N., & Soemantri, R. (2024). The Effect of Nature of Industry, Financial Stability, Ineffective Monitoring, and Changes in Company Directors on Indications of Fraudulent Financial Statements. *Indonesian Journal of Economics, Social, and Humanities*, *6*(1), 16-37.

Narulita, F. D., Baderi, R. N., & Hwihanus, H. (2024). The Impact of Fraud on the Detection of Fraud in Financial Statements and Discretionary Accruals (Meta-Analysis Study). *Journal of Advances in Accounting, Economics, and Management*, *1*(4), 1-16.

Yousefi Nejad, M., Sarwar Khan, A., & Othman, J. (2024). A panel data analysis of the effect of audit quality on financial statement fraud. *Asian Journal of Accounting Research*, *9*(4), 422-445.

Dashkevich, N., Counsell, S., & Destefanis, G. (2024). Blockchain financial statements: Innovating financial reporting, accounting, and liquidity management. *Future Internet*, *16*(7), 244.

Bamhdi, A. M. (2024). Analysis of intangible assets reporting standards and automation in KSA within an Islamic context–a case study. *Journal of Islamic Accounting and Business Research*.

Ginting, R., Yulindisti, E., Robiansyah, A., & Anandita, R. (2024). Semiotic Analysis in the Lyrics of the Song Tikus-Tikus Kantor and Its Significance for Fraud Accounting Actors. *Journal Sastra Indonesia*, *13*(1), 52-61.

Lokanan, M., & Yeldandi, N. V. (2024). A Review of Trends and Prevention Strategies for Mortgage Income Fraud in the Canadian Market. *The AI Revolution: Driving Business Innovation and Research: Volume 2*, 685-699.

Shbeilat, M. K. (2024). Managing Earnings Management: A Framework of Standards, Governance and Ethics. *International Business Research*, *17*(3), 1-48.