IMPORTANCE OF INTERNAL CONTROLLING IN FRAUD DETECTION IN CZECH ENTITIES

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Abstract

The aim of the paper is to present answers on questions of means used to prevent fraud commitment and early detection in organizations by using internal controlling department. Fraud is a serious problem everywhere in the world, which means huge financial losses not only for the company itself. Entities usually consider the risk of fraud inside as insignificant and therefore they do not take any preventive measures to minimize the possibility of its commitment. Companies lack the tools for quick detection of frauds and offenders. Here is the field of controlling, which deals with the basic issues related to the frauds in enterprises, their detection and prevention. Author performed research in 2018, when 51 employees of the controlling departments of companies operating in the Czech Republic participated in the questionnaire survey. Data were statistically evaluated using proportional and independence tests. For the purposes of the analysis, we have set the following research question: “How much is the function of the internal controlling officer in detecting fraud important in Czech companies?” We examined this research question from different perspectives and results showed that controlling staff plays important role within organizations for better fraud and mistake detection caused by accounting staff. Based on results some of fraud or mistakes detected had significant influence on company’s profit performance.

Keywords: Internal controlling, fraud, fraud detection, accounting

1 INTRODUCTION

The control concept is coming from the English verb to control, which means to check but also to control or lead. This concept applied by foreign and Czech entities became as an all-encompassing term applied to all areas. Nowadays, a modern enterprise can successfully compete only if it puts efficient controlling processes into practice. Controlling is a complex interconnection (integration) of information, planning, implementation, management and control system. The goal of controlling is to recognize and solve problems or suggest measures for solving them in order to avoid such problems in the future. The sense of controlling may vary depending on the form of business entity, its size and on the extent of the funds, which management is willing to provide. The most important purpose is to ensure the functionality of the enterprise, from the perspective of examining the state of accounting and physical, as well as reviewing the financial affairs of the company. An essential part of controlling is its relationship to accounting and mainly to financial audit whose relationships work in reverse as well. Internal controlling, as already covered in naming of this discipline, has the main message to check and observe results of work done by accountants in the entity and to provide results, completeness and evidence of their work. Members of internal controlling departments in organizations should be the first who can discover any clues of fraud behaviour in enterprises. The ultimate principle of bookkeeping is its true and fair picture, to maintain this rule, it is necessary to respect the honesty and reality of all data presented by companies. The accounting and current financial position of an enterprise is an integral part of the financial reporting of each company, so it is essential that the figures reported are consistent with the actual financial reality and not artificially created. However, if there is any modification or manipulation of the
data, we can speak of a certain amount of creativity in accounting or even fraud committed by employees of given organization. It is important to realize that fraud is on the increase and this is causing increasing damage to organizations. In some cases, their impact on the organization is also fatal.

The risk of fraud affecting virtually all economic operators is very common, but often underestimated. Committing fraud is a serious problem all over the world, as it often involves huge financial losses. Despite numerous studies, it is impossible to determine the exact extent of fraud losses. However, conducting crime studies is extremely important, as determining, the approximate size of a problem can make management aware of the estimated level of fraud loss and therefore decides to take action to effectively detect and suppress it. The fraud can negatively affect the business, causing huge losses of various types, such as reputational damage and reduced employee morale. All employees, regardless of their status or seniority, as well as people outside the company, can deceive organization. Therefore, it is extremely important for organizations to implement various anti-fraud measures and prevention measures, including awareness, detection, prevention and detection actions, as well as fraud risk assessment processes in the business. An Internal Audit or Controlling Department plays an important role in soon fraud detection. Effective internal audit or financial controlling can be very useful not only in founding fraud, but especially in the early detection and prevention of it. In order for these departments to work effectively, they need to have relevant knowledge of fraud, investigation techniques and relevant legal provisions.

That is why there is certain importance of controlling department within organizations. In academic literature and in business practice it is an increasingly present meaning. In the Czech business environment, it is a relatively new yet popular notion, which is nowadays getting wider. As business entities are open spaces for innovations and new terminology, controlling found its position very quickly in many types of worldwide companies. Controlling is spread through organizational structures does not matter how big the entity is, how many owners it has, or whether the enterprise is sourced by foreign capital. The controlling officer generally needs only basic accounting information as how to track costs, set prices, make future forecasts and check all financial outputs from accountants and management.

2 LITERATURE BACKGROUND

Perhaps accounting is most critical and important social function is situating public corporations. Books of account represent substantially what corporate businesses remember about how their pasts became their presents, i.e., accounting data correspond to prior events bringing them to their present condition. They do this partly for their own purposes (managerial accounting), to depose to tax authorities, regulators, various capital providers, and the citizens with whom they share certain rights. These corporations are now the most dominant and powerful institutions in most peoples’ lives. A corporation has no conscience or memory besides the one’s society gives it. Accounting serves a critical role in providing, that which situates the corporate entity because it is a primary means of regulating corporate behaviour. (Forejt, Habarta & Trešlová, 2012)

This flexibility in accounting opens the door for many different methods of creative accounting. The boundary between creative accounting and fraud is very often unclear. The basic accounting equation is assets and expenses equal revenues plus liabilities plus capital. Therefore, it is possible to maintain the symmetry within accounting but classify expenses as assets and loans to revenues. There are five main strategies for the creative accountant. Strategy 1 involves increasing profit by increasing revenues, for example by treating loans as sales, by the premature recognition of sales, by maximizing other revenues or by treating loans as sales.
Strategy 2 involves increasing profit, this time by decreasing expenses by methods such as provision accounting, increasing inventory, and capitalizing expenses, lengthening asset lives, minimizing bad debts, minimizing tax or using the big bath technique. Strategy 3 focuses on increasing the net worth of the balance sheet by increasing the assets, for example, by including brands and intangibles, goodwill and revaluing fixed assets. Strategy 4 also involves boosting the net worth of the balance sheet, however, this time by reducing liabilities through, for example, off-balance sheet financing or reclassifying debt as equity. Finally, strategy 5 involves maximizing operating cash flow. Maximizing of operating cash flow can be by two ways. The first involves maximizing operating cash flows. The second, minimizing operating cash outflows. (Fenyk et al. 2010)

Management accountants need high-quality data in order to become the ones who know and the ones who tell the truth. They therefore expand the scope of their tasks to cover methods and pure bookkeeping, for instance, in order to ensure data quality, which in this case relates to the reliability of the product schedule. (Lambert & Pezet, 2011)

All accountants’ technical expertise is linked the status and credibility attributed to the accounting profession not only to accountants’ technical expertise but also to their ability to project a public image of themselves as ‘ethical experts’. In other words, the function that accountants fulfill in the economic system is dependent on the profession’s ability to maintain the perception of high ethical standards and ensure for themselves a respectable image within the community at large. Therefore, to fulfil their function, it is necessary not only let accountants act ethically but also that the public perceives them to do so. (Caglio & Cameran, 2017)

As already mentioned, controlling is in the Czech business environment a relatively new yet popular word. Controlling consists of verifying whether everything occurs in conformities with the plans adopted, instructions issued and principles established. Controlling ensures that there is effective and efficient utilization of organizational resources to achieve the planned goals. Controlling measures, the deviation of actual performance from the standard performance, discovers the causes of such deviations and helps in taking corrective actions. (Daft, 2012)

Controlling has multiple meanings, as effecting, keeping in check or simply giving orientation. Controlling is not only about monitoring given plans. Thanks to the plans (raw material procurement, investment, repairs, production, sales, human resources, etc.) and accounting information from the company, it is easy to compose budgets and calculations for the analysis of the financial performance of the business and evaluate whether the entity is approaching its profit goals. Generally, for the term controlling exists no consistent definition in the scholarly literature. (Eschenbach, 2004)

There are existing two main trends:

a) Strategic controlling, which is oriented to the future. The main goals here play management of long-term profit potential focused on strategic business philosophy, analysing strengths and weaknesses of the company and mainly formulating strategic goals;

b) Operational controlling captures shorter periods, constantly compares the deviations from reality, flexibly interfered with the course of business operations, and thus optimized the activity. This trend checks, evaluates and determines the processes of leading to the stated strategic objectives. It establishes a quality reporting, which on one hand is used for basic data processing and presentation, on the other hand, participates in the creation of an appropriate information base and adequate management and control mechanisms.
2.1 Development of controlling

Development of controlling system was more than 100 years in American business practice. Experts designated controlling originally for a specific type of planning, covering controls in accounting, finance, and subsequently expanded to other business activities. It was only later begin to use in Europe, the most in the '50s in Germany. As a critical year for controlling is mentioned year 1880, which is associated with introduction of the position of controller in American society Acheson, Topeka & Santa Fe Railway System. The second milestone in the controlling history is year 1892, which is associated with the American industrial company General Electric Company, which as first in the industry set up a working position of controller. (Ciesielski & Weirich, 2015)

Controlling in Europe was firstly used after WWII and to Czech Republic came in the turn of the 20th and 21st century mainly due to the entry of multinational corporations into the Czech market. The introduction of controlling a larger scale was up with the economic crisis, which has increased the requirements for cost management and business planning.

Nowadays organizations establish controls in a number of different areas and at different levels. The responsibility for managing control is extensive. There are existing four basic areas, which definitely need controlling management to control over – physical, human, information and financial resources. Control on level of physical resources includes mainly inventory management, control of quality and equipment control. Human resources control as it is clear takes control over human resources in the company. This includes whole process of hiring of new employees, their selection and placement, training of all staff and their development, performance appraisal and compensation. Control on level of information resources includes sales-marketing forecasting, macro and microanalysis, public relations, all types of marketing, production scheduling and economic forecasting. The last type of control - financial resources control involves managing the organizations debt, cash flow and receivables/payables accounts. Control of financial resources may be the most important control of all and that is why we focused our patience to it in this paper.

2.2 Actual situation in the Czech Republic

Organizations need controls in order to determine meeting their goals and to take corrective action where it is necessary. Control in the entity is the regulation of organizational activities so that some targeted elements of performance remain within acceptable limits. These limits are usually set before the environment change and before controlling tool is used. The purpose of the control is mainly to adapt to environmental change and as already mentioned – act quickly and precisely. A control system can to anticipate, monitor, and respond to changing environmental conditions.

Following are some of the most essential errors, where perfectly settled controlling department can limit the accumulation of errors or reduce them. An error is coping with organizational complexity, which is a factor increasing dramatically over recent times. The next one is minimizing of costs, control can help reduce costs and increase output. This definition then leads to increase of profit, because properly settled limits can lead to increase of organizational profit. These are also fields of each financial audit; proper controlling can suffer big mistakes from financial audit, moreover check actual settlement of controls and provide entity with more details to catch more costs and debts.

Actual situation in the Czech Republic differs based on concrete controlling organization. Very usually do a separate department, chief financial officer, external staff, assistant director of the company and many other positions perform the controlling position across entity. Factors that affect this are the size of a firm position on the market, the need for innovation, the complexity
issues and mainly the company strives to innovate and develop. Usually no diversification of controlling department from accounting department in Czech entities goes from long-term external auditors’ practice.

Criminal activities and organized crime became the main generators of social and state instability in the recent years, much more that the wars. They generate significant illegal money and need to launder this money, which tends to integration to the legitimate financial system. Economic and financial crimes that called white-collar crimes, typically has diffuse costs to society and concentrated benefits for the perpetrators. The social expectations are that the auditors should play an effective role in reducing, if not eliminating, these crimes. New auditing standards require auditors to take a proactive approach to assessing whether management has in place appropriate systems and controls to manage the risk of fraud. (Petrevska & Petrevska, 2014)

Firms can see the role for the accountant two-dimensional: involvement in the internal operations of the company, focusing upon performance and compliance concerns, and in the external dimension relating to the disclosure of economic information to external report users. We can define those users as resource providers, recipients of goods and services and parties performing a review or oversight function. (Vollmuth, 2004)

In Czech practices these two trends of controlling stays for planning and reporting respectively. Unfortunately, there is no existing modern literature covering how controlling in praxes in the Czech environment really works. Czech entities still have only limited use of what controlling could really bring.

2.3 Fraud and fraud characteristics

The concept of fraud began to emerge during the 1980s. Even nowadays, there is not enough literature to fully cover or delimit this topic. Fraud is an act committed by anyone who misuses someone's ignorance, incapacity or credulity for their own unjust enrichment or benefit and misleads someone by their actions. According to literature sources (Drábková, 2017), defining fraud is a very complex problem. This term means misuse of accounting in order to better present the company in the financial statements. It is therefore possible to meet human creativity, knowledge and knowledge in the field of accounting theory and practice when preparing and presenting financial statements. In the Czech Republic, Section 209 of Act No. 40/2009, the Criminal Code, regulates this crime. There are not defined the boundaries between accounting creativity and accounting fraud in the processing of accounting data as well as between deliberate doing and oversight. We could simply say that we are talking about fraud every time the conduct is in contrast to the Criminal Code.

3 METHODOLOGY

The aim of the article is to assess whether internal control departments are helping to detect fraud in companies and in what possible material impact. In 2018, author sent out questionnaires by emails to haphazardly 92 selected companies, which has based on portal justice.cz its business office in the Czech Republic. Author do not considerate type of business, ownership and size of the enterprise. Only 51 employees of the controlling departments of companies operating in the Czech Republic participated in the questionnaire survey. Response rate for given questionnaire is 55.4%. Data were statistically evaluated using proportional and independence tests. Where the independence test showed a statistically significant relationship between the variables, sign variance schemes used to interpret the results.
3.1 Research question

For the purposes of the analysis, we have set the following research question:

**How much is the function of the internal controlling officer in detecting fraud important in Czech companies?**

We examined this research question from the following perspectives and settled for them following hypotheses:

1) *Do the controlling staff rely on the results of the accounting department staff?*

2) *In the performance of their duties, did the Controlling Officer detect any errors or fraud committed by accountants in their documentation?*

3) *How significant were the errors or fraud mistakes detected in comparison to overall yearly revenues of the entity?*

4 RESULTS

**First question - Do the controlling staff rely on the results of the accounting department staff?**

<table>
<thead>
<tr>
<th>Answer</th>
<th>Frequency</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Never</td>
<td>42</td>
<td>41.2 %</td>
</tr>
<tr>
<td>Almost never</td>
<td>20</td>
<td>19.6 %</td>
</tr>
<tr>
<td>Occasional</td>
<td>9</td>
<td>8.8 %</td>
</tr>
<tr>
<td>Often</td>
<td>22</td>
<td>21.6 %</td>
</tr>
<tr>
<td>Still</td>
<td>9</td>
<td>8.8 %</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0 %</td>
</tr>
</tbody>
</table>

As shown in Table 1, almost thirty-nine percent of controlling officers somehow rely on results reported by accounting department staff, and over sixty percent do not. In other words, more than one-third of controlling staff, within their prior review, rely on documentation given to them by department staff with less or no control over it and about two-thirds of them use own scepticism.

**Second question - In the performance of their duties, did the Controlling Officer detect any errors or fraud committed by accountants in their documentation?**

<table>
<thead>
<tr>
<th>Answer</th>
<th>Frequency</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not at all</td>
<td>30</td>
<td>29.4 %</td>
</tr>
<tr>
<td>Sporadically</td>
<td>53</td>
<td>52.0 %</td>
</tr>
<tr>
<td>Often</td>
<td>16</td>
<td>15.7 %</td>
</tr>
<tr>
<td>Constant</td>
<td>3</td>
<td>2.9 %</td>
</tr>
<tr>
<td>Total</td>
<td>102</td>
<td>100.0 %</td>
</tr>
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Table two shows that almost eighty-one percent of controlling officers detected no or very sporadically fraud or mistakes in accountants’ documentation. Twenty-nine percent of controlling staff officers have no experience with detecting errors or fraud commitment. Fifty two percent of controlling officers’ work with errors and fraud committed by accountants sporadically, and only sixteen percent work with them frequently. A surprising finding is that only three percent of requested controlling officers are constantly detecting errors or frauds committed by accountants.

**Third question - How significant were the errors or fraud mistakes detected in comparison to overall yearly revenues of the entity.**
Results of table 3 support results of second question that over twenty-nine percent of controlling officers did not find errors at all. Next results show that over thirty-one percent of controlling officers work with errors or mistakes coming from fraud commitment recalculated in amount less than 0.5% or overall yearly revenues. Over thirty-seven percent of found errors or fraud mistakes is in range of 0.5-10% of overall yearly revenues of the entity. Almost two percent of errors or fraud mistakes detected by controlling officers reached over ten percent of overall yearly revenues of the entity.

### 4.1 Statistical hypotheses

Statistical hypothesis HA1: *Most controlling officers are never relying or almost never relying on submitted results by accountants.* Stated hypothesis means in other words that controlling officers are checking documentation given to them by accountants and are never or almost never relying on data which accountants give them as being the right one. A one-sample proportional test at a significance level of 5% showed that most controlling officers are never relying or almost never relying on submitted results by accountants. (Z = 4.353, p-value <0.001).

HA2: statistical hypothesis: *Controlling officers, in the performance of their duties, are detecting mistakes or fraud in documentation performed by accounting staff.* Hypothesis is trying to reflect the fact, that mistakes and fraud is in documentation submitted by accountants as to being ready and properly done and controlling officers find them.

The results of the two-sample proportional test indicate that controlling officers, in the performance of their duties, are detecting fraud in documentation performed by accounting staff. (Z = -0.944, p-value = 0.827). Therefore, controlling officers plays important roles in fraud detection for entities with this position.

### 5 CONCLUSION

In many companies where they believe that they have a modern management system, are often confused with the process of the internal audit and the process of controlling. It is a basic misunderstanding of the functions of these activities. Controlling is part of the planning and management participates in the strategic philosophy of the business and formulation of basic strategic aims. Controlling in the firm behaves as a corporate filter, which should eliminate unnecessary costs and any mistakes and losses.

There are existing typical factors influencing the choice of appropriate organizational controlling, as is size of an enterprise, for example large enterprise means separate departments or controlling unit with many departments. The position of the enterprise on the market is very important. The pursuit of victory increases the importance of controlling in the organization. The complexity of the problem also plays its role - the bigger and more complex problems, the greater the importance of controlling within the entity is. Its role plays the need for innovation with a lot changes and challenges growing importance of organization controlling. Another factor is the state of information technology in the enterprise and the tradition of controlling in the firm. Controlling in entity definitely helps to save costs, better organizes internal processes,
show hidden mistakes and frauds and finally helps financial auditors during their audit proceedings.

Gained results showed that more than one-third of controlling staff, within their prior review, rely on documentation given to them by department staff with less or no control over it and about two-thirds of them use own scepticism. This means that controlling staff needs to take action and check documentation provided by accountant staff to avoid mistakes and errors in final financial statements. A surprising finding about importance of controlling department is that only three percent of requested controlling officers are constantly detecting errors or frauds committed by accountants. What is more, almost two percent of errors or fraud mistakes detected by controlling officers reached over ten percent of overall yearly revenues of the entity. The proportional test indicates that controlling officers, in the performance of their duties, are detecting fraud in documentation performed by accounting staff.

Results supported an idea that for entities without controlling department there is bigger chance for not detecting possible fraud or mistakes coming from accounting background. Such mistakes or fraud behaviour can lead to often-significant negative impacts for entities in means of financial loss or damage of good name of the entity. Importance of controlling department within entities is in its role as filter for next spreading and issuing of incorrect and fraudulent statements. This investment will certainly pay off in the end.

According to results of given research it is hard to say with certainty that it was mistakes coming from overlooking or fraud what committed differences in reported documents presented by accounting staff. Even fraud commitment can be firstly coming from few small not discovered mistakes resulting in fraudulent issues. First not discovered mistake can persuade accountant to try more hidden surprises inside presented documentation. Controlling department is definitely essential tool for entities, especially where the external audit is not mandatory. Results showed that controlling is definitely important for sooner fraud detection. Rather let the controller reveal a small mistake or fraud commitment now, rather than lay down the whole business later.

References


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