Course Book

FINANCIAL STATEMENT FRAUD

DLMFAEFA02

LEARNING OBJECTIVES

Financial statements are documents that provide a picture of a company's activities and its financial performance. They are important for both internal and external stakeholders. Whilst internal stakeholders may use them to improve the way they make business decisions, external stakeholders usually base their investment decision on the information that is publicly available on a particular company (business entity). If the information provided is fraudulent, the trust in the financial system, especially public stock exchanges, is shaken, and the investors may refrain from investing in that particular jurisdiction.

Whilst the preparation of financial statements is important, the audit that confirms to what extent the preparers have adhered to the increasingly international standards (International Financial Reporting Standards [IFRS]) is even more important. All publicly listed companies are usually required by company law (or its equivalent) to have their financial statements externally audited. Auditors by definition should be able to detect any fraud in the statements. However, this may not always be the case, as a number of financial fraud cases show (Enron, Wirecard, etc.).

Understanding the nature of financial statement fraud and how it can happen is very important for managers, both to prevent fraud and to ensure better monitoring of financial functioning. Some corporate culture may be more prone to fraud, especially if an aggressive performance culture is nurtured ("up or out)". Sometimes, misuse and misinterpretation of generally allowed methods and techniques can also lead to financial fraud in financial statements. Understanding and effectively managing risks is also crucial for ensuring that fraud is discouraged. Internal control may also reduce risks and monitor any eventual "red flags" that may emerge over time. Excessive use of "creative accounting" can also be one of the triggers that would merit review of the accounting methods and policies applied in a company.

The course book **Financial Statement Fraud** aims at providing students with a broader understanding of financial statement fraud and will provide various applicable tools. The course book aims at providing a broader understanding of why financial statement fraud happens and what its economic and social implications are.

UNIT 1

INTRODUCTION

STUDY GOALS

On completion of this unit, you will be able to ...

- understand the key financial statements.
- describe the role and importance of financial statements.
- recognize the process of financial reporting.
- explain fraud and fraudulent financial reporting.
- understand and present the major financial statement fraud scandals.

1. INTRODUCTION

Case Study

Ms. X is a seasoned investor operating from Hong Kong. She owns a few businesses herself, but the day-to-day management has been transferred to family members and/or professional managers, and she now reinvests the revenues to new ventures in Hong Kong and beyond, looking to invest in the countries of Asia and the Pacific. At present, Ms. X does not have any particular investment preferences and is not in a rush to commit her hard-earned cash. She is considering a few companies, and despite good market perception and her own feel for these companies, she has asked to be supplied with the companies' financial statements for the last five years. The companies have complied and have supplied her with their Statement of the Financial Position and the Annual Financial Report. Some companies are larger and subject to statutory audit, so Ms. X has asked for the audited financial statements as well as the auditor's reports. Ms. X is considering performing some basic financial analysis.

She has heard that some financial ratios may point to a potential financial fraud in financial statements. She also knows from her own experience that aggressive accounting policies, although legally allowed, may in fact contribute to fraud in financial statements that are not so easily detected. As companies operate in different countries, she is also worried about consolidation rules and the possible differences in financial standards or their interpretation. Although the Internationl Financial Reporting Standards (IFRS) are international standards and generally globally endorsed, their understanding and interpretation (although technically unacceptable) differ from country to country. So after all this, Ms. X has decided to hire a professional accountant to prepare a due diligence report on the target companies and furnish her with the report. She has not asked for financial advice, as she will make a final decision herself, but has asked for technical support in understanding the financial reports/documents and detection of any possible "red flags."

1.1 Overview of Key Financial Statements

Financial statements are a formal record of the business/financial activities/operations of an entity, which can be a corporation, an individual, a public sector body, or a third sector organization. Often, the focus is more on economic agents – corporations and individual entrepreneurs – than on actors in other sectors, as they are bearers of economic activities and actively contribute to the economic growth in a country. However, public and third sector bodies (civil society organizations [CSOs]) also have to complete and submit financial reports, usually to the government and/or regulator. Financial fraud may equally happen in a private and/or public organization, and the ultimate impact of the fraud will be the same – weakening of trust in the systems, organization, and processes.

Businesses usually complete a series of financial statements. Some of them focus on the long-term position of the business, whilst others are more concerned with yearly operations. There are four financial statements that businesses and other registered entities have to complete (but not the government bodies):

1. The major statement is a **statement of financial position** which presents the entity's assets, liabilities, and owners' equity at a given point in time, usually at the end of the financial year (e.g., "as of 31 December 2022"). The term "statement of financial position" is in use by IFRS since 2017 (IFRS, 2022a) and is still formally referred to in the US by its former name, the "balance sheet." Often, accountants in those countries that have adopted IFRS (like the EU) may refer to this statement informally using its old, traditional name.
2. Another important statement is a **statement of comprehensive income**, which also may be referred to as an income statement, profit and loss report (P&L report), or statement of revenue and expenses. It reports on an entity's income, expenses, and profits (surpluses) over a specified period (i.e., accounting period). This financial statement provides information on the operation of the enterprise. The income statement includes sales and the various expenses incurred during the specified period.
3. The third major financial statement is a **cash flow statement**, which reports on an entity's cash flow, particularly its operating, investing, and financing activities over a stated period.
4. The fourth financial statement/report is a **statement of changes in equity**, sometimes referred to as a statement of equity or statement of retained earnings, which provides information on the entity's changes in equity over a specified period.

Financial statements are prepared as part of the annual reporting cycle or may be produced whenever it is required by the management. While the annual reporting is required by a company regulator and tax authorities, interim reporting is used for better internal decision-making. Although financial statements provide a wealth of financial information that is used by both internal and internal stakeholders (and interested parties), they are open for interpretation (Tracy & Tracy, 2021; Zieschang, 2021). Some accounting decisions may be seen more favorably by one type of investors, and it will be reflected in their investment decision. For instance, a company may establish the stock repurchases practice, which some investors may like, and it would influence their decision to invest into a company. Others may perceive it negatively, making it an off-putting factor.

Statement of Financial Position

The statement of financial position or balance sheet is the most important financial statement. It provides information on the entity's assets, liabilities, and (shareholders') equity at a certain point in time. An outline of the statement of the financial position is as follows:

- **assets**: cash and cash equivalents; accounts receivables; inventory; prepaid expenses; property, plant, and equipment; investments; trademarks, patents, goodwill, and other intangible assets
- **liabilities**: accounts payable, wages payable, notes payable, dividends payable, and long-term debt
- **(shareholders') equity**: shareholders' equity, retained earnings

As we can see, the assets are what the company owns that have value. This includes both physical and nonphysical assets.

Table 1: Balance Sheet of ExxonMobil as of 31 December 2021

CONSOLIDATED BALANCE SHEET (millions of dollars)

	Note reference number	December 31, 2021	December 31, 2020
Assets			
Current assets			
Cash and cash equivalents		6,802	4,364
Notes and accounts receivable – net	6	32,383	20,581
Inventories			
Crude oil, products, and merchandise	3	14,519	14,169
Materials and supplies		4,261	4,681
Other current assets		1,189	1,098
Total current assets		**59,154**	**44,893**
Investments, advances, and long-term receivables	8	45,195	43,515
Property, plant, and equipment, at cost, less accumulated depreciation and depletion	9	216,552	227,553
Other assets, including intangibles – net		18,022	16,789
Total assets		**338,923**	**332,750**
Liabilities			
Current liabilities			
Notes and loans payable	6	4,276	20,458
Accounts payable and accrued liabilities	6	50,766	35,221
Income taxes payable		1,601	684
Total current liabilities		**56,643**	**56,363**
Long-term debt	14	43,428	47,182
Postretirement benefits reserves	17	18,430	22,415
Deferred income tax liabilities	19	20,165	18,165
Long-term obligations to equity companies		2,857	3,253

Other long-term obligations		21,717	21,242
Total liabilities		**163,240**	**168,620**
Commitments and contingencies	**16**		
Equity			
Common stock without par value (9,000 million shares authorized, 8,019 million shares issued)		15,746	15,688
Earnings reinvested		392,059	383,943
Accumulated other comprehensive income		(13,764)	(16,705)
Common stock held in treasury (3,780 million shares in 2021 and 3,786 million shares in 2020)		(225,464)	(225,776)
ExxonMobil share of equity		**168,577**	**157,150**
Noncontrolling interests		7,106	6,980
Total equity		**175,683**	**164,130**
Total liabilities and equity		**338,923**	**332,750**

Source: ExxonMobil, 2022, p. 72.

To understand and analyze financial statements, it may be useful to consider different items (lines) presented in the financial statements:

- **Cash and near cash** (or cash equivalents) are assets that are liquid, i.e., can be easily and with minimum cost turned into cash. Treasury bills and certificates of deposits are the best examples of this class of assets.
- **Account receivables** refer to the money owed to the company by its customers at the moment of reporting. For instance, customers may be given a period of usually up to sixty days to settle the accounts, and their obligations will be reported as accounts receivable. An inventory comprises of goods a company has in stock, with the intention to sell. An inventory may be made of finished goods in stock, half-finished (semifinished) products or row material that is yet to enter production.
- **Prepaid expenses** refer to the costs that have been paid in advance (i.e., before the due date).
- **Capital assets** owned by a company for its long-term benefit are referred to as “property, plant, and equipment.”
- **Investments** are assets held for expected (although speculative in nature) future growth, and they are not used in operations. For instance, a company may invest in real estate with the hope that the value will grow and the company may profit when the assets are disposed of in the future (capital growth).
- **Intangible assets** are those that cannot be seen physically but have value, such as trademarks, patents, and goodwill.
- **Accounts payable** are the obligations/commitments that have been incurred as a part of the regular operations of the company, e.g., a debt to the supplier of row material.

- **Wages payable** are payments that are to be made to the staff for their work for the company. Both wages and salaries are considered under this item.
- **Notes payable** are debt instruments that record official debt agreements, including the payment schedule and amount. The company will have to service debt, and if the debt is not managed well, there may be issues with liquidity – and, ultimately, insolvency.
- **Dividends payable** are dividends that have to be paid but have not yet been paid.
- **Long-term debts** are obligations that are due in their entirety in more than one year. Sinking bond funds, mortgages, or other loans are a good example of long-term debt. The short-term portion of debt is recorded as a current liability.
- **Shareholders' equity** is defined as total assets minus its total liabilities. In fact, shareholders' equity is understood to be the amount of money that would be returned to shareholders in the case of a company's liquidation.
- **Retained earnings** may be a part of the shareholders' equity and are the amount of earning that was not paid out to shareholders (in the form of dividends). Retained earnings are often used to support the growth of the company (internal accumulation of capital; Bragg, 2021).

Statement of Comprehensive Income

The statement of comprehensive income outlines the change in net equity of an entity over a given period. The statement will include all the sources of revenue and expenses, notwithstanding tax obligation and interest charges. It focuses on the income that has been accrued over a specified time period. Sometimes, it may not include information on changes that may have happened over a longer period of time (i.e., changes in the value of assets [gain or loss] will not be reflected). Thus, gains or losses from pension and other retirement programs, foreign currency transactions adjustments and derivative instruments trading impact (gain and losses), as well as debt securities exposures will not be reported in the statement of comprehensive income.

The statement of comprehensive income (income statement) is the reporting entity's primary financial report on the income. It will explain how an entity raises its revenue and the costs that it incurred during this process. The statement will report on all income, not only from core operations but from all other activities, e.g., non-core business, investments, and passive interest. It will also focus on all costs, including those that are not necessarily directly linked with the core operations, such as taxes and other public charges (if any). The statement of comprehensive income shows the net profit and how it is distributed as well as earnings per share. This is information that investors do look for; the higher the earnings per share, the more profitable the business. At the same time, as with all other financial statements/reports, the statement of comprehensive income is open to different interpretations. Namely, investors sometimes may be myopic and look only for information that is in line with their picture of the company but not necessarily with the full business reality.

Table 2: Statement of Comprehensive Income for ExxonMobil

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (millions of dollars)			
	2021	2020	2019

Net income (loss) including noncontrolling interests	**23,598**	**(23,251)**	**14,774**
Other comprehensive income (loss) (net of income taxes)			
Foreign exchange translation adjustment	(872)	1,916	1,735
Adjustment for foreign exchange translation (gain)/ loss included in net income	(2)	14	-
Postretirement benefits reserves adjustment (excluding amortization)	3,118	30	(2,092)
Amortization and settlement of postretirement benefits reserves adjustment included in net periodic benefit costs	925	896	582
Total other comprehensive income (loss)	**3,169**	**2,856**	**225**
Comprehensive income (loss) including noncontrolling interests	**26,767**	**(20,395)**	**14,999**
Comprehensive income (loss) attributable to noncontrolling interests	786	(743)	588
Comprehensive income (loss) attributable to ExxonMobil	**25,981**	**(19,652)**	**14,411**

Source: ExxonMobil, 2022, p. 71.

Furthermore, the statement of comprehensive income focuses on the immediate past performance of the company and does not give much information that can be used to predict future performance of its company. It does not disclose trends and will also not provide information on possible future obligations. Of course, for management (i.e., decision-making) purposes, one may develop a projected income statement that will be a budgeted form of income statement for the future period. However, it will not be a financial report but an internal modelling tool.

Cash Flow Statement

A **cash flow** statement provides a detailed picture of what has happened with a reporting entity's cash during a specified period. Cash is often called the "blood of the business," and if the cash flows become problematic, an entity will first face the problem of maintaining its liquidity, and secondly, if the problem persists, will face the challenge of (in)solvency. A cash flow statement tells the investor how an entity operates both short- and long-term, as it shows how much cash comes in and goes out of the business. The cash flow statement is usually split into three sections:

Cash flow
A cash flow looks at the liquidity that an entity has in a specified period (i.e., accounting period).

1. Operating activities
2. Investing activities
3. Financing activities

Operating activities report cash flow that an entity has generated from regular activities (i.e., sales of goods and services) and includes both revenue and expenses. Investing activities report cash flow from acquisition or release of assets – both physical and nonphysical assets but using (free) cash, not debt. Financing activities segment reports on cash flow from debt and equity financing alike. In principle, the entity's cash from operating income should routinely exceed its net income, and cash flow is different from profit. Hence, the cash flow statement has to be analyzed together with other statements; the statement of financial position (balance sheet) and statement of comprehensive income.

The cash flows can be calculated using direct and indirect methods. In the case of the direct method, all cash collections from operating activities are taken into account, and all of the cash disbursements from the operating activities are subtracted. In the case of the indirect method, the result depends on the accrual accounting method used at times other than when cash was paid or received. The starting point is an income from the income statement, and then adjustments are made to adjust for impact of the accruals that were made during the accounting period (Zions Bank, n.d.). A cash flow statement can tell a lot about where the entity is in terms of the business cycle (i.e., is it expanding or contracting). Often, an erratic cash flow may suggest that the business may face challenges soon or, e.g., that it may have a number of clients who may be facing challenges and cannot meet their obligations on time (liquidity problems). All of this can be off-putting for more conservative investors or attractive to those who are more drawn to higher risks.

Table 3: Cash Flow Statement for ExxonMobil

CONSOLIDATED STATEMENT OF CASH FLOWS (millions of dollars)				
	Note reference number	2021	2020	2019
Cash flows from operating activities				
Net income (loss) including noncontrolling interests		23,598	(23,251)	14,774
Adjustments for noncash transactions				
Depreciation and depletion (includes impairments)	3,9	20,607	46,009	18,998
Deferred income tax charges/(credits)	19	303	(8,856)	(944)
Postretirement benefits expense in excess of/(less than) net payments		754	498	109
Other long-term obligation provisions in excess of/(less than) payments		50	(1,269)	(3,038)
Dividends received greater than/(less than) equity in current earnings of equity companies		(668)	979	(936)
Changes in operational working capital, excluding cash and debt				

Reduction/(increase)				
– Notes and accounts receivable		(12,098)	5,384	(2,640)
– Inventories		(489)	(315)	72
– Other current assets		(71)	420	(234)
Increase/(reduction)				
– Accounts and other payables		16,820	(7,142)	3,725
Net (gain)/loss on asset sales	5	(1,207)	4	(1,710)
All other items – net		530	2,207	1,540
Net cash provided by operating activities		**48,129**	**14,668**	**29,716**
Cash flows from investing activities				
Additions to property, plant and equipment		(12,076)	(17,282)	(24,361)
Proceeds from asset sales and returns of investments		3,176	999	3,692
Additional investments and advances		(2,817)	(4,857)	(3,905)
Other investing activities including collection of advances		1,482	2,681	1,490
Net cash used in investing activities		**(10,235)**	**(18,459)**	**(23,084)**
Cash flows from financing activities				
Additions to long-term debt		46	23,186	7,052
Reductions in long-term debt		(8)	(8)	(1)
Additions to short-term debt (1)		12,687	35,396	18,967
Reductions in short-term debt (1)		(29,396)	(28,742)	(18,367)
Additions/(reductions) in commercial paper, and debt with three months or less maturity		(2,983)	(9,691)	1,011
Contingent consideration payments		(30)	(21)	-
Cash dividends to ExxonMobil shareholders		(14,924)	(14,865)	(14,652)
Cash dividends to noncontrolling interests		(224)	(188)	(192)
Changes in noncontrolling interests		(436)	623	158
Common stock acquired		(155)	(405)	(594)

Net cash provided by (used in) financing activities		**(35,423)**	**5,285**	**(6,618)**
Effects of exchange rate changes on cash		**(33)**	**(219)**	**33**
Increase/(decrease) in cash and cash equivalents		2,438	1,275	47
Cash and cash equivalents at beginning of year		4,364	3,089	3,042
Cash and cash equivalents at end of year		**6,802**	**4,364**	**3,089**

Source: ExxonMobil, 2022, p. 73.

Positive cash flows show that an entity is successful and that more cash comes into it than flows out. It allows an entity to invest in itself, settle the debts, and expand. If it is a company, it will also be able to pay more to its shareholders, and/or accumulate resources (retained profit). If the cash flow is negative, then companies spend more than it comes into it, and it probably has to draw on debt (usually short-term) to maintain its liquidity and meet obligations on time. Negative cash flow is not sustainable in the long run and has to be addressed. Business entities that have negative cash flow may be of interest to investors that are looking to acquire a business and restructure it in the hope that they can gain on the difference between the acquisition and sale value of the entity. However, negative cash flow may appear in the years when an entity is investing much in its growth, and hence, this may be a temporary situation (over a short period of time). Like all other financial statements, a cash statement has to be analyzed in conjunction with other financial statements.

The statement of changes in equity (which in the US is known as "Statement of Retained Earnings") reports any changes in a company's equity position, reporting within a year (from the opening to the end) on changes such as earned profits, dividends, inflow of equity (additional capital infusion), withdrawal of equity, etc. The statement of changes in equity (statement of owner's equity) is not often considered by investors when making the decision whether to invest in a particular company. In terms of the form, the statement will start with an opening balance, followed by the net income, other income, newly issued capital, net loss, other loss, dividends, and finally, reporting any withdrawal of any capital (Deskera, 2023).

1.2 Role and Importance of Financial Statements

Financial statements as instruments of regular financial reporting provide information on the financial performance and health of a reporting entity. It provides not only information on the financial position but also on the performance, operations, and cash flow. They also contain information on the entity's revenue, expenses, profitability, and debt.

These four dimensions are important to outside investors when they assess the company and decide whether to invest in it. Financial statement preparation and publication may also be a statutory duty (legal obligation) for companies that are public (i.e., listed on the stock exchange). They have to file reports with the regulator and make them available to the public. The quality of financial reporting is very important for the trust in the overall system of investment at the stock exchange. Investors need input to make an informed decision about their investments and be assured that the information given is correct.

Financial statements are prepared in line with the national or international financial reporting standards. The already mentioned IFRS are the most widely used regulations for financial reporting, whilst generally accepted accounting principles (GAAP) are used in the US. There have been ongoing discussions in how far the international (International Accounting Standards Board [IASB]) and the US (US Securities and Exchange Commission [SEC]) standards of regulation could converge (Bartlett, 2021; PricewaterhouseCoopers [PwC], 2023). However, it seems that this will not happen in the near future. This implies that global investors will have to "translate" financial statements that follow these different accounting standards (and practices) to ensure comparability. This translation practice has been used in the past when national accounting standards dominated the business scene (i.e., prior to the introduction of IFRS). The adoption of IFRS has reduced the need for translation of financial statements at the global level, although challenges for cross-country quality of financial reporting remain. Even though the EU has long adopted IFRS, there are some differences in interpretation (IFRS, 2021).

Although financial statements are prepared to communicate on the entity's performance to external stakeholders (i.e., current and potential investors), they are also important for the management of the company itself (communication with internal stakeholders) as well as the government (regulator and tax authorities). Each of these stakeholders may have different interests in financial reports (statements), but the common interest is to ensure their credibility and integrity. This is why preventing and detecting any potential financial statement fraud early on is important. Widespread financial fraud may have serious adverse effects on investors' behavior and their activities in financial markets. For instance, investors who are willing to take a risk may be interested in investing in emerging markets, but only if the quality of financial reporting is relatively good. If the quality of financial reporting is poor, investing in those markets will border on gambling.

Creditors and lenders are also interested in an entity's financial performance, as they first assess whether the entity is "bankable", that is, meeting the requirements for extension of credit, and when the credit is granted, whether they can (reasonably) expect that it will be repaid. Creditors are primarily interested in an entity's liquidity, debt, and profitability. Employers have vested interests in the entity's going concern, as they are interested in keeping their jobs. Hence, the strength of a financial performance is the best sign for how the internal labor market will operate and whether the entity (i.e., company) will expand and hence recruit new staff – or whether it will consider shedding staff to deliver some operational savings. A company's financial strength should also indicate as to whether there will be a salary increase, payment of bonuses and other financial rewards.

Financial reports are important to the very entity that prepares them, as they will provide information on debt and obligations to others. In other words, what it may owe at present and possibly in the future may influence the adjustments in their (financial) strategy and trigger certain changes in financial management practices. A company (as well as external analysts) may then look at tracking various report items (using horizontal analysis), compliance, and liability management. The application of various financial ratios may help gain a broader, albeit not complete, picture of an entity's financial performance. The more thorough a comparative analysis of all financial reports is, the more comprehensive the overall image.

Various sections of financial statements will provide different perspectives on the business and its performance. Understanding assets, liabilities, and shareholders' equity are central to understanding and using the financial statement. Different financial statements will focus on respective aspects of the business. For instance, a statement of the financial position will provide a snapshot of an entity's financial position on a particular date (usually the last day of the reporting period/year). The cash flow statement will show how much cash has entered the company and how much cash has been paid out. The income statement will focus on income from all operations/activities that a reporting entity has been involved in during the reporting period (i.e., accounting period). The usual issues that appear in financial statements are revenue recognition and failure to capitalize expenses. In the case of revenue recognition, the conservative approach may adversely influence the reported sales number, and this may have a somewhat negative influence on the company. In contrast, failure to capitalize expenses may lead to a boost in a company's earnings. Ultimately, financial statements are subject to interpretation, and as is the case with interpretations, there will be differences in how certain positions are seen and evaluated.

1.3 Process of Financial Reporting

The process of financial reporting can be understood as a classic accounting reporting cycle. An accounting reporting cycle is a process of usually eight steps to complete a company's necessary accounting/reporting tasks. The accounting/reporting cycle coincides with a specified reporting period (i.e., accounting period). Accounting/reporting cycles will differ based on the needs of the company and external regulations.

Some reports are prepared for the use of management (i.e., management accounting reports), whilst others will be mandated externally (financial accounting reports). Financial statements are externally required. However, it does not mean that they cannot be used for supporting management decisions (i.e., as management accounting reports), either in their original or modified form. For instance, a cash statement is a financial report, but in the planning process, the company may produce a "budgeted cash statement" trying to outline future cash flows, and it will be prepared for internal use as an element of the company's planning process. A company is mandated to report externally on an annual basis. However, the management may require reports to be provided monthly, quarterly, or semiannually, too. Most companies, especially dynamic ones, will require

reports to be provided monthly so that necessary corrective actions may be taken in a timely manner, ensuring the highest impact. The accounting/reporting cycle comprises eight steps:

1. Identifying transactions
2. Recording transactions in a journal
3. Posting
4. Unadjusted trial balance
5. Worksheet
6. Adjusting journal entries
7. Financial statements
8. Closing the books

The first and sometimes most challenging step in the accounting/reporting cycle is identifying transactions. Business entities make numerous transactions whilst undertaking business operations. Keeping the record and being able to document each of the (major) transactions is the key to good financial reporting. Processing transactions require having appropriate documentation because otherwise the transaction cannot be processed.

After the transactions have been identified, they have to be appropriately logged into a journal (i.e., recorded), which is the second step in the accounting/reporting cycle. In accounting terms, a journal is a detailed account which records all financial transactions of an entity. It is to be used for future reconciling of accounts and passing information to other accounting records (i.e., the general ledger). With digitalization, for example, the use of a point of sale (POS), it is possible to combine steps one (identification) and step two (recording). An entity also has to decide on the accounting method that will be applied. It is possible to use cash or accrual accounting. Cash accounting methods follow the cash, whilst accrual accounting logs the transactions as they appear. Accrual accounting requires the matching of revenues with expenses, so both must be recorded at the time of sale. It also requires double-entry booking, so for each transaction there are two corresponding entries. In other words, in the double-entry booking, each transaction has a debit and credit entry that are equal. A single entry is simpler and often referred to as keeping a checkbook.

The third step is posting. When the transaction is properly recorded in a journal (journal entry), it should be posted to an account in the general ledger. The general ledger provides a comprehensive overview of all accounting activities by account. The general ledger provides a record of each financial transaction and contains account information needed for the preparation of the company's financial statements. All the financial information provided by the general ledger can be tested by trial balance. A cash account is one of the most important accounts in the general ledger. With digitalization, the importance of the general ledger has diminished because the transactions are now automatically logged.

Step four is an unadjusted trial balance. At the end of each accounting period, an unadjusted trial balance is produced, which reflects a company's unadjusted balances in each of the accounts. The purpose of the unadjusted trial balance is to ensure that the credit bal-

ance and the debit balance correspond (i.e., that they are equal). At this stage, it is possible to identify inconsistencies that will require further analysis and adjustment. If the numbers do not match (add up), mistakes have to be identified and addressed.

Step five is called worksheet. A worksheet is prepared and then used to ensure that debits and credits are equal. If there are any discrepancies, they have to be addressed, and appropriate adjustments have to be made. When accrual accounting is used as an accounting method, revenue and expense matching has to be undertaken together with the error correction.

Step six calls for adjustments. During this step, necessary adjustments have to be made. If the accountant has identified the errors, they have to be addressed. Adjustments in the journal entries have to be made where necessary.

Step seven is financial statements. After the adjustments are made, financial information is used to prepare financial statements. In principle, the reporting entities will prepare three major financial statements: income statement, statement of financial position, and cash flow statement.

Step eight refers to closing the books. Books are closed at the end of the accounting/reporting cycle. The closing of one accounting cycle is usually the beginning of another one. For instance, most companies in Europe will close their books on December 31st and will open them for a new accounting cycle on the first working day of the next financial year.

Following the steps of the accounting cycle ensures the accuracy and conformity of financial statements (i.e., facilitates consistency, accuracy, and efficient financial performance analysis).

1.4 Understanding Fraud and Fraudulent Financial Reporting

Fraud can be defined in various ways. For instance, a police form will define fraud as financial cheating: “Fraud occurs when an individual deceives another by inducing them to do something or not do something that results in a financial loss” (Gardaí, 2022). It is an intentionally deceptive action designed and undertaken by the perpetrator. Second, this action has to lead to unlawful gain for the perpetrator, or to denying a right to a victim. In the context of economic theory, fraudsters (physical person or legal entity) exploit information asymmetry, as the perpetrator is usually aware of some information that the victim is not aware of. They may misinterpret information and/or deny the victim access to that information. Fraud is criminalized in all legal jurisdictions without exception. However, although all fraudulent behavior is in its nature illegal, not all cases may be prosecuted and brought to trial in a court of law. Although a perpetrator may not be tried in the criminal court, a victim still can pursue a civil suit and request damages and compensation. In this case, the plaintiff has to demonstrate that the perpetrator has made a false

statement, that he or she knew that the statement is false and thus had the intention to defraud, and that the victim believed in and acted upon the false statement and ultimately has suffered the financial (and other) losses.

Types of Financial Fraud

In the context of finance and financial services, we consider various types of fraud, such as

- tax fraud,
- credit card fraud,
- mortgage fraud,
- bankruptcy fraud,
- securities fraud,
- wire fraud (especially in the US),
- insurance fraud, and
- financial statement fraud.

Tax fraud

Tax fraud happens when an individual or entity willfully and intentionally falsifies information to reduce tax liability (Association of Certified Fraud Examiners [ACFE], 2022). Tax fraud is complex because it encompasses numerous activities that aim at reducing tax obligations. For instance, a taxpayer may fail to report all the income, may claim the allowance to which he or she is not entitled, overestimate some of the costs, or under- or overreport pension obligations that may be subject to certain tax allowances. Sometimes, tax authorities may consider certain behavior as an honest mistake and not as tax fraud.

Tax fraud assumes a conscious, willful action with the planned outcome of avoiding tax obligations. Tax evasion or intentional failure to pay taxes is the most common type of tax fraud. Tax evasion, as unallowed behavior, has to be distinguished from tax avoidance, which is the use of legal schemes and exploration of legal loopholes to ensure that one's tax bill is lower than it would be otherwise. Both physical and legal persons can commit tax fraud, although the types of tax fraud may differ. For instance, whilst a person may not report all income, the company may commit fraud through wrong payroll reporting and simultaneous cash payment of some workers outside the standard payroll.

Credit card fraud

Credit card fraud is a complex and generic type of fraud that involves the misuse of payment cards (credit and debit cards). It may take on different forms. One is where a card holder transfers money to an account controlled by the criminal, and the other type is where criminals gain information on a credit card and make an unauthorized payment with the credit card without the knowledge of the card owner. The latter is often committed as card-non-present fraud. The increase in online trading has made credit card fraud more complex. If there is a security breach and account information is compromised, the thief may decide not to use this information immediately but after some time, making it ever more difficult to detect how and when the account information was compromised.

Banks are introducing different types of verification to reduce fraud. In some countries, cardholders may be required to produce an additional identity document, or a special one-time pin may be sent to the cardholder via text message to complete a transaction. A bank app may also generate a transaction code that can be used to complete a transaction. Artificial intelligence (AI) is also increasingly used to detect transactions that seem unusual for a customer's habits and refuse them if they are deemed suspicious. For instance, a large online transaction far away from the cardholder's usual place of residence may be flagged as suspicious. While contactless payment, up to a certain sum, may facilitate the use of cards and make payment simpler, it also allows perpetrators to make a number of small transactions before being detected and having the card blocked.

Credit card fraud has been on the rise, but banks are getting better at blocking suspicious transactions and preventing fraud. Further use of AI and more proactive behavior of cardholders may help reduce, albeit not eliminate credit card fraud.

Mortgage fraud

Mortgage fraud can be committed by both an applicant and the organization. For instance, the individual applicant may steal somebody's identity or provide false information on his or her revenues to increase the amount of the approved mortgage. Professionals may play with the valuation of a real estate and use loans to dupe the system. Mortgage fraud can also be linked with flipping, which is a practice of acquiring property with intention of keeping it for a short period of time and making profit with quick sale (rather than long-term gain). There is also the case of occupancy-status-related fraud, in which an applicant claims that they will occupy the property to ensure better and lower interest rates, although the intention is to rent the property.

There is also the possibility that mortgage fraud will be committed by a "straw buyer." A straw buyer is a person acquiring property for somebody else. Although buying property for someone else is not illegal in itself, knowingly acquiring property for a person who otherwise would not be eligible to do so is a fraudulent act. The use of straw buyers may be more complex and elaborate than it may look at first sight. For instance, property agents, valuers (appraisers), and mortgage brokers may use the straw buyer for illicit gains. Often, prosecutors may try these cases as organized crime.

Bankruptcy fraud

Bankruptcy fraud happens when someone knowingly misrepresents or fails to mention a piece of information about finances on their application for bankruptcy, while the bankruptcy process is ongoing, or takes actions to hide assets. The usual forms of this type of financial fraud are falsified statements and claims as well as hiding assets. Associate illegal behavior can be filing a bankruptcy claim in several jurisdictions or even offering bribes to the participants in the bankruptcy procedures (Legal Information Institute [LII], 2023a). Almost 70% of fraud is related to concealing assets.

Securities fraud

Securities fraud is another type of complex fraud. The SEC defines securities fraud as any criminal activity that may include the following (all these activities essentially involve the deception of investors or the manipulation of financial markets):

- **high-yield investment fraud**: These investment schemes include any activities where investors are offered high-yield returns that are in essence "too good to be true".
- **Ponzi schemes**: These schemes are those where the collections from new victims are used to pay the high rates of return promised to earlier investors.
- **pyramid schemes**: These schemes are more or less similar to Ponzi schemes where the recruitment of new members is needed to keep the fraud going and paying out the returns to earlier members.
- **advanced fee schemes**: These schemes are those where victims are invited to pay small amounts of money with a promise of greater returns, but these returns never materialize because there is no underlying investment involved.
- **foreign exchange fraud (FOREX)**: This fraud is understood as any trading scheme that is used to defraud traders by persuading them that they will make large profits by trading in FOREX markets. In principle, FOREX markets are a zero-sum game, but if fees and transaction costs are included, the foreign exchange trade may be a negative-sum game (i.e., traders are exposed to almost certain losses). The fraud may take on different forms: selling dubious trading software, promising high returns, opening an account that may be raided and the fraudster company being closed. FOREX fraud usually happens in countries where financial market regulations are laxed and law enforcement capacity is low (primarily due to corruption).
- **broker embezzlement**: This is a type of financial fraud where the broker has betrayed the client's trust and misappropriated money on the client's account for personal and/or company gain.
- **pump and dump (P&D)**: This type of fraud happens when the price of an owned stock is inflated through false and misleading positive statements with an intention of selling the cheaply purchased stock at a higher price. This is often the case with the small cap cryptocurrencies and small companies (called "microcaps"). P&D fraud may be facilitated through spam email, (fraudulent) investment research websites, social media (campaigns), and systematically placing misinformation.
- **hedge fund fraud**: This is a type of securities fraud that is broadly defined and understood as any act of financial misconduct committed by or for the account of a hedge fund. It may be similar to other types of securities fraud, but it is different insofar as the perpetrator must be a hedge fund. Fraud may happen if a client was not informed about the risks associated with investing in hedge funds. Hedge funds are financial intermediaries that are perceived as very risky and are often deemed to be appropriate for the savvy, experienced investors who can bear excessive financial losses.
- **late-day trading**: This is a type of financial fraud where trades are executed after the market closes, and thus, charging the stock price that was valid when the market was still open and trading and would have been the next day's opening price. This type of trading differs from the official after-hours trading that may be allowed. Although illegal in the US, late-day trading may be allowed by some mutual fund managers.

Wire fraud

Wire fraud happens when the fraud is perpetrated by using various types of communication facilities and devices, such as telephone, computer (email, VOIP, etc.). It is a federal criminal offence in the US and is often one of the crimes that perpetrators are charged for in combination with other forms of offences (e.g., criminal stacking). The use of technology to commit fraud is an important element of this crime. In the past, the majority of fraud cases were mail fraud because they were committed by mail. Phishing and online fraud are usually cases where wire fraud charges are brought (US Code, Title 18; LII, 2023b).

Insurance fraud

Fraud may also be linked with insurance and other financial subsectors. Insurance fraud may be defined as any willful act to defraud an insurance process. For instance, a claimant may try to extract some benefit or advantage they are not entitled to, or an insurer denies some benefit that is due, knowing that the claimant has every right to it. There also may be fraud in terms of damage assessment, imposing unlawful limits on the claims, sabotaging the claim process, unreasonable delay, etc. As with all other financial frauds, insurance fraud is multifaceted and may take on different forms.

Financial statement fraud

Financial statement fraud happens when financial statements are intentionally doctored so that one side acquires illegal gains. In the case of financial statement fraud, investors are usually on the losing side. Major types of financial statement fraud are

- overstating revenues,
- fictitious revenue and sales,
- timing differences,
- inflating an asset's net worth,
- concealment of liabilities or obligations,
- improper or inadequate disclosures,
- falsifying expenses, and
- misappropriations.

Although these practices may be a source of financial statement fraud, some of these practices are not illegal and fraudulent per se. In other words, their illegality will be examined in the context in which they have been committed. Again, as with all other cases of fraud, a prosecutor will have to prove intent to defraud. The burden of proof is always with the prosecuting party. Without intent to defraud, fraud as such does not exist. One may consider these as cases of incompetence or gross negligence, but not fraud per se.

1.5 Historical Examples of Financial Statement Fraud

Financial fraud is probably as old as society itself. Different pyramid and Ponzi schemes have existed since ancient times. Human desire for a quick and effortless gain has probably contributed to that. If financial fraud cases are carefully studied, one would find that most of them "offer" (promise) returns that are unreasonably high (i.e., "too good to be true"). In the case of financial statement fraud, numbers are excessively manipulated and adjusted to desired results, or information is intentionally and willfully doctored to give a wrong and misleading impression to potential investors so that they will invest in the company.

Most accounting scandals prior to the 20th century are mainly associated with selling worthless shares and prospects. It is claimed that the first documented case of financial fraud happened in ancient Greece, where a ship captain or owner called Hegestratos took out a large insurance policy known as "bottomry." As a security, he offered his ship and its cargo of corn. However, he planned to sink the empty boat, keep the loan (the insurance at that time was a hybrid between loan and insurance, similar to the better known "Fenus nauticum", an institution of Roman law), and finally sell the corn. However, the plan backfired and he died while trying to escape an angry ship crew and passengers who found out about his plans (Subramanian, 2014). Most likely, there have been earlier attempts to commit financial fraud, but they have not been documented.

Early US financial history records early manipulations of federal and state bonds where insider trading was rampant and almost led to a market crush. The US treasury had to engage in bond repurchases and act as a **lender of last resort** to save confidence in the financial markets (Sylla et al., 2009).

Lender of last resort
A lender of last resort (LLR) is a central bank that lends money to a bank in a liquidity crisis in order to ensure the stability of the financial system and prevent bank runs.

In 2008, Lehman Brothers, one of the most prestigious investment banks in the world, collapsed, and according to many, triggered the financial crisis in 2008, now known as the Global Financial Crisis (GFC; Aliber & Zoega, 2019). At its very peak, just before the collapse, Lehman Brothers was the fourth largest investment bank in the US, with 25,000 employees worldwide. It had $639 billion in assets and $613 billion in liabilities (Wiggins et al., 2014). The Lehman collapse could not in itself initiate the crisis, but it certainly contributed to an increased market insecurity and mistrust. The bank collapsed when it was discovered that it hid over $50 billion of loans as sales. When it was realized, it was clear that the company was insolvent and the attempts to save it failed. Some would claim that its collapse would have been prevented if the US government had reacted the way it reacted to the subsequent banks crises (Freidheim, 2018). Efforts to sell it to overseas investors (Gulf countries' financial institutions) have also failed, and Lehman filed for bankruptcy on 15 September 2008 (Ball, 2018; McDonald, 2015).

The same year, Bernard L. Madoff Investment Securities LLC was declared bankrupt within the largest Ponzi scheme in financial history. Madoff defrauded investors for an estimated $64.8 billion. Madoff and his two accountants were handed prison sentences and a restitution to the amount of $170 billion. Madoff himself received a sentence of 150 years in

prison for the following federal charges: securities fraud, investment advisor trust fraud, mail fraud, wire fraud, money laundering, false statements, perjury, making false filings with the SEC, and theft from an employee benefit plan (Arvedlund, 2009).

In 2009, Saytam Computer Services was charged with falsifying revenues, margins, and cash balances at about 50 billion rupees (approx. $605 million in December 2022). All senior managers were charged with fraud, but they were released when the authorities failed to document the cases and find proof of intentional wrongdoing. The company attracted attention during the 2008 financial crisis, as some of the suspicious business property transactions led investigators to the company, especially after Saytam Computer Services' failed to acquire another company. When the case was uncovered, the chairman admitted that the accounts showed profits that had never existed and that there was cash at a bank that did not exist. This seriously inflated the value of the shares, and at the peak the senior managers sold their shares. Based on good results, the company was given cheap loans in the US, but they were never on the books because they finished up in private pockets (the chair and his closest associates). At the same time, it was discovered that over $3 million were spent on salaries of staff that had never worked for the company (ghost workers). Finally, the company that filed for bankruptcy, with the assistance of the Indian central government, was acquired by another Indian conglomerate, the Mahindra Group. Interestingly, international auditors PricewaterhouseCoopers (PwC) gave Saytam a clean bill of health and an unqualified audit opinion, not raising any concerns whatsoever. The US SEC fined PwC India with $6 million for gross negligence (Stempel, 2011).

The most famous case of accounting/financial statement fraud in the 21st century is most certainly the case of Enron. Enron was a US energy, commodity, and trading company that branched out in some other industries as well. At its peak, the company had a turnover of $101 billion and was considered the most innovative American company. However, in 2001 it was discovered that the company had run a systematic, creatively well-planned and executed accounting fraud at an organizational level for several years (Healy & Palepu, 2008).

Since the early 1990s, Enron had set up several limited-liability, special purpose vehicles and entities. In principle, they are not illegal, and they are a common business practice in the energy industry to manage separate projects. This practice allowed Enron to transfer some of its liabilities off the books, which had a strong impact on the stock price and supported good investment grade credit ratings. Enron was successful in exploiting the deregulation of the energy market in the US and other countries. It also had a very strong international acquisition spree in the 1980s and 1990s, taking over companies in both developed and developing countries. This expansion was often financed by debt, and that debt was often linked with special purpose vehicles. Intercompany transactions and other elaborate financial schemes were used to ensure that the unprofitable entities were kept hidden and outside the scope of scrutiny.

The Enron scandal led to the downfall of the Arthur Andersen accounting firm because it had issued unqualified audit opinions for a number of years. After the Enron scandal, a major shakeup of corporate governance and an auditor-client relationship overhaul was launched by the promulgation of the Sarbanes-Oxley Act, 2002 (formally, the Public Company Accounting Reform and Investor Protection Act of 30 July 2002). For instance, auditors now cannot simultaneously serve as consultants for a firm due to a perceived conflict

of interest. Company boards have been empowered to govern the company and question senior management more effectively. This has also led to several regulatory innovations in other countries, including the EU.

The European Commission enacted the Directive 2014/56/EU, establishing the framework for audits, public oversight of auditors, and cooperation between EU authorities; the second component is Regulation (EU) No. 537/2014 which specifies audit requirements for public interest entities; and later, the establishment of the Committee of the European Accounting Oversight Bodies. The Directive 2014/56/EU has empowered EU officials to investigate and, if necessary, impose sanctions to ensure that the interests of investors are properly protected (EC, 2003).

The WorldCom scandal followed just a year after Enron. When the scandal emerged, it was discovered that the telephone company had overinflated its assets in the region of over $11 billion. Again, with the knowledge and support of the senior management, WorldCom had (a) underreported line costs by capitalizing instead of expensing them and (b) had inflated its revenues by making false entries. These are two basic techniques used in accounting and financial reporting fraud. The scandal emerged when WorldCom's own internal audit found over $3 billion in fraudulent accounts. When WorldCom went bankrupt, over 30,000 jobs were lost and the investors lost over $180 billion. The chief executive officer (CEO) was sentenced to prison for financial fraud, conspiracy, and filing false documents.

Beside these major scandals, there have been many cases of supposed accounting and financial statement fraud. For instance, the UK construction company Carillion misrepresented results and filed for bankruptcy, accumulating a debt of £900 million and £600 million of pension deficit. In 2018, KPMG UK was fined for failures in auditing the fashion company Ted Baker. In 2013, the Kraft Heinz Company inflated savings (a management expense scheme) and paid the SEC $62 million. CHS, an international agribusiness conglomerate, filed materially false financial statements for over five years and was fined by the SEC. Recently, the Patisserie Valerie announced that it had a number of false entries on its books, and the former chief financial officer (CFO) has been investigated for fraud, together with Graham Thornton, the company's auditors. The company itself went into administration despite the owner's efforts to put his own money into covering the losses and trying to save the company. Granite Construction, a US firm, reported in 2022 that their former senior manager had "played with the accounts" and ensured positive project results by manipulating profit margins and not recording the costs (Bhaskar & Flower, 2019).

All these accounting and financial reporting scandals point to the responsibility of the senior management in these companies, their boards, and their ability to oversee the operations. Auditors themselves question the capacity of the standard audit procedures to

detect fraud, especially sophisticated, well designed ones. It is possible that in many cases the discovered fraud will be followed by financial fraud investigation, which is a more aggressive and confrontational method of examining financial reporting outputs.

SUMMARY

At the end of the financial year, business entities are mandated to prepare financial statements and, in the case of large and public (i.e., listed) companies, publish them (i.e., to make them public). A company's financial statement serves many purposes, including informing existing and potential investors of the company's performance so they can decide whether to keep or sell the shares or acquire the shares of the company in case. Trust in financial statements is of paramount importance for stock exchanges to operate effectively. Therefore, the regulator and the public have an interest in seeing that any manipulation of financial reports is minimized, if not totally eliminated. However, despite all efforts, from time to time, accounting scandals emerge and shake the financial world. Some of them are of local importance, whilst others, like Enron, have not only called for significant punishment for the perpetrators but also triggered significant regulatory reforms at a global scale. In most cases, statutory auditors have failed to notice early discrepancies in financial statements and express their concerns. Hence, the auditors were held accountable for not discovering the fraud early on and have in some cases (Enron) paid with their bankruptcy (Arthur Andersen). The duty of a well-organized internal control system and external audit is to, ideally, prevent fraud or, if not, to ensure that financial statement fraud is detected early enough before it reaches catastrophic proportions.

UNIT 2

FRAUD TRIANGLE THEORIES

STUDY GOALS

On completion of this unit, you will be able to ...

- understand fraud triangle theory.
- name and critically examine major fraud theories.
- compare strength and weaknesses of various fraud theories.
- apply major fraud triangle theories in practice.
- describe and present major fraud theories (agency, stakeholder, public interest, capital needs, and communication theory).

2. FRAUD TRIANGLE THEORIES

Case Study

Ms. X has been an active investor for years. She has carefully considered the performance of companies, not only in Hong Kong but also mainland China. As her disposable income has grown over the years, she has decided to broaden her portfolio. Being a businessperson herself, she preferred investing in manufacturing and companies that produce goods, rather than companies that provide services. However, recently she has looked to invest in the financial sector and has focused on traditional large banks and major insurance institutions. Her interests have now shifted toward Southeast Asia, as she believes that it is just a matter of time before these countries become the future stars of economic growth. The shift of production from China to some of these countries (most notably Cambodia, Lao PDR, and Vietnam) she sees as a clear sign of support for her views. At present, she is investing in a number of production companies in Hong Kong, China, Malaysia, and Singapore. She has been looking at more volatile markets such as Lao PDR, but she remains skeptical due to the lack of transparency, inconsistent government policies, and poor protection of international investors. As she has spare cash, she is considering other investments. She receives a call from a foreign exchange (FOREX) trader, operating from a small jurisdiction that has neither the regulation nor enforcement capacity to oversee FOREX trade. She, the FOREX trader, sells software and provides Ms. X with training to engage in FOREX trade herself. So Ms. X invests a few thousand US dollars and begins trading. However, very soon she realizes that the fees and other charges that her "broker" has imposed have eaten her investment, whilst she has not realized any gains. When the FOREX trader becomes more aggressive in advising Ms. X to invest more and move to a more expensive "premium" trading accounting without explaining why, she realizes that something is wrong, and she decides to withdraw the money. However, the "broker" refuses and soon she cannot contact her on her number. At that point, Ms. X realizes that she is a victim of securities fraud and reports it to the authorities but is told that very little can be done because the broker operated in an unregulated jurisdiction and most likely has closed the company and moved somewhere else. Ms. X accepts the loss and returns to her equity investment in long-standing production companies and strong, credible financial institutions.

2.1 Agency Theory

Agency theory is probably one of the most widely used theories in both economics and management. Agency theory was proposed by Jensen & Meckling (1976), stating that there is an underlying conflict of interest between the principal (company owners) and agent (hired managers). Managers behave as a self-maximizing agent and have their own interest at heart rather than the interest of the principal. Therefore, the principal has to ensure that they have an effective control mechanism so that they can monitor the behavior of the agent. When discrepancy between the interest of two parties is small, their working relationship may still be effective. However, if the differences are significant and the

principal does not have effective measures to punish the principal, additional problems may emerge, and thus the costs of controlling the agent (i.e., the agency costs) may be high.

Although agency theory has been developed in the context of corporate management, it may be equally applied in other contexts. For instance, elected officials are agents, whilst the lectorate (voters) are the principal. Similarly, any person hiring someone to work on their behalf will have a similar problem. Those hired will be agents, and those hiring will act as principal. Conflicts of interest are explained by using the concepts of moral hazard and adverse selection.

Moral hazard is a concept developed in economics: An economic agent is enticed to increase the level of risk exposure because he or she will not bear the full consequences of risk when it gets realized. In this context, the agent may be enticed to act as a risk lover because the principal(s) will ultimately bear the costs of any risks.

Sometimes, a moral hazard may be explained by information asymmetry, and those involved may not have complete information and hence will have a skewed perception of reality, which may influence their position on risk. However, in the context of a moral hazard and a principal–agent relationship, the information asymmetry may not really trigger risk-loving behavior but rather a self-maximizing drive. A conflict of interest emerges when an economic agent holds multiple interests simultaneously, but serving one interest may actually impede serving the others. In other words, the conflict of interest, in principle, may create a situation where none of the interests may be served appropriately. Adverse selection happens when one party in a negotiation has relevant information the other party lacks, and this asymmetry of information influences the final outcome. So, for example, the manager being in an operational role may possess information that a shareholder as a principal may lack.

Multiple principals may also complicate the principal–agent relationship. If multiple principals exist, it is of utmost importance to ensure they act as one and agree on coordinated action toward the agent. If this is not done, opportunities for free riding arise. Principals may also be in conflict among themselves. Steering and monitoring of the agent may also be inefficient. Individual principals may also decide that it is in their own best interest to lobby the agent rather than to participate in a coordinated fashion.

From a legal perspective, the principal–agent relationship may be addressed through a contract in which the rights and duties of both parties are well stipulated. Under the contract, the principal will employ the agent and use various incentive measures to ensure his or her best performance. For instance, various bonus schemes may be offered as well as management stock and other similar models. Enforcement of the contract may be expensive, but both sides will then be motivated to fulfill their contractual obligations. Nonfinancial compensation and team performance may also be used to boost efforts on behalf of the agent.

Control fraud may emerge within the context of a principal–agent relationship. Control fraud appears when a trusted person in a senior position within any entity of the public, private, or third sector subverts the organization and commits extensive fraud for a per-

sonal gain (Black, 2005). The concept of control fraud states that the head of the organization (i.e., chief executive officer [CEO]) is in the best position to remove any checks and balances on fraud within the organization and influence the process through (selective) hiring and firing. In such an environment (i.e., lax control), the manager may initiate accounting fraud, manipulate financial results, influence financial statements/reports, and hide underperformance from both investors (shareholders) and the public. “Massaging the books,” when there is no internal control, may become a standard practice. Managers may also make investments that have no value and then engage in bringing in friendly valuators and external auditors to confirm the quality of the decision.

In the context of a principal–agent relationship in the public sector, the US has instituted the crime of honest service fraud. This type of fraud happens in cases in which private individuals breach their fiduciary duty. The person breaching a fiduciary duty is the public/civil servant, and the beneficiary is a member of the public (ultimately, a taxpayer). In the interpretation of the US Supreme Court, honest service fraud refers to “fraudulent schemes to deprive another of honest services through bribes or kickbacks supplied by a third party who ha[s] not been deceived” (Skilling v. United States, 2010).

Motivation and incentives are supposedly set to align the interests of principal and agent. If rightly motivated, the agent will act in the best interest of the principal and will be interested in direct self-maximizing activities. Monitoring and control are another facet of the relationship where appropriate mechanisms that will influence the behavior of managers and lead to an alignment (superficial or not) between agent and principal are to be set. However, in practice, especially in the case of failed companies, the role of CEO and chairperson was combined, so one person was acting in both capacities (Enron, Tyco, Adelphia). In the case of WorldCom, the CEO and chair were very close, making monitoring and control ineffective.

CEOs have to be given enough freedom to lead a company, but at the same time, an effective control mechanism has to be established to ensure that their behavior does not harm the interest of the company and its shareholders. Various reporting mechanisms and engagement with the shareholders (i.e., principals) have to be in place along with incentives and reward schemes to provide motivation for the CEOs to act on behalf of their shareholders and not in their own interests. Curtailing opportunistic behavior, such as shirking responsibility or indulging in the benefits of the position, is the duty of the board (Donaldson & Davis, 1991).

Agency theory has been considered one of the simpler management concepts, and some claim that that is the main reason for its attraction. However, criticism of agency theory calls for more robust study and understanding of human preferences (Davis et al., 1997). Modern approaches see people as more complex. Simple economic models cannot fully explain human behavior. Personal traits, culture, and the strength of someone’s personality may be additional crucial factors in defining a manager’s behavior, rather than limiting him or her to an economic model of a self-maximizing economic agent. For instance, job satisfaction, a sense of purpose and belonging to an organization may play a more important role in defining executives’ behavior than pure economic theory would admit. Hence, complexity-driven models are needed to model human, managerial behavior and its impact on the organization. Agency theory, in its classical narrow sense, would explain

corporate fraud as a consequence of extreme self-maximizing behavior of a manager and the lack of checks and balances. However, this is only one perspective in understanding fraud, especially finance-related fraudulent behavior.

2.2 Stakeholder Theory

Stakeholders
They may be seen as "groups without whose support the organization would cease to exist" (Freeman & Reed, 1983).

Stakeholder theory looks at a company beyond its shareholders, that is, people who have direct interest in a company. The duties of corporations extend to all stakeholders. Stakeholders are those with vested interests in the company, its operations, environment, etc. Stakeholders are shareholders, workers, suppliers, debtors, creditors, customers, government, regulators (if any), business associations, etc. In other words, the stakeholders list may be long and often specific to the society, business culture, country, etc. In some cultures, the relative power of workers as stakeholders will be higher than in others. For instance, in Germany, the Institute for Codetermination and Corporate Governance (Institut für Mitbestimmung und Unternehmensführung [IMU]) gives workers their rights to participate in the management of their company (Müller-Jentsch, 1995). In other countries, especially the Anglo-Saxon ones, this certainly would not be the case. Freeman (1984) is of the opinion that companies have responsibilities to stakeholders for setting forth concerns and fair treatment.

Some find the stakeholder model to be "a model of the firm based on Kantian notions of duty: each stakeholder has a right to be treated as an end itself, and not solely as a means to an end" (Shankman, 1999, p. 323). Corporations have a duty to the shareholders primarily on a moral basis. In other words, morals and values in managing an organization are important, and the focus of the company should be on corporate social responsibility, market economy, and social contract theory. Stakeholder theory brings together many other theories such as organization theory, strategic management, systems theory, corporate planning, and corporate social responsibility. This makes the approach richer and stronger.

The theory states that a company – and by extension its management – has a fiduciary duty to all its stakeholders. In fact, they must ensure that all stakeholders are fully appreciated and not discriminated against. Clark (1995) states that the management of a corporation is responsible for ensuring that the stakeholders' stakes are transformed into profitable products without having them be exposed to any involuntary harm or loss.

Donaldson and Preston (1995) state that stakeholder theory has multiple distinct aspects: descriptive, instrumental, and normative. The descriptive approach describes and explains the characteristics and behaviors of corporations (how are they managed, work of the board of directors, managers' behavior and attitudes, and the nature of the firm itself). The instrumental approach, using empirical data, outlines the links between the management of stakeholder groups and the achievement of multiple corporate goals. The normative approach, which Donaldson and Preston (1995) consider the most preeminent, explores the function of the corporation and states the moral or philosophical guidelines for its operation and management.

Other authors focus on the attributes of (a) power (imposing will), (b) legitimacy (structures or behaviors that are socially acceptable/desirable), and (c) urgency (time sensitivity or criticality of the stakeholder's claims; Mitchell et al., 1997). The stakeholder approach has also been endorsed by the International Organization for Standardization (ISO) for some of their international standards (ISO 26000 Social Responsibility) (ISO, 2010) as well as some other international initiatives, like the Global Reporting Initiative (GRI). It has also been widely spread in nontraditional "industries," such as education, health, and other social services where consultation with the stakeholders is crucial for the success of the initiatives considered. For instance, many national and social dialogues are designed along the lines of stakeholder theory.

Figure 1: Stakeholder Theory Mapped

Source: Željko Šević (2023).

In the stakeholder model, all stakeholders have a right to information that is provided timely and fully. In providing this information, a corporation is responsible for the quality of reporting information. Information must also be provided to all stakeholders without segregation or any possible discrimination. One should also recognize that it is possible (and most likely) that stakeholders may have different conflicting interests and expectations. In those cases, it will be very difficult, if not impossible, to satisfy them all. This is

why there may be a need for additional political negotiations, maneuvering, and agreement on the basic principles that all actors will adhere to. However, some claim that stakeholder theory – as it is based on a form of social contract – may undermine the very foundations of the market (capitalist) system. A corporation should return to its core function and focus on two principles: property and contract. These two principles, and not serving the interests of (other) stakeholders, will reinvigorate the corporation (Mansell, 2013).

Shareholders are usually at the center of attention when it comes to financial fraud. It is believed that they are the major victims due to their financial exposure. However, stakeholders would most likely experience financial and other losses, too. For instance, workers may lose their jobs, suppliers the market, creditors will miss their loans being repaid, governments may lose taxes, and communities the positive impact of the company. Hence, the impact of fraudulent behavior on a company has an even wider impact than initially thought – or as understood by various approaches. In the case of fraud, employees may not only lose their current job and outstanding compensations but also any accrued pension rights. The CEOs of major companies that perpetrated fraud (Enron, WorldCom, etc.) have also raided pensions of their employees – and this was one of the charges that ultimately led to the prison sentences.

Customers may be deprived of services that they became accustomed to, or the service may be provided by less trained or untrained personnel, which in some industries (e.g., health care) may be detrimental to personal safety and welfare (e.g., services provided by an unlicensed medical staff). Communities may benefit from the presence and positive spillover effect of surrounding companies, which can be lost or reversed when these companies are found guilty of fraud and are ultimately closed.

Financial statement fraud is ultimately perpetrated by misreporting financial results, modifying or misrepresenting results, and providing misleading information for the purpose of influencing the behavior of stakeholders. Stakeholder theory outlines the moral responsibility of a corporation and its management for timely and quality reporting as well as protection of their shareholders' interests. However, the theory has limitations in explaining why the management of a corporation engages in fraudulent behavior and adversely affects the financial well-being of its shareholders.

2.3 Public Interest Theory

Public interest theory states that government regulation is introduced to protect and benefit the public. Public interests look after the welfare of the public and the wider society. The theory was developed within the broader framework of representative democracy and government. It assumes a benevolent role of the government in regulating social life and the role of civil service within the process. Civil servants deliver their duties by respecting the structure. The existence of norms ensures impartiality, as the civil servants have to subsume to norms or balance means and ends. The framework that regulates the behavior of civil servants is set by politicians, but at the same time, politicians (political representatives) are often highly dependent on the civil service to be able to function.

Public interest theory
This theory states that through regulations a government aims to protect and serve the interests of the public.

Public interest theory has been predominately called upon in legal and political science theory. It has often been regarded as the "go-to theory," i.e., the theory that scholars and practitioners would turn to when certain phenomena are to be explained (Bozeman, 2007). It has shown a remarkable level of resilience and flexibility and has been used across various sectors and schools of thought (Feintuck, 2004). Despite all this flexibility and robustness, Bozeman (2007) finds that public interest theory has three core facets: (a) normative, (b) "consensualist," and (c) process approaches. The approach chosen influences the outcome. Within the normative approach, interest is seen as the crucial goal which public officials should pursue and is used as a moral framework for understanding public policy and policy interventions. Consensualists claim that the public interest is reflected in the interests of the majority, and therefore, a useful means to determine what is in the public interest in democracies. The process approach to public interest theory assumes a few different and often competing approaches. A process theory can be seen as "an aggregative conception that follows the utilitarian idea the public interest is the greatest good for the greatest number of citizens" or as the competition among interests (the "pluralist" conception), and finally, a view of the public interest as "interest reconciliation and fair procedure" (Bozeman, 2007, p. 93).

Public interest is situation-dependent and dynamic. It may change with the times, and often the shift in political views and values will have a direct impact on the understanding and practices of public interest. Public interest can also be understood as action, rather than just a theoretical concept representing the dominant view of certain groups. Of course, a public view may call for reconciliation of various groups' perceptions and views. Again, the public interest may not necessarily represent the average view of various groups but most likely a prevalent one.

Within legal thought, public interest policy has often been called upon in protecting fundamental values and limiting the powers of government. For instance, it is stated that a policy as such "cannot be in the public interest if it conflicts with the elements of the minimal value structures that define the society" (Held, 1970, p. 222).

Public interest theory strengthens the democratic approach to public policy (Feintuck, 2004) and as such ensures that "interpretations" are made to protect the interest of the majority (democratic interests). At the same time, the "rule of law" principle (law and order) can also be seen in the wider context of public interest theory. Observance of law (systematic legal rules) and effective enforcement of laws certainly contribute to the public interest. Engaging the public can also strengthen the implementation of laws and support the public interest. For instance, giving nongovernmental organizations (NGOs) active legitimation and allowing them to initiate lawsuits points out the public interest in vindicating rule of law and its requirements (e.g., acting within powers, due process, reason-giving, proportionality, and fundamental rights; Gordon, 2013).

Public interest theory has also been criticized almost from the moment it emerged. Early critics go back to 1908 (Bentley, 1908) and continued throughout the 20th century (e.g., Downs, 1962; Schubert, 1960; Sorauf, 1957). Criticism revolved around issues of ambiguity and vagueness and also whether it can be utilized and contribute to political debate. However, a concept cannot be discarded because of its vagueness and ambiguity but has to be

improved and contextualized. In fact, certain ambiguities may allow different societies to define "public interest" in a manner that would serve those societies in the best possible way (Flathman, 1966).

For the public interest to be served, there must be an acceptable level of democratic justification, which is endorsed by the citizens that can be construed as the public. Equality, which is a major political and legal concept, is also central to public interest theory. In other words, if there is no equality as such, it will be difficult to argue for and build any form of public interest theory. Public interests vary from one society to another and from one time (frame) to another. So public interest, although generally understood, does not represent any nailed-down concept(s) that can be uncritically applied around the world. Its timeliness is critical as well as a better understanding of the time and societal conditions in which a particular public interest theory issue has been promoted and used to justify that very public interest.

Citizens in a (fully) democratic society may bring their concerns to the fore and discuss, seeking a common position among group interests that eventually may be declared a public interest (i.e., should they be able to mobilize other interest groups and strike a deal with them). Therefore, balancing various interests in an effective manner is an issue of institutional capacity that has to be effectively addressed before a public interest can be defined.

A public's interest is to reduce and, ideally, eliminate any forms of fraud. Society therefore promulgates laws and regulations that target fraud and create organizational, institutional, as well as other societal infrastructures that minimize fraud. Although one may argue whether fraud may ever be fully eliminated, even when economic progress in a country is evident. However, it may not be that simple. Governments promulgate and enforce regulations, and citizens are expected to follow legal and other regulatory requirements. In short, the development of an institutional framework that could effectively fight corruption is a must, but at the same time it is necessary to develop the right reform mindset so that the current bottlenecks and system-wide inefficiencies are addressed.

The public accountancy profession is performed in the interest of the public, and regulation, increasingly complex and onerous, recognizes that and is becoming very stringent in terms of detecting and fighting fraud. The concept of "know your customer/client (well)" is important: banks and professional accountants must be able to detect any behavior that sticks out and may suggest that there are issues that need to be addressed.

2.4 Capital Needs Theory

Capital needs theory emphasizes financial statement fraud as the case where the manipulation of financial data is undertaken to influence capital markets and the players therein. Activities, such as smoothing reported profits and losses, temporarily inflating profits, exhibiting earnings growth (Lev, 1989), changing profit margins or profit and assets ratios,

misreporting borrowing restrictions, or falsely improving management performance (Whelan & McBarnet, 1999) are done to influence those who are active in financial markets.

Most financial statement fraud theories emphasize that fraud usually happens because managers (i.e., the company) have to report to a wide array of users who may have different interests, expectations, etc., and then the managers, in the desire to meet their users' expectations, may in fact be more interested in meeting shareholders' expectations than reporting the actual results. In the context of capital needs theory, managers or any group that has "acquired" an accounting function may in fact have a vested interest in manipulating financial positions in order to attract investors or present the firm in a better light than it really is. Mergers and acquisitions require serious due diligence being conducted in order to secure the position and interests of the acquiring entity. However, even in the case of proper due diligence, some elements of "financial gymnastics" may remain undetected for some time. Some authors (e.g., Smith, 2003) see financial fraud and misreporting as a consequence of shareholder theory and its limitations.

A business needs to acquire capital to be able to operate effectively and efficiently. The groups that have taken control over the financial reporting and/or company management will have that as their main motive, and then financial reporting misrepresentation may be the way to attract additional resources. Whether this is merely a misinterpretation of financial results or a more complex and elaborate fraudulent activity, in principle, does not matter. Investors, and those who provide capital (including financial institutions), may suffer losses due to the wrong (misleading) information provided. Public bodies (especially the regulator) may be worried about the reputation of the financial market and public trust (or lack of it) in financial markets and what can be done to prevent systematic fraudulent behavior that may have a long-lasting negative impact. Although attempts have been made to contrast capital needs theory vis-à-vis other theories, such as agency and stakeholder theory, in the first instance, the final outcomes do not really differ.

It is believed that fraud driven by capital needs has only one aim: to attract and acquire the needed capital. They therefore always require that profits are either overstated or presented as being of higher quality, in other words, more consistent than they really are (Putra, 2021). The argument is that the main (if not the only) feature of fraud related to capital needs theory is "overstatement of profits," whilst in the case of other theories, the fraud may be more complex and include other forms of financial statement fraud (e.g., intentional misrepresentation/misstatement used to hide negligent or dishonest performance, i.e., underperformance).

2.5 Communication Theory

Communication theory, developed in the 1950s, has emphasized the improvement of communication in the (financial) reporting process (Gabor, 1952). Financial statements are an instrument of disclosure, and the information about a company is made public through the preparation and dissemination of financial statements. With technological develop-

ments, companies, investors, and also the public have better access to information, and financial reports are more accessible to interested parties. In a way, a financial report is to be seen as a tool that can disseminate the needed information.

Still, however, the financial reporting and financial communication process are the ultimate responsibility of a company's management to provide credible and correct information on time (Kuhn, 2008). However, communication failure happens when some information that may have potential negative impact on the company is suppressed or has been presented in an erroneous manner. For instance, information pertaining to the poor financial position of a firm and possible risks that have been associated with it may not be included in its financial report. Some of the financial information that may have a negative impact in a future reporting period but is already known at the time of the report's preparation should be included in the notes to the accounts, but they may be intentionally omitted. If the management of a company knows that the bank guarantee will be activated in January next year and may have a major impact on the company and its operations, it should report this in the **narrative part** of the financial report for this year.

Narrative part
A narrative part or narrative report is the provision of nonfinancial information in a company's annual report, enabling better understanding of a company's (financial) performance.

Increasingly, financial reports include nonfinancial information that is included in the narrative part of the report. So both financial and nonfinancial information are becoming more important for proper and effective (financial) communication. Both investors and financial analysts are looking for all the signs that would provide a proper and more complete insight into the company and its operations.

With the increase of digitalization and the use of technology, the spectrum of financial fraud widens. The extensive use of financial software contributes to even more elaborate and complex financial misreporting and fraud. Access to computer systems, networks, and the internet may lead to more elaborate fraud. For instance, there has been a noticeable growth in banking fraud where bank employees embezzle some money from clients' accounts and then commit financial statement fraud to hide that and secure their position. The use of technology also increases the odds of computer-induced fraud. Those with access to the system may be incentivized to ensure that the information is not shared on time so that the fraudulent behavior is concealed, at least for a while. The role of internal control and audit should not be neglected in these cases because they are often the first line of defense.

Those in the company (organization) may be interested in engaging in games to ensure their position (Kuhn, 2008). Firms may be playing games to attract capital where capital cannot be acquired without an elaborate participation of other actors (Bernard, 1938). According to Kuhn (2008) this plays an important role on a textual level as well: "The marshaling of consent also directs attention to the authoring of texts and, in particular, their capacities to discipline and direct attention" (Kuhn, 2008, p. 1239). "Textual shaping" is an important concept of power that can be found in governance or competence theories.

Coordination and control may often face certain types of resistance that cannot be easily or effectively managed. The participation of different groups within a company may also differ over time. In other words, willing players over time may lose interest, and hence the game dynamics may change. Developing a general consent inside and outside a company with various stakeholders may be the key, especially those that are formally outside the

firm (business partners [creditors, debtors, suppliers], government[s], regulators, etc.). The "payoff" for engaging in a company's games is the accumulation of use or exchange value (Bowman & Ambrosini, 2000). Desire to acquire capital is important, and capital in this context may have many facets and forms, such as the following (Bourdieu, 1991):

- economic (control over assets)
- social (connections to others who provide support)
- cultural (forms of knowledge, a mastery of language, or possession of socially valued goods)
- symbolic (attribution of prestige or honor by others)

At the same time, all these forms of capital are ways to generate capital. For instance, the communication and interaction during the annual general shareholders' meeting may rely on some of these types of capital – cultural, symbolic, social – although at the very core further increase economic capital. However, this may not be a straightforward approach but more another form of playing a complex game. Economic capital may be generated and captured at the end of the process where other forms of capital may be acquired and put under control.

Textuality
As a concept, textuality goes beyond the words used and includes the reader's interpretation as well.

Managerial capitalism
This refers to the form of capitalism where the market is dominated by large firms that are led by a professional manager class.

Textuality may represent the way organizations present themselves. In other words, the organizations may frame and reframe their own existence and present themselves accordingly. In fact, it "is not so much that an organization is a product of communication, as a necessity for it, an object in the absence of which collective action would cease to exist" (Cooren & Taylor, 1997, pp. 254–255). Predominant theories of the firm may also influence the way companies are perceived by society/community. For instance, a company may be seen as a way of acquiring and controlling resources or as a legal entity that has been developed on the premises of **managerial capitalism**.

A company may be involved in games trying to improve its market position, acquire additional capital, be positively assessed by an analyst, and ultimately be appreciated by the market. In doing so, it may seize the opportunity to improve (on paper) its economic performance or hide some organizational and other deficiencies that would ultimately adversely affect the credibility as well as the economic and market position of the company. These deceptive practices may last for a long time, and often by the time it is developed, the damage has been so great that it leads to the bankruptcy of the company.

SUMMARY

Explaining fraud is an onerous task. Theories of fraud have tried to develop a different take on fraud and why it emerges. The dominant economic principal–agent theory will see a natural conflict between the principal and agent where the agent is more likely to follow his or her own interest rather than the principal's, and the principal may thus be subjected to fraud. Public interest theory believes that the actions of economic agents should ultimately be for the benefit of the wider society and not just for maximizing individual or group welfare. Capital

needs theory believes that the need or desire to acquire additional capital may also push companies to cook the books and misinterpret financial information. Communication theory focuses on the use of words and their understanding because the misinterpretation of words (statements) may often lead to fraud being perpetrated. Incomplete and/or insufficient information may mislead an economic agent, and he or she may suffer the losses because of that. Understanding theories of fraud and contextualizing them in each case may help in both addressing fraud prevention and (timely) fraud detection.

UNIT 3

TRADITIONAL FINANCIAL STATEMENT FRAUDS

STUDY GOALS

On completion of this unit, you will be able to ...

- describe the relationship between revenue-based techniques and manipulation of financial statements.
- understand the role of asset-based techniques in financial statement fraud.
- apply early warning indicators in detecting financial statement fraud.
- understand these issues with different approaches to asset valuation.
- define fair value accounting and its role in financial statement fraud.

3. TRADITIONAL FINANCIAL STATEMENT FRAUDS

Case Study

Ms. X is a seasoned businessperson and investor who has built her own business and has mentored others to success in business. Now, after years of frontline business dealing, she has transited to an investor, both traditional and "business angel". In fact, she is more attracted to small, new start-ups with a great prospect to grow, if supported at the right time and in the right way. Whilst she can rely on the published statements of the large companies that she invests in because they are well scrutinized by being listed on various stock exchanges (Shanghai, Hong Kong, Singapore, and Tokyo, due to Ms. X's focus on the Chinese and Southeast Asian companies), she has had problems with trusting the statements that have been produced by the small start-ups. Although she is a very trustful person, Ms. X has been highly cautious of the practices that some companies apply by overestimating some accounting position, reclassifying them so that they can boost the reported revenues and profits. She has already experienced a potential company ready for private equity investment that had underestimated some expenses, as they were shared between two different products under development and the more successful project bore almost the entire expenses, whilst the less successful was allocated a small portion of it. Similarly, some other expenses were shifted from one project to another with some false reasoning. For example, the treatment of development and senior management costs were allocated to other companies within the group but not to those struggling (which have in fact used their services the most and have generated the costs). Although Ms. X has always been a self-starter, she has decided to engage a professional public accountant to help her understand the practices and advise her on the issues that need to be looked at when considering investment into companies that are not listed on the stock exchanges. Ms. X was surprised to learn from her accountant (who is also a certified fraud examiner) that even listed companies can play with the accounts and go undetected for a number of years. He mentioned Enron, WorldCom, General Electric, and Lehman Brothers. She was shocked to see that some schemes were able to last for years before being discovered.

3.1 Revenue-Based Techniques of Financial Fraud

Revenue-based techniques are usually those that are most frequently encountered in the case of financial fraud, especially financial statement fraud. Companies may often be involved in earnings management. Earnings management tends to prepare financial statements that present a company's business activities and financial position in an excessively good light. This is an allowed practice as long as it does not conflict with accounting standards (international and national ones), current legislation, regulations, and any other business standards and practices that have generally been adopted. Authors will

often claim that a company and its accountants should only focus on standards and legislation/regulation and not necessarily observe the industry's practices. To fully appreciate the level of tolerance on a national level, one should consider the court practices and see what the courts have upheld in their decisions.

Revenue-based techniques are only one of the forms of earnings management that focus on the positive presentation of a company's revenues, often reporting future sales as those that are occurring in the current accounting period. In other words, the invoiced sales that have not been paid may be reported as realized so that the accounting results for the current financial year will be boosted.

It is also possible that a company changes its accounting policy (which is allowed), but with the view of boosting revenues in the short run. For instance, a company may change the approach to stock treatment. If a company applied the "last in, first out" (LIFO) method and then switched to the "first in, first out" (FIFO) method, it would boost revenues in the short run. This short-term "accounting success" may be beneficial to the outgoing management who may receive an end-of-the-year bonus, cash in their shares, and/or realize their options; however, in the next year, revenues will suffer as the difference will be felt in the financial statements.

The revenue-based techniques are the following:

- bill and hold
- side agreements
- illegitimate sales transactions
- related-party (sales) transactions
- trade loading or channel stuffing

"Bill and hold" is one of the practices that may be used often. To meet the specific requests of a customer, a company may sell the stock, bill the customer, but agree to hold on to the goods and ship them only when the customer requests them. The reasons for the customer request may vary. For instance, a company may try to save storage costs or apply just-in-time management practices, so it has products in stock only when needed or has just leveraged its market position by acquiring additional stock (which it cannot store due to limited storing facilities) if it expects the market demand to grow rapidly or if market shortages are expected. Regardless of the motives of the company, the ones selling are the ones who may break the rules when they recognize the early revenue of "bill and hold" sales transactions (Rezaee, 2002). In principle, the revenue is recognized when the goods and services are delivered to the customers. In order to avoid any inappropriate claims, it is necessary to ensure that we have clear **arm's length transactions** (Rezaee, 2002).

Arm's length transactions
These happen when two or more independent organizations decide to do business together but still act independently from one another.

Another form of revenue-based technique are the side agreements that may be used to change terms and conditions of recorded sales transactions. This is usually done so that customers accept the delivery of goods and services, and often they may change the rights and risk exposure of the customers. The problem with side agreements is that they are hidden and usually known to just a small number of (senior) staff. They are often practices

in computing and other high tech industries, mainly due to an increased demand for products and often a dominant market position of a seller. Often, this agreement may impede the recognition of revenues.

Illegitimate sales transactions is a practice of processing fake sales with either imaginary or real customers and with fictitious or incorrect invoices recorded in one reporting period, causing an overstatement, which is then usually reversed during the next period. Improper revenue recognition in contract accounting processing happens when the company's management intentionally falsely reports the percentage of completion, and the project is not complete as the financial statements would suggest and is often supported by false or fabricated documentation.

These types of transactions happen when there is a link between the companies that are involved in the transaction. In this case, the value of a transaction can be overstated and/or understated for tax optimization purposes or any other reasons for improving the financial performance on paper. This is why tax authorities and regulators pay attention to transfer pricing, which usually happens cross-border, although not exclusively. Companies may be related financially or in other ways in domestic markets, which may lead to a false representation of their financial results.

For instance, a holding company may decide to disinvest a particular division or subsidiary, and to make it attractive, may generate revenue through very high prices charged for its products but sold to the related companies within the holding (group of companies). This is why transfer prices are usually limited by market prices as an upper limit. In practice and historically, there were cases where companies were moving the stock within the company group, boosting revenues (on paper). When this type of fraud is investigated, one looks for a series of sales that have been completed with an undisclosed related party that is insignificant if considered on a one-by-one basis but in total are significant (or in audit terminology, "material"). Sometimes, these practices may also be a sign of money laundering, especially if the companies participating in it have opaque governance models where it is difficult to establish who the ultimate owners are (Financial Action Task Force on Money Laundering [FATF], 2021).

This is a practice of inducing buyers (i.e., distributors) to acquire more goods than they can realistically resell at a given time and thus build unreasonable stocks. Often, the producers have market power, so they induce them to purchase goods or lose some benefits, including distributor rights. Of course, a positive sanction may also be applied: Distributors are given heavy discounts if they acquire large quantities of goods. Again, these practices usually appear close to the end of a reporting period, especially at the end of the financial year.

Window dressing
In the context of financial services, this refers to presenting results in a more favorable manner to attract investors and customers.

This practice, if not treated properly, is a classic example of **window dressing**, as one reporting period may be overloaded with numbers indicating success, and then there may be a drop in the next one. It should be noted that, sometimes, distributors may also invoke this practice, for example, when they put their orders close to the end of a reporting period in the hope that producers would like to boost revenues at the end of the quarter (or the financial year), and thus they (the distributors) will be the ones initiating a discussion on purchasing an unusually high quantity of products at a deep discount.

Revenue recognition techniques are not necessarily illegal, although the ethics of their implementation may be discussed. Nevertheless, these practices are used in a way that contravenes with the laws (especially tax laws) and accounting standards, and with an intention to defraud, we have a case of financial fraud and a fraudulent presentation of financial statements. An average investor may have a problem detecting these practices, although a company's auditors should be able to raise concern and advise the company to refrain from such behavior in the future. Similarly, during a due diligence process (if the company is to be acquired), the fraud examiner should also be capable to detect inappropriate behavior. At the end, one should always remember that financial statement fraud is an illegal, i.e., illegitimate act committed by management, adversely affecting external parties (investors, analysts, government authorities, partners, etc.) through incorrect and misleading financial statements.

3.2 Asset-Based Techniques of Financial Fraud

Asset-based techniques are usually the second most common practice in financial statement fraud, following the revenue-based techniques (Beasley et al., 2000; COSO, 1999; COSO, 2010). Usually, companies may overestimate accounts receivables, but they can also overerstimate other assets. The focus on accounts receivables is natural because for any analyst (as well as investor and other financiers), the accounts receivables are second to cash. This is why asset recognition is so attractive for manipulation in financial reporting.

When asset-based techniques are applied, a company usually inflates the value of its assets, affecting the balance sheet and financial ratios that may be used by analysts and investors in the (quick) analysis of the company's performance. One of the most frequent cases involves "shifting the loads" where (physical) stocks in two separate plants (company locations) are reported and shifted from one plant to another but would be reported as stock in both locations. Hence, we will have a double counting of the stock. Sometimes, to make fraudulent behavior even more conniving, stock may be shifted from one place to another during an (external) audit. In some instances, it may be done with some other assets reported in various locations that are, in fact, shifted from one site to another at the time of stock review or audit. About 30 years ago, when computing equipment was expensive, companies would report the same equipment as being located at different sites. This has created a false sense of the value of assets and presented a company, if not technologically driven, at least as highly technologically aware. At present, the value of basic **information and communication technology** (ICT) equipment is relatively low to be chosen as a natural candidate for this kind of misreporting and fraud. The highly expensive computing equipment nowadays is usually difficult to move from one site to another and is often nonnecessary material (tangible).

Information and communication technology
This is a term that encompasses traditional information technology (IT) and new communication technologies such as internet, wireless networks, smart phones, VoIP technology, computers, software, middleware, video conferencing, social networking, and other media applications and services, including innovative and emerging ones.

Companies often may overvalue obsolete supplies and goods. Assets may be revalued when the requirements put forward by the accounting standards (or national accounting legislation) are met. In those cases, companies stipulate in their accounting policies how the assets will be revaluated and what kind of professional will be engaged to evaluate the assets. Possible asset-based techniques are the following:

- appraisers
- phantom assets
- inventory theft and sudden inventory

Appraisers may be engaged, and as professionals they will sell their expert services. However, as in many other business situations, their assessments may not be realistic because the appraisers would succumb to the pressures of the client, as they would like to secure the business. For instance, a mobile phone producer may have several older-generation phones that the market does not require anymore. The main issue is that the phones cannot be sold in the market without a significant discount attached to the sale. However, the company may value that stock, neglecting the realities of the market situation and using other methods of valuation. The value may be attached to the costs that were paid to the providers or any other value that is associated with the past (and not the current) value of these phones. This would certainly increase the value of the obsolete stock and ultimately influence the company's financial statements and misrepresent the company's financial position.

Phantom assets
These are assets that have been invented by the company and are reported as existing in the stock, although they do not exist and, as a rule, have never existed.

Another way of inflating the assets, which is a straightforward fraud, is the creation of **phantom assets**. In other words, companies invent assets and place them on books, although they do not exist. These "assets" are usually rolled over from one reporting period to the next, although at the end they may be written off using different excuses or circumstances (worn out, destroyed by fire, water, or simply "lost"). As long as the procedure has been properly followed, the outcome (writing off the assets) may yield the desired result. Phantom items can also be created by ordering the items and reporting them on books even though they have not been delivered. Sometimes, a thorough audit may reveal that orders have been made and then later cancelled. In some cases, falsified delivery notes may be produced although the items have never been delivered.

In other cases, companies may claim that the item has a high value because it is a special substance needed for a particular operation. However, these items may be in fact replaced by those of far lesser value (e.g., a special-purpose oil may be replaced by water or any other liquid of similar color without having the specific characteristics). Companies often use this practice to an extent that creates an entirely distorted picture of the company and its performance. Overstatement of the inventory is not only about the quality of the product but also their quantities. Companies in a challenging economic position may overvalue certain items, for example, when an item that has the current market price of $1.50 is valued at $1.90 or more in the books. Just this error in valuing the stocks has increased the value of the stock by at least 20%.

Assets overvaluation can be the result of both fraudulent and nonfraudulent behavior. Sometimes, these errors may be genuine (i.e., made with the intention to defraud or misrepresent the financial position of the company). Stocks can be wrongly listed during the

inventory due to objective reasons. Sometimes, sampling or using the weighting of stock rather than counting individual items may be used. To really be able to comprehend the position, one should look at the inventory levels of previous reporting periods and benchmark against similar players in the industry. It is most likely that companies of similar size and market standing exhibit comparable stock/inventory performance (although an exception may always present itself).

Finally, inventory theft and sudden inventory are types of write-downs that can be other forms of asset-based financial statement fraud. Although the assets have been stolen or misappropriated by either external or internal parties, the assets are still kept in the books. Similarly, these assets may be outside the direct control of the owner (i.e., the company), yet they may still be reported as the company’s assets. Sudden write-downs may also trigger alarm because it should be established what initiated these sudden moves.

An asset may also be overvalued, respecting the requirements of financial standards and laws, but, again, the upper limit for this exercise should be the market price (value) and/or replacement costs. Anything above that will likely be fraudulent behavior, with an intention to defraud or mislead potential external stakeholders.

3.3 Expenses and Liability-Based Techniques of Financial Fraud

Liabilities and obligations should be reported in books as and when they appear. However, in practice they can be concealed for various reasons. Some of them may be legally allowed (e.g., deferred tax obligations) and do not contain the motive of defrauding third parties but aim at optimizing (accounting) profits, all in line with current accounting standards, national commercial legislation, and standard practices. However, if they are kept off the books to inflate equity, assets, and net earnings, then one may consider the motives for such concealing of accounting information. In practice, companies usually conceal warrants attached or associated with sales, loans, underreported health (and other) benefits, salaries, and (paid) vacation time. In the US context, where health benefits represent a significant part of the pay package, underreported “incurred but not reported” (IBNR) health benefits may be a significant unreported item. The simplest manner in which this type of financial statement fraud may be perpetrated is the mere omission of expenses and/or liabilities.

The first type of expenses and liability-based techniques is false expenses reimbursement, which is a type of expenses-related financial statement fraud where an employee submits a false claim. It may be overinflated (the claim is higher than the actual business-related expenses made, i.e., the employee may have spent $400 on business-related activities but they submit a falsified invoice for a higher amount. The employee may also claim the same expenses twice or falsify the expenses (i.e., to claim expenses that have not been incurred at all). All these are small claims, but if they become a company-wide practice,

they add up, and, subsequently, the costs to the company may be noticeable. A strong corporate culture that does not tolerate slack but maintains high-quality internal procedures will usually deter this type of fraud or at least keep it at a low level.

The second type is fraud related to employees' health insurance, which is a significant type of financial statement fraud. Health insurance is an important employment benefit in the US and many non-European countries. However, with the national public health systems in Europe facing many challenges, companies in Europe offer additional health insurance packages to their employees. Or in other words, private health insurance is increasingly becoming a norm for many successful companies, regardless of the country of operation, and a number of insurance companies may offer internationally mobile health insurance (i.e., the ability of a beneficiary to transfer the benefits from one country to another). Although it is a very important benefit to be used in the conditions of poor health, there are individual employees who may try to cash in benefits by devising different fraudulent schemes.

For instance, they may claim benefits when they are not actually ill or generate falsified or inflated health invoices and claim reimbursement in collusion with the medical services providers. They may claim nonexistent medical conditions or try to maximize benefits of the health insurance schemes in a way that ultimately pushes up the insurance premium and out-of-pocket expenses (OPE). In some cases, this increase in premiums may adversely affect the ability of some micro, small, and medium enterprises (MSMEs) to afford health insurance for their employees in the long run. This type of fraud also includes claims where out-of-job injuries are reported as incurred at work and, as such, would be covered by the health insurance.

When it comes to expenses and liabilities fraud, the most regular type of fraud is concealing or failing to report some liabilities and expenses. Not all invoices, or just selected ones, may be recorded in the books. In practice, the management may often require the accounting department to miss recording all invoices in order to boost the company's financial performance. Sometimes, there may be a systematic approach where every tenth or fifteenth invoice may be missed, or they may just choose randomly which invoices not to record. Interviews with the management, accountants, and other workers may disclose why this behavior was supported and who the people are that are responsible for processing the invoices and related documentation (i.e., delivery notes, so we can be sure that the goods or services have been delivered successfully).

In brief, underestimating liabilities is one of the easiest ways of manipulating financial statements. If this is done (e.g., liabilities hidden [concealed]), all other items, such as net earnings, assets, and equity, are inflated. Expenses and liabilities fraud relates to the timing of recognition of positions ("manipulating timing"). In this case, companies recognize revenues early or postpone expenses. Manipulation of expenses and liabilities are usually done for two reasons: to reduce ("optimize") tax liabilities and to make the company more attractive to investors or influence the share price. The manipulation of expenses and liabilities may be done in a few ways (Association of Certified Fraud Examiners [ACFE] Brisbane, 2020):

- Reclassifying short-term liabilities into long-term ones will have a positive impact on the working capital.
- Expenses may be capitalized and written off over a long period of time, taking off pressure from the current period (i.e., making the current period more successful). In other words, the expenses will be spread over a longer period.
- One may miss writing certain assets when required to do so. For instance, the company may keep the bad debt on the books and increase the total value of assets that it keeps on the books or assets whose values are intrinsically volatile (e.g., share and investments) and that are not reported appropriately (i.e., kept in the balance sheet when their value is minimal).
- Finally, moving reserves from the balance sheet (making them off-balance-sheet) reduces expense accounts on the profit and loss account.

Expenses and liabilities manipulation is usually done in conjunction with other types of financial statement fraud, such as revenue- and asset-based manipulation techniques. Using different types of manipulation may increase false performance, often enhancing results of a single technique through synergy. For instance, asset-based techniques may increase the value of an asset, and expense and liability manipulation may also support it when the asset-associated expenses have also been effectively misreported. Similarly, with other types of financial statement fraud, liabilities and expenses manipulation will be supported (if not requested) by a company's management because they would like to present the firm as more successful than it is at present. This may be because of the need to meet short-term targets or boosting the company's performance so that it can be more attractive on the acquisition market and secure a better deal for current shareholders.

3.4 Asset Valuation

Asset valuation is a process of determining the current value of a corporation's assets. Although often the literature will focus primarily on physical assets (buildings, fixtures, machinery, land, etc.), valuation should also be performed for all other assets (i.e., intangibles, including financial instruments). Since asset valuation can be performed in a few different ways, it also may be subject to further manipulation and use of financial statement fraud.

Assets are usually valued or revaluated by professionals who either can be certified valuation professionals in some jurisdictions or professionally qualified, often public practicing accountants. These professionals may suggest the best possible methodology for valuation and will take into consideration multiple external factors that can influence the value of an asset. Those who are familiar with real estate (property) valuation would know that location is the most important factor in property valuation. Typically, a real estate valuator will state that the three main factors influencing the value of the property are: "location, location, location" (West Properties Colliers, n.d.).

Although one focuses on the valuation of assets, it should also be noted that a company may also value the liabilities. For instance, a company may have to evaluate corporate bonds that it has issued as well as those corporate and/or government bonds that it keeps in its portfolio (i.e., as a financial asset).

When it comes to valuing assets, a company usually values both tangible and intangible assets. Tangible assets are those that are physical and have been acquired by the company for the purpose of generating goods and services. Tangible assets can be classified into two groups: fixed and current assets. Fixed assets have a long life and have been purchased to be used and not converted into cash. Current assets are those that are used for one business cycle.

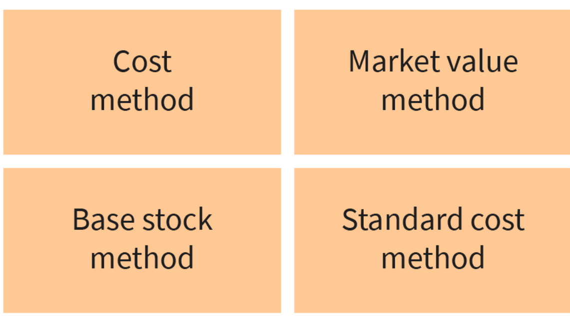
Figure 2: Fixed Assets: Examples

Source: Željko Šević (2023)

Fixed assets are defined by their durability. It should be noted that, though some equipment of small value (e.g., hammers) should be classified as fixed assets, they are treated in accounting terms as current assets. So although cash is the best representative of current assets, current assets are all those assets that are expected to be used for less than a year. They can be sold, consumed, or exhausted within a year or one business cycle (whatever is shorter). Although a hammer can be used for more than a year, it is considered a current asset due to its low value. Tangible assets are generally easier to value because we know the purchasing price for all of them, and it will be their initial book value. Their value will depreciate (and amortize) over time, although in some cases the value of a fixed asset may grow, especially if it is linked to alternative investment strategies. For instance, a painting by an old well-known painter will most likely grow in value over time, which should be appropriately reflected in the company's books.

Although it may be difficult to value some of the tangible assets, the main problem is with the valuation of intangible assets. Intangible assets are those that do not have a physical presence but do contribute to the company and operations providing future benefits. The usual examples of intangibles are logos and patents. The value of these categories of assets is sometimes best disclosed when the company goes bankrupt, and investors (usually other former competitors) are more than willing to acquire these assets and pay the market price. For instance, when the large British retailer Debenhams filed for bankruptcy, the name of the company was acquired by an online company that continued to use the department store's name in the virtual space. There are also many other cases where companies ceased their operation, but their name continued to be used for trading purposes. Companies have several methods that they can use for asset valuation. The methods that are standardly used are presented below.

Figure 3: Asset Valuation Methods



Source: Željko Šević (2023)

The cost method is usually the simplest, where the valuation is done based on the historical price paid for a particular asset. It differs from the book value of an asset that should reflect the depreciation of the asset. Even if the asset is not used, its value will most likely decline over time. For instance, computing equipment has been purchased to be used by a particular department within a company, but due to resistance, focus on old methods, and a low technical culture and capacity, they have not been used at all or used very little, but their value in the books would most likely go to zero within three years (the usual current computing equipment life span). The cost method can be influenced through the massaging of inputs, falsifying historical data, or pretending that the data is not available and turning to possible reconstruction (of the price paid at the time of acquisition) and the use of estimates.

The market value method uses the current market price or projected market price if an asset is to be sold in the market. This method recognizes the change in asset value, taking into account the movements on the market and economic conditions. In principle, this method is the most accurate because it focuses on the current asset value as recognized by the market. However, not all assets may be on the market at all times. In the case of the absence of a proper market price, the valuation may be undertaken by using the **Net realizable value** (NRV) model. The NRV model takes into consideration the total amount of money a particular asset may generate when sold, reduced by costs, fees, and taxes associated with the disposal. In principle, the costs have to be reasonable because sometimes their overestimation may be a fraudulent technique in itself. NRV is usually found in inventory accounting and is calculated as follows:

Net realizable value
This is the net amount that a company will receive by selling an asset, based on a current contract/agreement.

$$\begin{aligned} &\text{NRV} \\ &= \text{ Reasonably expected sales value} \\ &- \text{ reasonable costs of sales} \end{aligned}$$

The market value method can be influenced through choosing a nonrepresentative market sample, inflating the values, or falsifying the input data. Also, manipulation of data may be even more complex where a number of inputs are influenced simultaneously. We may also look for a market price in the market where assets will not or cannot be sold for various reasons, so the market price may be nonrepresentative but good for providing desired (fraudulent) results/outcomes.

The base stock method of valuation states that there is a predefined stock that has to be valued by using this method. The model assumes that an inventory is refilled one unit at a time and that demand is random. The model, in its nature, is stochastic and has several assumptions attached to it. Again, it is often used in inventory management, but due to its complexity, it is not the most preferred one, and if its limitations are seen, another method may be deployed (e.g., the **newsvendor model**). The base stock method uses many variables in estimating the model (such as replenishment lead time, demand during replenishment lead time, safety stock, and lead time), and each of them can be "doctored," influencing the outcome. Hence, it may be relatively easy to influence an outcome and difficult to detect the fraud without a deep-dive approach.

Newsvendor model
This is a mathematical model used in economics and operational research to determine optimal inventory levels.

The standard cost method uses estimated rather than actual costs, and the estimates are derived from a company's experience. However, a company has to keep a record of the difference in costs (i.e., the difference between estimated and actual costs in the past). This provides a credible input in developing the standard cost method. In fact, studies of past expected and actual costs are those that support the application of the standard cost method. In this case, fraud my take place through the manipulation of input data (i.e., overestimating actual or reducing expected costs or the combination of both), so that through massaging the numbers, the "desired" level of standard costs can be "developed."

Whenever one applies valuation, there are always opportunities to manipulate inputs and influence outcomes. Market-based costs are usually available and best to be used in most cases. However, they may not always yield the desired results. The market can sometimes be temporarily distorted in the process of finding a new equilibrium, or there may be a situation of temporary market failure or external shocks.

3.5 Fair Value Accounting

The concept of fair value has been contentious for centuries in accounting and economic thought. In principle, fair value is seen as the mark-to-market value of an asset or company. In applying a fair value, one estimates how much the asset or company would be worth by taking into consideration current market conditions. Whilst the concept has been attractive for several years, it has also been contentious, especially after a major financial or corporate crisis. Most recently, the failure of Enron has attracted attention in terms of using the fair value approach in financial statement preparations.

In economics, fair value is considered by both traditional and behavioral approaches. In the case of neoclassical economics, the endorsement of the efficient market hypothesis (EMH) would suggest that the market price (value) will be the fair value because all the available information will be reflected in the market price. However, even in the case of EMH, there are different views on the hypothesis in terms of its forms (weak, semi-strong, and strong), reflecting the quality of information it emanates. The **behavioral finance approach** contends that the market fully reflects the publicly available information because the prices (of share) may also divert from real value due to cognitive biases of both buyers and sellers. In practice, however, the market may react in ways that are difficult to predict.

Despite the traditional use of market price and fair price as synonyms in accounting, the **International Valuation Standards** (IVS) have made a delineation between market and fair value. A fair value (now called equitable value) requires "assessment of the price that is fair between two specific parties taking into account the respective advantages or disadvantages that each will gain from the transaction" (International Valuation Standards Comittee [IVSC], 2022, p. 25). In the transaction between two parties a "special value" may be created, which will be recognized by the two contracting parties and that may be higher than the market price. The market price (or market clearing price) has to disregard all these special values that may exist in a particular transaction or in dealings between two parties. For instance, in some cases of acquisition, an acquirer may pay more than the market price for a particular company (company shares) because they believe that the company may be undervalued and has a higher intrinsic value than the one suggested by the market.

Behavioral finance approach
This theory explains the process of decision-making in real life, especially those decisions that do not appear rational, showing that economic agents may not always behave in a rational manner, which is how other theories present them as behaving.

International Valuation Standards
As internationally pronounced standards, they outline the required actions that need to be taken when performing valuation and are supplemented by further technical information and guidance.

In accounting, fair value accounting is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (International Financial Reporting Standards [IFRS], 2017, p. 13). This is in line with the US Generally Accepted Accouting Principles (GAAPs), i.e., Accounting Standards Codification (ASC) 820, as the two standards have converged. In principle, fair value is the price that would be received if the asset is sold in an appropriate transaction between market players at a particular (measurement) date. When determining fair value of derivatives, the credit risk has to be considered, and reporting entities are required to calculate a credit valuation adjustment (CVA) and debt valuation adjustment (CVA).

Fair value accounting has always been a contentious issue. It was an unwelcome yet not forbidden practice between the 1930s and the 1970s, and then from time to time, usually after financial crises, the issue was raised again (Ramanna, 2013). Traditional views would usually state that historical costs are the most appropriate in accounting, and for centuries this has been the case. However, other schools of thought would argue for a mark-to-market approach according to which the current market value should be reflected in the accounting books as more "realistic." However, if the market value approach is fully adopted, the volatility of (financial) markets may also be extended to financial statements that should provide real and credible information. For instance, certain shares may be popular and rising in value for a long time, and then a sudden structural shock may lead to market overreaction, and the values will go down very quickly, questioning the financial position of the company.

Annual financial statements may provide a certain picture of a company but will not necessarily provide the "right" picture because the situation may change immediately after the financial statement for the last year has been published. A usual example is when a major guarantee may be activated in early January, immediately changing the liability side of the company's balance sheet (statement of the financial position), but will not be formally made public until the next publication of the financial report. Accounting standards do require this information to be disclosed in the notes to the accounts if this information is known (i.e., pending) at the time of the preparation of the financial report.

Interest in and application of fair value accounting has clearly been on the rise in recent years (Livne & Markarian, 2018; Ramanna, 2013; Shuv & Ostrovsky, 2022). This development is most likely a response to the recent crises as well as the changing nature of the assets and liabilities that corporations (especially in the financial sector) hold. So fair value accounting will usually be applied in the case of derivatives and other hedging (risk) instruments, treatment of employee stock options, various financial assets, and goodwill impairment testing (or more broadly, the intangibles). The rise of interest in and promotion of it is also due to the growing importance of service industries in the developed countries and the push of the financial industry for quicker (or timelier) recognition of market gains, especially in the years when financial markets were on the rise.

Those who are against the use of fair value accounting would argue that it does bring additional volatility to accounting but also, in that sense, defeats the purpose of accounting (Andrews, 2014). Allowing the extensive use of fair value accounting may also lead to more fraud because economic agents may be more prone to “cook the books” and misreport within a wider maneuvering space. It is often difficult to fully reflect the market price or value, making them estimates. Sometimes, a fair value may be seen as a collective estimate of future price movement (mainly rise). These collective expectations, when supported by market rise, may inflate future expectations, pushing prices higher or, in opposite cases, lead to serious negative market reactions. In both cases, financial statements will not reflect the true financial situation in a company and will send false signals to investors and other interested stakeholders. At the same time, it may lead to excessive management rewards during “good” times and not necessarily restrictive management compensation during difficult times (due to various embedded **golden parachutes** in executive employment contracts).

Golden parachutes
This is the practice of guaranteeing certain special rights, compensations, and benefits to senior employees (i.e., the management) if their employment is (abruptly) terminated.

3.6 Case Studies

One of the most recent financial scandals that has led to legislative and regulatory changes on both sides of the Atlantic is that of Enron. Enron was a US registered corporation that focused on energy, commodities trading, and services provision. From humble regional energy trading beginnings, it grew to become one of the most respected companies for its innovation efforts before it then became a synonym for systematic corporate and accounting fraud. In its last year of operation in 2020, Enron reportedly had revenues of $101 billion (Enron, 2001). At the time of failure, the corporation employed over 20,000 employees around the world, operating plants in numerous countries such as the US, India, and the UK. Not only had it been very active in electricity generation and trading as well as in other energy markets (oil, gas, etc.), it also entered the pulp and paper industry.

In 2001, it emerged that the company was a “paper tiger” that had perpetrated an institutionalized and well-planned accounting fraud for several years. Some of the fraud included very creatively interpreted fair value accounting rules, while others involved the creation of a series of special purpose vehicles (SPVs) to conduct some operations off-book and hide transactions between the connected legal persons. The Enron case has also triggered the review of the current accounting and audit legislation, leading to the enactment

of the Sarbanes-Oxley Act of 2002 (SOX; Pub. L. 107–204). SOX had influenced other countries, with similar regulations and legislations enacted across the world (e.g., in the EU – the Directive 2014/56/EU and Regulation [EU] No 537/2014).

Enron was a complex business in itself, and on top of that they also resorted to complex financial reporting. It was reported that Enron's financial statements were difficult to understand by both analysts and stakeholders (Bratton, 2002). Some of the standard accounting items were slightly modified, which created confusion (although technically, the modifications were usually explained in the notes to the accounts). Some operations had been taken off the books and entrusted to SPVs, which created opaque reporting practices, making it difficult to establish the real relationships. Modifying balance sheets and misrepresenting earnings were standard practice (Healy & Palepu, 2003). Beside the overuse of fair value accounting (mark-to-market accounting practices), the executives were also pushing for additional modification, so the values that were received through the application of mark-to-market accounting were even further inflated to impress with excellent results, although fraudulently secured (McLean & Elkind, 2003). One of the major examples of the misuse of mark-to-market accounting practices had been the reporting on the partnership with the Blockbuster video company within on-demand entertainment services. Even after the partner had withdrawn and although the deal had clearly ended in financial loss, Enron still claimed "future" profits.

Revenue recognition also contributed to the problems: Enron introduced the "merchant model" in reporting, in which the entire transaction would be reported, even if Enron acted as an agent and should report only the agent (intermediary) fee as a revenue. This merchant model would boost revenues; if applied properly and consistently, it would not necessarily have been a fraudulent practice. The profits would have been the same, but revenues would have differed, (i.e., be inflated). Just in four years, from 1996 to 2000, Enron's revenue grew over 750%, from $13.3 billion to $100.3 billion. Enron also misclassified loans as sales so that revenues would be boosted even further. Even SPVs had not only aggressively adopted reporting practices, but they also had been used to further inflate revenues and ensure that these revenues were in line with Wall Street's expectations. One of the interesting creative accounting practices was to report costs of canceled projects as assets, pretending that they were ongoing projects. In many cases, Enron's behavior had some legal logic, but, in principle, the behavior was initiated with a premeditated intention to sanction fraudulent reporting practices.

Another major accounting scandal was WorldCom which took place in 2003. At the time of the scandal, WorldCom was the second largest long-distance telephone operator in the US. Again, through the use of creative accounting practices, the company had overestimated its assets. It was discovered when the company's internal audit found over $3.8 billion worth of fraudulent accounting entries. It was found that the company had a hole of over $11 billion, which made it, at the time, the biggest US financial scandal in history.

WorldCom and its predecessor company MCI had a reputation for employing aggressive accounting practices. The order to book labor expenses on capital projects across WorldCom divisions, rather than a single capital project, triggered a chain of events that ultimately led to the WorldCom internal audit discovering the fraudulent behavior. The term "prepaid capacity" was used for movements between capital accounts, although nobody

within the WorldCom financial division was able to define the term or explain its use. The internal audit team started tracing the "prepaid capacity" entries and tried to build a picture of the practices. Often, these entries were not closed in terms of double-entry bookkeeping practices and could not be explained. In order to not attract attention that the server was overloaded, the auditors worked at night, trying to locate as many "prepaid capacity" entries as possible (Cooper, 2009).

The internal auditors had found that large sums of money had been transferred from the income statement to the balance sheet, just between the third quarter of 2001 and the first quarters of 2002. In fact, these 28 entries "created" $130 million profit for WorldCom, whilst, if they had been treated appropriately, would have resulted in $395 million losses. The costs had been capitalized because they had been associated with the fixed line leases, even if revenues were dropping. Internal auditors claimed that that logic had some business sense, but an accounting one (Cooper, 2009). Finally, before the board's audit committee meeting, the questionable transfers from line cost expense accounts to assets from 2001 to 2002 amounted to $3 billion. Further work discovered 49 entries in total, with $3.8 billion being questionable transfers within WorldCom. The board had to brief the Security and Exchange Commission (SEC) about these discoveries and had to restate earnings for five quarters. The external auditors conducting the special review of accounts at the request of WorldCom's board established that these shifts between the accounts had been made with the sole purpose of meeting Wall Street's expectations.

WorldCom was hit by this scandal when it was already facing many other market challenges. Its share price fell significantly, and its corporate bonds were classified as junk bonds. With $30 billion in debt, WorldCom filed for bankruptcy and was taken over by Verizon Communications.

Interestingly, both WorldCom and Enron had Andersen as an external auditor, and in both cases the external auditors had failed to spot the problem and instead provided respective companies with a clean bill of health. At the time of the WorldCom fraud discovery, KPMG was an external auditor, as they had acquired Andersen's WorldCom account. Andersen itself had already been effectively disbanded, and the "Big Five" accountancy firms became the "Big Four" (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers). Whilst the Enron fraud was discovered by external parties (some financial analysts had raised their concerns about the performance), in the case of WorldCom, the internal audit performed its actions well and undertook work overlooked by external auditors. In the end, it emerged that the external auditors had not looked at those accounts and entries. Inability or disinterest of auditors to challenge contributed to the failures.

SUMMARY

Financial statement fraud has many possible forms. However, it is often difficult to distinguish between aggressive yet allowed accounting practices and those practices that constitute financial fraud. For instance, fair value accounting is not only allowed but also legislated in the instance of financial instruments, but at the same time, in the case of a very vola-

tile market, one may question the moment at which the fair accounting value is measured or (when the markets are thin) manipulated (e.g., the company itself repurchasing the shares is a main player in the market). Both the asset and liability side of the financial statement may be manipulated, expenses may be overstated or invented, and invoices may be fabricated. Even salary positions may be manipulated, as the payroll may have some “ghost workers” whose “paid-out” salaries may be a way to milk cash out of a company. Financial fraud is not reserved for only developed countries but developing ones as well. However, due to the high capacity of the accounting profession, fraud detected in developed countries always attracts more attention and triggers the globally present trend in corporate law and regulation of accounting.

UNIT 4

DETECTION OF FINANCIAL STATEMENT FRAUD

STUDY GOALS

On completion of this unit, you will be able to ...

- understand detection in the context of financial statement fraud.
- name and critically examine major fraud detection practices and approaches.
- explain the importance of internal control.
- appreciate the use of ratio analysis to determine a potential financial statement fraud.
- evaluate the major approaches to financial statement fraud.

4. DETECTION OF FINANCIAL STATEMENT FRAUD

Case Study

Ms. X, being an experienced entrepreneur, has faced different forms of fraud during her professional career. However, as an investor, she was made aware of various challenges that she may face in understanding different financial statements and the possibility that some of the financial statements are not prepared in line with accounting standards and practices and corporate legislation. Her accountant has explained to her all the major types of financial fraud, stating that the list is not exhaustive. Ms. X knows that accountants may manipulate both assets and liabilities, overestimate expenses, use various accounting practices in a manner that would make financial results opaque and difficult to understand by stakeholders, use valuation to over- or undervalue assets to receive gains, etc. However, understanding the scope and scale of possible financial statement fraud is just the first step because, as an astute investor or financial analyst, one has to be able to "see through" financial statements and perceive possible financial fraud. Being able to see red flags to trigger further analysis is important in both preventing fraud and modifying the perception of a particular business entity. Ms. X has used financial ratios to make business decisions in the past, and she has also learned that financial ratios may assist in detecting financial fraud. She has always paid attention to building a strong corporate culture in the businesses she built, and as they became successful, the focus on strengthening a positive business culture has been ever stronger. So she understood that to prevent financial statement fraud, one has to build a culture where such behavior is neither approved nor condoned, and when fraud or attempted fraud is discovered, both legal instruments and moral suasion are used to remedy the situation. Ms. X has reiterated her belief that timing is everything in managing fraud detection as well as ensuring effective introduction and application of internal controls.

4.1 Understanding a Company's Overall Culture

Corporate culture refers to a set of shared beliefs, values, traditions, and behaviors that are exhibited within a corporation. It can often be seen as a galvanizing factor that keeps the organization together outside the formal relationships. It can also be seen as a "pattern of basic assumptions" that have been acquired over time to deal with external and internal challenges (Schein, 1990).

People within an organization acquire certain assumptions that guide them in the way they deal with a job's challenges as well as affect the way they deal with each other and behave within an organization. It will determine the relationship between stakeholders and define how people see themselves within an organization (i.e., how they identify

themselves with the organization; Schrodt, 2002). Large organizations may exhibit a series of corporate subcultures that have developed in different parts of the company (Kotter & Heskett, 1992). For instance, geographical dislocation may lead to the building of different subcultures or a specific nature of a business unit (e.g., internal audit, quality control, organizational health, and safety).

Organizational culture defines the way people behave within the organization, both as a group ("corporate being") and as individuals. Company values that are outlined in strategy documents become principles that guide an organization. The strength of the values and underlying principles are often tested in a situation where an organization (i.e., a company) faces external (market) threats and challenges. Most recently, a company's organizational culture has been linked with its corporate vision (Denney, 2019).

Cultures can be strong and weak. Strong organizational cultures are reinforced by corporate rituals, ceremonies, and regulations. In the case of a weak organizational culture, organizational belonging is not easily noticeable. Strong cultures use every opportunity to strengthen themselves and spread their norms and values. An introduction program for newly appointed employees would include some form of cultural "indoctrination", although the culture will be acquired through the interaction with other coworkers in the organizational context.

There is a danger that the development of an organizational culture may end in **groupthink** (Janis, 1972): to keep the harmony unchallenged, the group may make irrational and unproductive decisions. In the case of groupthink, the members of the group may have different ideas and approaches to a problem, but they do not challenge each other and ultimately end up in a position that is not productive for them as a group or individual members. Groupthink is based on the human desire not to confront and upset a group of people who already have developed their own group thinking. Groupthink, if it appears in professional service sectors, can create an adverse situation where issues pass unchallenged and ultimately may lead to a point where the very existence of the organization may be questioned. For instance, auditors sometimes do not challenge a client to maintain good working relations, and fraud may thus remain undetected for much longer. Janis (1972) has outlined three factors that support groupthink:

Groupthink
This phenomenon describes a situation where a particular group achieves a consensus without evaluation of the consequences or alternatives and critical thinking.

1. High group cohesiveness
2. Structural faults
3. Situational context

In the case of strong group cohesiveness, we may detect deindividualization of a group member and the illusion of unanimity. Structural faults are an insult to the group, the lack of impartial leadership, lack of norms requiring application of methodological procedures, and homogeneity of members' social backgrounds and ideology. A situational context may present itself as highly stressful external threats, recent failures, an excessively difficult decision-making process, time pressures, and moral dilemmas (Janis, 1972).

A corporate culture can also be negative or even toxic. In this case, there is very little that brings people together, and the organization may survive but will never thrive. Strong corporate cultures support strong internal control mechanisms, and they in turn provide a

good framework for preventing fraudulent behavior across the organization. A corporate culture impacts the entire internal control spectrum, i.e., the control environment, risk assessment, information and communication, monitoring activities, and existing control activities (Committee of Sponsoring Organizations of the Treadway Commission [COSO], 2013).

A strong corporate culture reinforces its shared ethical values and supports competence, accountability, and responsibility within the organization. In a competent and accountable organization with a responsible leadership, the probability of any type of fraud appearing is lesser than in an organization that is siloed, lacking accountability or clear reporting lines, overshadowed by an omnipotent leader (autocrat). Information sharing and appreciation of risk would also contribute to a stronger fraud prevention framework that the organization may have in place or wants to develop. Breaking silos, sharing information, and focusing on common goals would create an environment where fraud is less likely to appear again. Organizations that are prone to sharing are more effective in detecting and preventing fraud.

Although it may be difficult to build a corporate culture, as there are many unknowns, an organization that has or wants to build a strong corporate culture should be prepared to embark on a journey of self-discovery and be ready to hear both good and bad news. The first step is to take stock of corporate culture, followed by an appropriate SWOT analysis (i.e., strengths, weaknesses, opportunities, and threats). Weaknesses that have been identified have to be addressed, and an action plan should be developed to enable an organization to effectively tackle them. Most importantly, an organization has to be aware that, despite all its efforts, the threat of fraud is real, and it happens even in the best organizations. The issue is how quickly it can be detected and how damaging it may be in the short, medium, and long run. Fraud may also be catastrophic and lead to the demise of an organization. The Enron, WorldCom, and Lehman Brothers cases are testimony to that.

4.2 Reading Red Flags for Fraud

In well-functioning organizations, fraud usually does not come as a surprise. These organizations factor in the risks of fraud in their risk management frameworks and have established internal control and audit procedures that not only detect fraud but also prevent it. If the “policing” mechanism is effective, it is most likely that potential perpetrators will be deterred by the high level of probability of being detected and subjected to various sanctions – administrative, civil, criminal, etc. Reducing opportunities for fraud usually leads to a decline in the occurrence of fraud. Education and promotion of antifraud measures and promoting positive behavior will improve the overall situation with regards to financial and other types of fraud being committed in the organization.

A proper internal control framework will provide a platform for consideration of various signs that fraud may be happening within the organization or where an intention to commit fraud is possibly present. Although theory has tried to provide a full taxonomy of (financial) fraud, its definitions of fraud have never been fully comprehensive. **Red flags** in principle can be behavioral, financial, and procedural (Fraud Advisory Panel, 2011).

Predicting and detecting financial fraud should also be seen as part of wider organizational efforts to prevent fraud. Even before an internal controller or auditor uncovers financial fraud, there are other signs that may point to fraud taking place. For instance, in many cases, fraudsters refuse to share a job with someone else and try not to be absent from the office (i.e., refuse to go on annual and other leave). This is because they know that their activities may be discovered if someone was to take over "their" activities.

Red flag
This expression refers to identifying or drawing attention to a particular issue or challenge that needs to be addressed.

Refusal to implement recommendations by management, the internal control/audit, etc. may also indicate that something unsanctioned has been done or is going on. Ignoring approved internal procedures and operational policies may also be considered a red flag as well as failing to keep appropriate documentation and always having excuses when certain things have not been followed through. If employees actively seek access to areas that are outside their professional remit, this may also suggest that their activities should be closely monitored. A constant high level of stress and a strong sense of entitlement may also indicate that the person is at risk of committing fraud against their organization. Bullying and serious conflict with colleagues may also be an indicator that something wrong is going on.

There are many other signs that suggest that fraud is taking place. Many of them will be organization-specific. Changes in somebody's behavior in general suggest that there may be an issue to look at more closely. These red flags should usually trigger internal investigations (not necessarily fraud investigation), and following the preliminary findings, further investigations may be performed. Fraud investigations are usually more confrontational than an internal control or internal audit.

The classic red flag for financial statement fraud are accounting anomalies. For instance, revenue growth without corresponding cash flows may be an indicator. Financial performance that is contrary to current market conditions should be looked at, for example, if there is a significant growth in sales when the market is saturated and many other competitors are struggling or are pushed out of business. Increase in corporate revenues in the last quarter of the year is usually an issue that has to be investigated. Revenues may be reported as ordinary revenues to boost performance and, in that way, may distort the overall picture of a company's performance.

A company's depreciation and amortization policies that are at odds with dominant industry practices may also be investigated. Tax laws usually provide some guidance on what is to be considered acceptable when deciding on the asset's **useful life**. If a company replaces assets too quickly (in the eyes of the tax authorities), it will most likely be taxed on these transactions. An excessive use of complex third-party transactions that add no or very little tangible value may also be an indicator of possible financial statement misreporting. These "inflated" transactions are often used to conceal the debt level of a company.

Useful life
This is an estimation of how long an asset may remain profitable.

As a rule, weak and ineffective corporate governance is something that should immediately attract attention and warrant investigation. Most likely, this will not be picked up by internal controls and audits but will have to be noted by an external auditor and properly investigated. The existence of a good framework that is not implemented (i.e., merely existing "on paper") does ring the warning bells. Also, a sudden and poorly explained

replacement of an external auditor should attract the attention of the regulator and the tax office. Sometimes, minority shareholders should also be mobilized by this. Linking senior management compensation to short-term targets may also serve as a red flag.

In brief, any sudden and unusual change should attract attention and trigger further analysis. Changes may not materialize at first sight, but if they are systematic, their impact may be far stronger than initially assessed. Internal control and audit in combination with an overall corporate vigilance should ensure that red flags are quickly spotted and the appropriate measures taken.

4.3 Fraud Risk Indicators

An indicator refers to the result of some comparison or measurement that provides information on the quantity and quality of something (a circumstance, an occurrence, a characteristic, or a certain development). *Ipso facto*, a fraud risk indicator provides information on the level of risk exposure to fraud that an organization may face. In many instances, measuring red flags may provide information on fraud risk indicators.

Fraud may be seen as an aspect of operational risk and be treated as such. Whenever a company engages employees, it may be exposed to a potential fraud risk. Strengthening the corporate culture, training (and indoctrinating) employees, and creating a conducive work environment are mitigating measures that a company may devise to promote positive behavior and reduce the risk of fraud. Fraud indicators and their signals that an organization's internal control team receives will lead the internal control to enforce further mitigating measures, intensify control, and ultimately prevent potential fraud as well as stop any fraud that has already been perpetrated.

Understanding and detecting red flags as well as acting upon them will provide initial risk indicators (Fraud Advisory Panel, 2011). Risk indicators interpret red flags within a wider context of organizational risk management. Fraud indicators may be understood as quantified red flags. For instance, a shrinkage of stocks could be a red flag. The fact that it happens does not necessarily mean that fraud has taken place, but after it has been quantified and assessed as excessive compared to previous periods, it will trigger further investigation that may ultimately lead to discovering fraudulent behavior.

If during routine control certain practices have been discovered, they may suggest that fraud has taken place. For instance, the Institute of Internal Auditors (IIA), a professional body regulating the internal auditors' profession, suggests a number of possible red-flag-type indicators, such as the following (IIA Australia, 2017):

- Transactions are performed at unusual times.
- The names used in the transactions suggest that people are not real (perpetrator is showing off).
- Unusual, suspicious, and excessive overrides, duplications, or cancelled transactions appear.
- Transactions are split so that they may avoid the required authorization.

- Documents are incomplete and difficult to find, often corrected, etc.
- Only one person processes particular transactions (type of transactions).
- A particular transaction sticks out due to its number, value, speed, etc.
- A transaction differs from the usual practice, industry practices, standards, etc.
- Transactions are the result of "tidying up" and reconciliation, often not fully clear and transparent (why they have been done).
- Transaction(s) fully meet key performance indicators (KPIs).
- Transactions simply do not make sense either individually and/or collectively.
- Transactions are processed by people who usually would not process them.

Fraud indicators by their nature are company- and industry-specific. For instance, some accounting practices that are allowed in certain industries (e.g., oil exploration) will not be regarded as standard (or allowed) in other industries (e.g., construction). Hence, over time, the internal control or audit function will develop a set of specific, derived indicators that they will use in detecting fraudulent practices within their organization. External auditors and/or certified fraud examiners (CFEs) will then build a database of possible fraud indicators, and they will pay attention when conducting an audit or investigating an alleged fraud case. Fraud indicators may be "rationalized," and the following may be taken into consideration when deciding on the possible cases of fraud taking place (IIA Australia, 2017):

- inadequate organizational policies and procedures, not allowing to draw a clear ethical line
- inadequate ethical training, new employee induction program, etc.
- training that is purely formal and does not motivate employees to behave in a desired way (training is just a motion)
- weak organizational culture, absence of ethics, and a general perception of managers being ethically challenged, unfair, and/or corrupt
- poor practices being tolerated (or encouraged), such as bullying, disrespect for customers, external stakeholders, lapses in safety practices, tolerance of slack
- individuals and/or groups having a very negative perception of the employer, its practices, policies, and what it stands for; employer's, suppliers' and other stakeholders' ethical stance
- general adversarial relationship in existence between management and employees
- perception of general management failure
- strong sense of entitlement

Giving and taking opportunities to perpetrate fraud are also an important factor: An inadequate or failed internal control, an absent or weak internal audit, as well as a disinterested management, will create an excellent climate for fraud, and even otherwise loyal employees will consider fraudulent actions. Although fraud may be committed by any member of staff, financial statement fraud is often committed at the instruction of the top management in order to yield undeserved gains. Listed companies will be under pressure of investors, business, and the financial analysts' community to meet their expectations.

In the case of major accounting scandals, the top managements wanted to satisfy the expectations of Wall Street (in the US), and hence some "creative accounting" practices have been encouraged or, even worse, stipulated. If the senior management is a major cul-

prit, then it is very difficult to prevent and detect such fraud, as has been seen in the cases of Enron and WorldCom (Cooper, 2009; McLean & Elkind, 2003). However, the WorldCom case has also shown the importance of a resilient internal audit: The internal audit had persevered despite being instructed to drop some aspects of their investigations, focus their attention on other (unimportant) issues, return the “borrowed” staff due to operational needs elsewhere, etc. (Cooper, 2009).

Mobilizing the support of one’s shareholders (and stakeholders) has proven to be another major resource that has allowed the internal audit at WorldCom to be able to complete their investigation and unearth the major accounting fraud that has amounted to the $3.8 billion, perpetrated through a small number of “false” transactions. In this case, there were very few, if any, fraud indicators and red flags at the time when the internal audit began. This shows that sometimes fraud can be so well covered that it does not really attract attention at first sight.

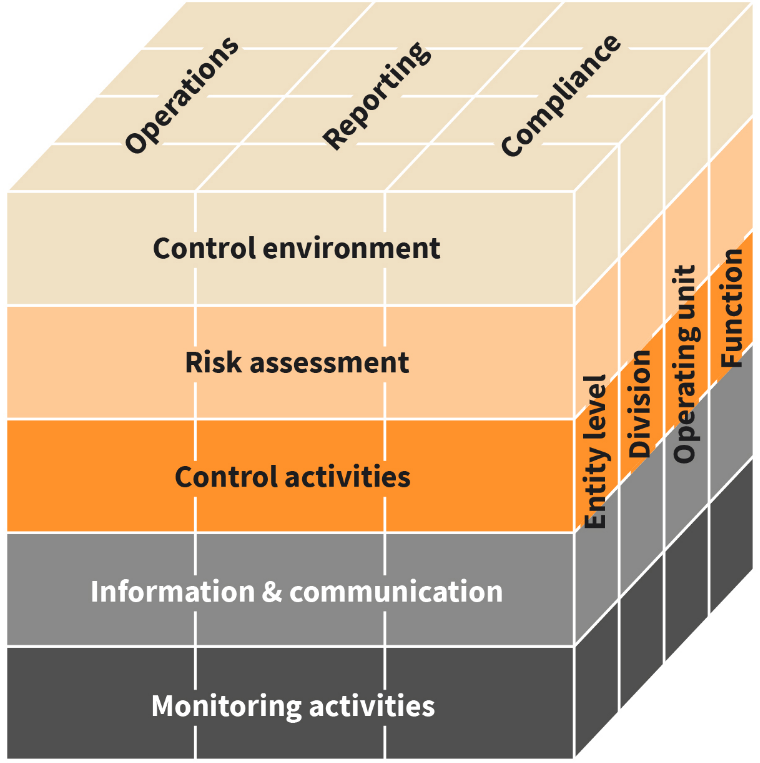
4.4 Internal Control Indicators

Internal control is one of the major management functions. Companies with a strong internal control framework are usually those that provide transparent financial reports and are rewarded by lower costs of capital and higher share prices (Feather, 2020). The development of an internal control framework is also a requirement of effective risk management. In order to define and manage risks, it is important to ensure that the internal control will provide feedback information, closing the information loop.

Internal control is an activity within a company (organization) that ensures that external legislation and regulations, as well as internal rules and policies, are observed. Often, the internal control may be simplified through a simple compliance activity. However, the COSO Internal Control Framework (2013) defines internal control as “a process effected by an entity’s board of directors, management, and other personnel designed to provide reasonable assurance of the achievement of objectives in the following categories” (COSO, 2013):

- control environment
- risk assessment
- control activities
- information and communication
- monitoring

Figure 4: COSO Cube: Internal Control Framework



Source: COSO, 2013.

The control environment offers a set of requirements that have to be considered when implementing an internal control framework. These serve as indicators that have to be respected and include the following (COSO, 2013):

- Exercise integrity and ethical values.
- Make a commitment to competence.
- Use the board of directors and audit committee.
- Facilitate the management's philosophy and operating style.
- Create an organizational structure.
- Issue an assignment of authority and responsibility.
- Utilize human resources policies and procedures.

The aspects of risk assessment include the following (COSO, 2013):

- Create companywide objectives.
- Incorporate process-level objectives.
- Perform risk identification and analyses.
- Manage change.

The control activities are as follows (COSO, 2013):

- Follow policies and procedures.
- Improve security (application and network).
- Conduct application change management.
- Plan business continuity/backups.
- Perform outsourcing.

The information and communication aspect is covered by focusing on the following (COSO, 2013):

- Measure the quality of information.
- Measure the effectiveness of communication.

Finally, monitoring activities are covered by the following aspects (COSO, 2013):

- Perform ongoing monitoring.
- Conduct separate evaluations.
- Report deficiencies.

Each of the activities in the COSO Internal Control Framework can be regarded both as a requirement and an indicator of good performance. For instance, an organization may define what minimum compliance is when it comes to the implementation of organizational policies and procedures. The assumption is that it should be over 80% or 90% (Kim et al., 2018), although it is possible that the organization (i.e., the company) may require full compliance, and the expected organization-wide performance may be 100%. Performance scholars will say that the desired technical limit is 96%, even in the best performing organizations. Delivering 100% compliance is almost impossible because there will always be some unaccountable oversight or divergence from policy. A policy breach (i.e., a delinquency event) may not necessarily be intentional.

The application of the COSO Internal Control Framework should enable an organization (i.e., the company) to develop effective control functions and define measures to monitor its implementation. The targets that are aimed at in monitoring and the agreed indicators should be specific, measurable, achievable, relevant, and time-bound (SMART). Monitoring the implementation should be continuous to ensure feedback information and the improvement of the framework (i.e., that the organization presents itself as a learning organization). Having the ability to learn and improve will strengthen the internal control function, which, together with an internal audit, should provide a pillar in developing anti-fraud strategies within the company.

Defining the indicators for internal audit processes is even more complicated (Public Expenditure Management Peer Assisted Learning network [PEMPAL] & Internal Control Working Group [IACOP], 2020). First, an internal audit is seen as a function of management, although it is also possible to argue that an internal audit (IA) is a function of organizational governance because it directly reports to the board. Performance measurement and quality assurance processes underline the internal audit as a function within an organization. An internal audit must consider the quality of value that it delivers both inside and outside the company (i.e., to external stakeholders; so aspects will be internal, external, qualitative, and quantitative measures). A good internal audit function focuses

on what internal and external stakeholders expect from it, and by engaging with the stakeholders, the internal audit can improve in meeting their expectations. The internal audit function also has to take into account indicators for its maturity, that is, expanding the internal audit function will result in its maturity and overall effectiveness (PEMPAL & IACOP, 2020).

Although some guidance is provided, ultimately, both internal control and internal audit indicators (in general and related to fraud risk) will have to be developed to fully reflect the specifics of the organization, its operational (i.e., business model), corporate/organizational culture, values, mission, vision, and ethical leanings.

4.5 Use of Ratio Analysis to Detect Fraud

Financial or accounting ratios is a quantitative method that is used for a quick understanding of the performance of a company. Financial ratios represent a relative magnitude of two selected items from a company's financial statements. Financial ratios are used by management for monitoring the performance of the company and by potential investors to have a general idea of the company's performance before they decide to invest or not.

There are, in principle, five main financial ratio groups (Groppelli & Nikbakht, 2000):

1. **Liquidity ratios**: These focus on the capacity of companies to pay their obligations when due (bringing into relationship cash and due obligations).
2. **Activity ratios**: Also called efficiency ratios, these measure how quickly a company will transform its products (outputs) into cash.
3. **Debt ratios**: Also called leveraging ratios, these measure a company's ability to meet its long-term obligations (debt).
4. **Profitability ratios**: These focus on measuring a company's use of its assets and control expenses management in delivering an acceptable rate of return.
5. **Market ratios**: These measure stock prices and compare market prices with those of a company's competitors.

In some cases, capital budgeting ratios may also be used focusing on the capital budget performance. However, capital budgeting ratios are not used very widely.

A good characteristic of the ratios is that they can be used for comparing the performance between various companies, industries, markets, etc. However, there is no definitive list of ratios that can be used in financial analysis, as different financial analysts may use different sets for a preliminary analysis of a company's performance before a deep dive into the performance of the company. At present, there are over 50 different financial ratios that are used in financial analysis.

The financial ratios are used in fraud prevention and detection, but usually as one of the first analytical steps. The financial ratios may focus on days sales in receivables and leverage multiples, while other vital statistics of the company may also be established. The internal control, as well as internal and external auditors, are looking for any inconsisten-

cies that may suggest untoward behavior (i.e., fraud). One of the models that is used for company analysis is the Beneish model. It focuses on eight ratios that are, in principle, not the standard ones but developed for the purpose of model design/building. The model was developed by American academic Messod D. Beneish. He looked at manipulative practices and suggested a systematic relationship between the probability of manipulation and some financial statement variables. The model proposes the use of the following eight ratios (Beneish, 1999):

1. **DSRI**: days sales in a receivable index
2. **GMI**: gross margin index
3. **AQI**: asset quality index
4. **SGI:** sales growth index
5. **DEPI**: depreciation index
6. **SGAI**: sales and general and administrative expenses index
7. **LVGI**: leverage index
8. **TATA**: total accruals to total assets

The suggested ratios essentially capture major types of financial report manipulations, such as dropping in gross margins while operating expenses, and leverage rising and significant sales growth being recorded. Calculating the individual ratios provides input for calculating the M-score, which ultimately suggests whether a company is manipulating its accounts (i.e., potentially committing a financial statement fraud). In essence, if the M-score is lower than –1.78, the company is most likely behaving in a proper manner and does not engage in financial fraud, whilst higher results will suggest that the company is possibly committing financial statement fraud.

The M-score integrates all the individual ratios and assigns them a predetermined weighting. Each ratio may suggest one or more manipulation practices, and although they all contribute to better understanding potential fraudulent behavior, they do have different influences on the outcome. Hence, the M-score integrates the weightings in itself and can be calculated using the following expression:

$$\begin{aligned}&\text{Beneish M-score}\\&= \text{d–}4.84\\&+ 0.92{*}\text{DSRI}\\&+ 0.528{*}\text{GMI}\\&+ 0.404{*}\text{AQI}\\&+ 0.892{*}\text{SGI}\\&+ 0.115{*}\text{DEPI}\\&- 0.172{*}\text{SGAI}\\&+ 4.679{*}\text{TATA}\\&- 0.327{*}\text{LVG}\end{aligned}$$

Each of the ratios will cover certain aspects of the fraud. For instance, an unusually large growth in receivable days may point out that a company expedited revenue recognition to inflate profits that would be captured in the DRSI ratio. GMI would reflect the situation where a company's deteriorating gross margin may lead to the company inflating its profits. An increase in long-term assets (AQI) are brought into relation with total assets may

indicate that a company resorted to cost deferral to inflate profits (one of the techniques that is used here is capitalization of costs). Unusually high-growth sales and a falling level of depreciation (DEPI) relative to net fixed assets should also raise a flag.

As a rule, a significant jump in sales and general and administrative expenses (SGAI) relative to sales, may signal that the company is playing with its accounts to present itself in a better light. The leverage index (LVGI) brings together the total debt in relation to the total assets, and a shift in leverage may create a situation where the manipulation of financial statements becomes attractive. Total accruals to total assets (TATA) takes into consideration a change in net working capital to total assets. Engagement in practices where higher accruals is promoted (supported) does suggest a significant presence of profit manipulation.

The analysis of other financial ratios may also suggest certain irregularities in a company's financial reporting. Although it should be noted that the financial ratios have to be seen as a first step within financial fraud analysis. They may point to irregularities in a company's financial reporting, but a further analysis is needed to establish if fraud has been perpetrated.

SUMMARY

Developing a strong company culture that does not tolerate fraud is an important step in addressing potential fraud in the company, including fraudulent financial reporting practices. Companies with a strong culture have been successful in both preventing and dealing with fraud. Senior management plays a very important role in creating a culture of intolerance toward fraud and early reporting of suspicious behavior. Although fraud takes companies and societies by surprise, there are always some indications of fraud taking place but that have not been effectively noticed or, even worse, ignored due to various organizational and cultural reasons. Hence, red flags have to be observed and should trigger further investigation and analysis, ensuring that all possible aspects are considered and, if necessary, explored. Internal controls and internal audits play a prominent role in strengthening honest behavior and preventing fraud. In companies where internal control is perceived to be effective, fraud cases are minimal because potential perpetrators know that they will very likely be discovered and their case processed (in a criminal and or civil court). Monitoring financial ratios by both internal and external parties may also contribute to an early and better prediction of fraud and ensure that fraud is discovered before reaching massive proportions.

UNIT 5

PREVENTION OF FRAUDS AND ASSESSING LIABILITY

STUDY GOALS

On completion of this unit, you will be able to ...

- understand the importance of fraud prevention in an organization.
- appreciate and discuss the role of audit in the fraud prevention process.
- understand the role of litigation as a factor in ensuring the performance of stakeholders.
- describe the role of (good) corporate governance in fraud prevention and the organization and functionality of internal control.
- discuss the importance of reining in executive compensation.

5. PREVENTION OF FRAUDS AND ASSESSING LIABILITY

Case Study

Ms. X, as a highly skilled businesswoman, had her ups and downs. Some of the first businesses did not do well, and they were closed after some time, mainly due to problems with liquidity. She was fully aware that the market challenges at the time were grave, and she was simply not in a position to secure the support from financial service providers (i.e., banks) to ensure that the cash flow gaps were bridged effectively. However, she knew that she and her team had not done anything untoward and that the failure was mainly due to misreading the market or her overly positive outlook on the market. However, when she started being an external investor, her perspective changed. She became aware that there are many cases of financial fraud, and more often than not, they come as a surprise. So even old, well-established companies are prone to fraudulent behavior. She also realized that one cannot fully trust financial statements and all other publicly available information about a company, although the very system of stock exchange and share/stock trading is about trusting the published information. Being a small business owner and a serial entrepreneur, she did not have to work with auditors. She had many companies, and as they were separate legal entities, all of them were not a subject of a statutory audit, being classified as micro, small, and medium enterprises (MSMEs). As she was reading an auditor's report, due to the technical language, she felt unable to fully understand what was said and asked for the assistance of her accountant. He explained to her that auditors do review accounting statements, confirm whether they were prepared in line with international standards, and in principle confirm what the management said. He also discussed with her the role of internal control and internal audit as well as the importance of good governance, explaining to her that she is also an investor and a player on her own. Ms. X was surprised to learn that external auditors are contracted and that they provide a commercial service. She saw that as a potential conflict of interest and was astonished to learn that there is no conflict of interest unless an auditor has provided consultancy services to the company that he or she is auditing now. Surprised by the answer received, Ms. X decides to read more about auditors, their regulation and their role, so that she can form her own view of their work (although she naturally trusts her accountant).

5.1 The Role of the Auditor

Auditors are professionally qualified accountants who review financial statements and confirm that they represent the true and fair situation of a company. In other words, they confirm that the financial statements prepared by the company are prepared in line with accounting standards or accounting legislation. In the majority of countries, nowadays, international (or national) accounting standards apply, although in some countries, a national law on accounting has to be followed. Even in the countries where the Interna-

tional Financial Reporting Standards (IFRS) are used, they have been introduced to the national legal system in the form of a law that has declared them a part of the national corporate law legislation.

The IFRS (formerly the International Accounting Standards [ISA]) do not tolerate competition, and they have to be applied alone and not in parallel with national accounting standards. Also, national accounting regulators are not allowed to interpret IFRS, but must follow international interpretations issued formally by the International Accounting Standards Board (IASB), the supranational regulator. The exception is the European Union, which was one of the relatively early adopters that has endorsed the standards with a disclaimer referring to the version adopted by the EU (Regulation [EC] No 1606/2002).

An auditor's position (especially external) is specific: They have to confirm with a reasonable level of certainty that the financial reports have been completed in line with the accounting standards. Their primary purpose is not to discover and prevent fraud. However, they are expected to discover, during their examination, whether any manipulation of information, data, or wrong interpretation and implementation of accounting standards may have changed the picture of the organization and whether fraud has been perpetrated.

Initially, up until the 1920s, auditors were employed to uncover fraud, but since the 1930s, the focus has shifted to the financial statements review and confirmation that they have been done in compliance with the standards (Porter, 1997). Even with the growth of financial fraud in the 1960s, the audit profession has refused to take responsibility for uncovering fraud. With the technological developments of the 1980s, they started paying more attention to possible fraud, but still the auditor's responsibility for discovering fraud was not established. However, the Enron scandal in 2001 changed everything. The audit company that failed to uncover the fraud for years, Arthur Andersen, broke down, and one of the oldest and most respected accounting partnership disappeared from the market. The Big Five accountancy firms have since become an elite club of only four accountancy firms (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers).

The scale of the Enron fraud also triggered a legislative response from the US legislative branch, and the US Congress enacted the Sarbanes-Oxley Act in 2002 (Pub. L. 107–204). The Act has, amongst other issues, legislated the responsibilities of auditors and has limited some practices that in the past were allowed although not always perceived as ethical. In the case of Enron, the issue that aggravated the regulators was that Arthur Andersen earned a significant amount of money providing accounting services/consultancy to Enron at the same time when they were the company's external auditor. This was perceived as a conflict of interest that narrowed their own vision, making them unable to review Enron's books in an objective and professional manner. An auditor's independence is one of the golden principles, and here their behavior raised suspicions.

The role of audit is shifting in a modern and dynamic business environment. Some regulators claim that investors and other stakeholders that are interested in a company are increasingly interested in a wealth of information about the company where most of the information would not have been subjected to (statutory) audit (Institute of Chartered Accountants in England and Wales [ICAEW], 2019). Auditors now look beyond standard

financial statements. They consider a number of other issues as well (Center for Audit Quality [CAQ], 2019). So, auditors will look at financial statements in a comprehensive manner (both the output and the process that led to it) and at the internal control over financial reporting (ICFR). ICFR is a tool designed to address risks related to financial reporting.

Auditors will now assess nonfinancial information as well as the key performance indicators (KPIs) as stated in the company's reports. Nonfinancial information may be clearly stipulated, like in the US, or more vaguely referred to as in other jurisdictions. In the US context, for the Security and Exchange Commission (SEC), nonfinancial measures are, for example,

- earnings before interest, taxes, depreciation, and amortization (EBITDA),
- adjusted EBITDA, and
- adjusted earnings per share.

In the US, KPIs are defined in a negative manner: KPIs are all those key measures that have not been listed as such by the regulator. They also contribute to understanding the success of a business but were not, per se, prepared by the company (SEC, 2020).

In the retail industry, KPIs may be, for example, number of stores, number of customers and sales per square meter. KPIs are often industry-specific, and although the company may be free to select them, industry practices dictate the set of financial indicators. At present, auditors are not required to report on environmental and social governance (ESG) issues, though some do voluntarily. This may also change in the future, with environmental and social issues attracting the attention of both investors and the public. In countries where ESG is mandated or under the regime of "comply and explain," the probability that even ESG reports may be subject to fraud does exist, and it is just a question of time before auditors will review them and confirm the authenticity of ESG reporting and its outcomes.

Internal auditors are employed by the company, and they work on the development of certain processes and procedures and are charged with checking on compliance with the rules (internal regulations) as well as with external sources (relevant legislation and regulations) and checking on the company's systems, processes, and procedures. They may also look at the financial reporting within the company but will usually focus on that in terms of processes rather than pure financial standards compliance issues.

External auditors in contrast provide a service where they "certify" that a company's financial statements have been prepared in line with accounting standards and national legislation. External auditors will also look at risk processes and risk management and will state whether a risk management system is functioning and recording appropriately. Risk has been added to the remit of external auditors relatively recently. Traditionally, they have looked at the quality of (external) financial reporting. External auditors are paid for their service, and as a professional service provider, they are required (often by law) to be professionally insured so that in the case of their failure losses can be recuperated. In other

words, an external auditor can be sued in the case of substandard service that has resulted in damage for the interested parties (i.e., parties that can demonstrate clear interest and losses).

5.2 Litigation Against Auditor Failures (Wirecard)

An accountant/auditor is a provider of a commercially negotiated professional service and may be held responsible and subjected to legal proceedings. A company's stakeholders who have suffered losses due to inappropriate or unprofessional work by auditors may decide to enter a litigation against them. In the litigation process, those who suffered losses may ask for their recovery and additional damages from the auditor. Litigation may be completed by determining the damages that the auditor has to pay to the plaintiff, or the agreement may be reached through an out-of-court settlement (Chy et al., 2021). In either option, we consider the outcome as achieved through litigation. In the business world, out-of-court settlements are used more often than litigation (i.e., the court procedure).

As a provider of professional services, auditors face **litigation risks**, and there is always a risk of being exposed to a court case where a client may be dissatisfied with the service provided or where the service provided was substandard, leading to a situation where the client has suffered significant damages and is thus suing an auditor to recover the damages. Thus in most jurisdictions, auditors will be required to acquire professional indemnity insurance as a prerequisite to conducting audits. In fact, litigation risk is a risk of an auditor being subjected to a court case (Sun & Liu, 2011). With the litigation risk comes a reputational risk. Whilst the litigation risk may lead to an immediate financial sanction, the reputation risk may lead to a situation where auditors may lose future income because their reputation has been tarnished so that "clients will run away from them."

Litigation risks
These materialize when an auditor is exposed to legal action and is requested to appear before the court regarding an audit service provided.

Because auditing is a private service offered in a competitive market, one's market reputation and perception are very important for securing a good market position. For instance, it is well known that international audit firms (and especially the Big Four) command higher fees compared to national firms (Joshy et al., 2018). One of the main reasons is their international reputation, but they may also have access to better resources due to their membership of a global network. The Big Four also tolerate less managerial discretion, and their clients usually enjoy lower costs of debt and easier access to credit. Sometimes, stakeholders and shareholders may see auditors as insurers against misreporting and the associated losses. Therefore, their high fees may be seen as a particular insurance premium as well (Joshy et al., 2018).

Although litigation risks may positively influence auditors by making them more diligent in conducting the audit, it is clear that litigation risks also trigger auditors' fear of their own survival. There have been cases in the past where large accounting firms (e.g., Laventhol and Horwath [L&H]) went bankrupt following a litigation suit. In fact, L&H's bankruptcy triggered some changes in the US, where a new organizational form – Limited Liability Partnership (LLP) – was allowed in a number of states for professional service

organizations, and the class suit options were somewhat limited in 1995. The experience of L&H's failure was also important because the seventh largest US audit firm had been growing so fast that its effective control was limited, and the partners in the process of growth may have "merged into a lawsuit." The failure had also curbed, at least for a while, an appetite for growth through mergers and acquisitions amongst audit firms (Stiner, 2010).

In the case of the Enron collapse, the auditor Arthur Andersen was accused before the court for "obstruction of justice in the fraudulent activities and subsequent collapse of Enron" (Arthur Andersen LLP v. United States, 2005). Initially, the firm was convicted, but in a case before the US supreme court, this was overturned, and the government was accused of "overreaching," and the first judge was found to not have properly instructed the jury and set the threshold of proof fairly low. However, the supreme court decision had not really meant anything for Arthur Andersen, as the company had lost almost all clients, and they had less than one percent of their employees left working for them by 2006 when the Supreme Court decision was reached (Toffler & Reingold, 2004). The initial decision destroyed their reputation and the company never recovered. Non-audit arms separated and continued as a firm on their own (Accenture). The case is also interesting because one of the supreme court justices (Antonin Scalia) labelled the government action as "weird" (Greenhouse, 2005).

In recent years, the number of litigation cases against auditors has been dropping, and it is expected that the trend will continue. It may be the consequence of a series of rulings in the US that narrowed liability standards (Lagace, 2019). Plaintiffs (e.g., institutional investors) now have to prove beyond reasonable doubt that auditors knew, or should have known, of their clients' financial statements containing errors (Tellabs v. Makor [2007] and Janus v. First Derivative [2011]). Although the number of cases is falling, it does not mean that shareholders are likely to let auditors get away with major errors and neglect, especially in other jurisdictions that were somewhat late to adopt these class action models for litigations.

Another case is Ernst & Young (EY), which is a Big Four company that has had a large market share of the audit market. They were the auditor of Wirecard, a German company that went bankrupt in 2020 due to financial fraud. They accumulated losses of €3.2 billion and €1.9 billion of cash that went missing. The company engaged in payment processing and provision of financial services (including risk management).

The said losses were made public just days after EY completed the audit without raising the issue of losses. The case against the auditor was filed by the German Shareholder Association (Schutzgemeinschaft der Kapitalanleger [SdK]) for criminal neglect. The audit firm is now being subjected to a class action suit where numerous small shareholders require justice. In early responses, EY stated that it was impossible to detect fraud in the case of "highly collusive fraud" behavior within the company. The civil case is based on EY allegedly failing to flag improperly booked payments on Wirecard's 2018 accounts. Soft Bank and *Der Spiegel* magazine have initiated court procedures against EY as well (Storbeck, 2021).

The case against EY is ongoing as of 2023, and it is most likely to set a precedent in Germany due to the large number of participants in the class action suit, which was an unusual practice in the continental European legal systems just a few years back. This will likely lead to an increase in litigation cases against auditors in Europe and also to higher audit fees because the cost of insurance premiums will have to be factored in. As the case is against the German subsidiary of EY (Ernst & Young GmbH Wirtschaftsprüfungsgesellschaft) only, the conviction outcome may push a subsidiary into bankruptcy but will not necessarily influence the global EY business, except for some damage to their overall market reputation.

5.3 Corporate Governance and Internal Control

A well-functioning corporate governance system is vital for the prevention or timely detection of financial fraud. Corporate governance is understood as a way that companies are governed and for what purpose. However, the term "corporate governance" may have a different meaning for specialists in different fields. Economists will focus on the efficiency aspects of corporate governance, whilst lawyers (or legal scholars) may be more interested in structure and the institutions. Hence, corporate governance may attract different interpretations based on the context in which the phenomenon is understood (or contextualized). It may be the reason why the modern approach to corporate governance is multidisciplinary (i.e., encompasses approaches from different disciplines).

One of the pioneering policy works on corporate governance, the Cadbury Committee Report, defined corporate governance as "the system by which companies are directed and controlled" (Cadbury, 1992, p. 15). Corporate governance may also refer to the processes, structures, and mechanisms that influence decision-making processes and the direction which a company has taken; this provides a more dynamic view. Structures and mechanisms may be static, but processes are, by definition, dynamic.

The Organisation for Economic Co-operation and Development (OECD, 2015a) sees corporate governance as relationships and structure(s): "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders" (p. 9). From a legal perspective, corporate governance may be seen as a set of laws and regulations that address the relationships between major stakeholders. In fact, as the importance and adoption of good corporate governance is on the rise, definitions and approaches are also growing. One may consider corporate governance in the context of a court case (Pacy Sifuna, 2012) or in a more contractual/bargaining context (Zingales, 2008). International discussions have resulted in the development of principles of corporate governance, such as the following:

- rights and equitable treatment of shareholders
- interests of other stakeholders
- integrity and ethical behavior
- disclosure and transparency

In principle, all shareholders have to be treated equally, and organizations have to ensure that they can exercise their rights effectively. Of course, some of the rights will be linked to the size of their ownership, but this does not mean that those who are with a lesser ownership do not have a right to express their opinion, contribute to the organization, etc. Processes and procedures within a company should ensure that shareholders may exercise their rights effectively and without unnecessary limitations. As modern organizations do not operate in a vacuum and should have an effective relationship with the community and wider environment, the corporate governance model applied within an organization/ company should also take care of stakeholders. Both internal and external stakeholders have to be supported in exercising their rights. Stakeholders usually include

- employees,
- investors,
- creditors,
- suppliers,
- local communities,
- customers,
- government, and
- regulatory agencies.

A company's board plays a decisive role within corporate governance because it is the main operational governance body. Shareholders meet at least once a year, and they do not have the time or a way to monitor the management in an effective manner on a regular basis. An individual shareholder may ask questions, require information from the management, and sometimes even express a greater-than-usual interest in the day-to-day management of the organization, but it does not necessarily mean that the shareholders are interested in running the organization at a professional level. A company's board will provide a regular oversight of management and provide strategic guidance to managers, ensuring that they meet their shareholders' expectations. To provide leadership and effective oversight, the board has to be made up of members who possess appropriate knowledge, skills, and experience to project respect and confidence.

Integrity
This is a human behavior associated with or equated to honesty and a consistent and uncompromising adherence to strong moral and ethical principles and values.

Integrity and ethical behavior are emerging as major requirements as well, following the large international scandals and the failure of existing governance mechanisms to ensure that the laws and regulations were observed as required and that the interests of the stakeholders had been protected. Both companies and individuals are expected to behave ethically, ensuring that moral values are observed in running the company and in interacting with the wide variety of both internal and external stakeholders.

Code of conduct
This is an internal regulatory act that outlines standards, rules, and responsibilities of an organization and/or individual within an organization.

In formal terms, organizations are expected to develop a **code of conduct** that stipulates what kind of behavior each member of the organization should project and what kind of behavior is encouraged. A code of conduct provides necessary guidance and ensures that desired behaviors are known to the members of the organization and provides tools for the enforcement of those desired behaviors and adherence to the ethical principles that the organization (company) endorses.

Disclosure and transparency are also one of the principles of corporate governance. Companies are expected to disclose information of interest to their shareholders and the public, especially those that are listed on the public exchanges (i.e., listed companies). Investors, and potential investors, expect and should be provided with information on the economic and other performance of a company in a timely manner so that they can make an informed decision. Current corporate law legislation usually makes some reporting mandatory, such as the publication of an annual report, including the annual set of accounts. Even if a company is not listed, in many jurisdictions the annual report will have to be submitted to the company register or regulator. Whether the public will receive the information free of charge or will have to pay a fee differs from country to country. Usually, very basic (e.g., corporate governance) information is free, whilst more detailed financial information is available at a charge.

Good corporate governance does not only mean the effective organization of bodies and achieving their full functionality. It is also about developing and enforcing policies, procedures, and protocols. They have to be clear and provided in a written form so that all individuals within an organization can relate to them effectively and understand what is expected of them as a member of the organization. These policies (internal regulatory acts) regulate different aspects of corporate behavior, from human resources to finance. Good or effective governance outlines roles, creates an oversight system, and reduces opportunities for fraud. The development of policies promotes transparency within an organization, and increased transparency, *ipso facto*, creates an environment that is not conducive to fraud. Although no policy may fully prevent fraud, it may reduce the probability of fraud. Detecting fraudulent behavior before it becomes detrimental to an organization is very important because the costs after fraud is detected may be of such a magnitude that it may trigger a domino effect and contribute to a global crisis. For instance, the Lehman Brothers collapse in 2008 is testimony to that.

Good corporate governance ensures that the duties of a top manager (chief executive officer [CEO]/managing director) and a top governance officer (chair of the board) are separated so that potential conflicts of interest are eliminated. A chair of the board has to supervise the CEO and ensure that he or she acts in the best interests of the company and its shareholders. As principal agent theory suggests, managers act in their own interest, so a chair is there to ensure that this does not happen or does not happen undetected.

Good corporate governance also requires setting up structures and processes of internal control. If economic agents know that they will be subjected to (regular) control, they are more likely to behave in a desired manner. This serves as a preventive measure and ensures that any misbehavior is detected early and referred to the corporate governance bodies. Internal control focuses on compliance issues, i.e., whether members of the organization (i.e., employees) observe the internal and external rules and regulations and adhere to the policies that have been promoted within the organization. If the organization is set up as a learning organization, it will be able to internalize all that has been learned and ensure that errors are not committed. At the same time, it will be able to more proactively deal with new knowledge, endorse new technologies as well as new processes and procedures, which will make it more robust and ensure that fraud and corruption are dealt with effectively.

Establishing good and functional communication lines with stakeholders will also ensure that any suspicion of fraudulent behavior is appropriately and timely reported up the responsibility chain or to the internal control or internal audit units. Supporting whistle-blower culture and processes (e.g., a fraud hotline) is also a measure that can be built into a good governance organization. Additional checks and monitoring of spending habits of key employees may also be a measure to be considered. All these activities may be undertaken by an appropriately established and effective internal control unit.

5.4 Better Reporting System

After every major financial fraud case, governments and regulators initiated serious reforms that were supposed to reduce possibilities for financial fraud. However, the problem of reporting system effectiveness and efficiency needs to be considered holistically. Financial reporting is just a segment of the overall reporting process within a company. A silo approach where the focus is mostly on financial reporting may create an environment in which reports are not comprehensive enough, with important aspects left out. To address the shortcomings of narrow reporting in the case of financial statements, narrative parts of the report were introduced in which the management explains the main trends, policies, and results of the company in plain language for the benefit of the stakeholders. Both current and future investors benefit from the wealth of information thus provided (enhanced transparency) as they reassess their investment in the company.

A good reporting system not only provides necessary information but also ensures that this information is properly communicated to all stakeholders in a way that they can relate to and use information in a meaningful matter. A good information system has to provide the following (Helmy, 2020):

- agood information flow
- accurate information
- proper timing
- relevant information
- basis for comparison
- clear and simple reports
- costs
- visual reporting
- consistency
- proper scheduling

Creating a good reporting system is a challenge for every organization, as often this process requires elimination of existing practices and the introduction of new approaches, methodologies, processes, and procedures that the organization (i.e., members of the organization) may decide to refuse. Each of the steps above may be improved. For instance, information flow may be subjected to one or several information bottlenecks that slow down information exchange and make overall decision-making processes slow and, ultimately, irrelevant because by the time the information is received it may be obso-

lete. Bottlenecks thus affect timeliness and accuracy because the information may lose some of its integrity. Therefore, following the information flow and ensuring that it is unobstructed becomes one of the major activities.

Information accuracy is important because with false input the output decision will also be inappropriate and false. Often, information may be an estimate, but the organization has to ensure that every effort is made to ensure that the information provided is as accurate as possible. If preliminary information is used, it should be corrected as soon as possible (i.e., when the correct information is obtained).

Information must be provided timely because of its short-lived nature, it may become obsolete and irrelevant. In fact, with the lapse of time, even the legal rights may be lost (forfeited), and information (especially in finance) is time-bound. It is often said that if you wait long enough, any information becomes free. For instance, learning trading platforms are provided with data that are delayed (so cannot be used for actual trading), and thus their costs are just a fraction of the costs of real-time data provision. Relevance of information is an important requirement because a mass of data may often be generated, but not all of it is needed for decision-making. In fact, information overflow may have an adverse effect on the quality of decision-making. Hence, a reporting system must focus on relevant information only.

A good reporting system provides user-friendly reports. Reports must meet regulatory and legislative (minimum) requirements but at the same time have to be accessible to stakeholders. Legal thinking will usually go for average users and their ability to relate to the document (report) in a meaningful manner. Technical jargon should be avoided so that the report is user-friendly. Sometimes, legislative requirements may prevent simplicity, but to create a better reporting system, the organization (i.e., the company) needs to do whatever is possible to make its reports accessible, keep its stakeholders in mind, and support them in realizing their rights.

Reporting, like any other business activity, triggers some costs, and these costs have to be reasonable. If the costs of reporting are high, it is most likely that it will not meet expectations. Organizations may try to push costs down and compromise on quality, otherwise reporting will be seen as an onerous activity that does not add any value. In either case, the aim is not achieved. Costs have to be commensurate with the benefits that it generates to be accepted.

Reports serve various constituencies that may have different expectations. Some users may want to look for financial information, whilst others may be more attracted to the graphical presentation of data. This is why a good reporting system will generate reports that meet the expectations of different stakeholders. Consistency (i.e., the stability of reporting templates and forms over a long period) is something that a good reporting system emanates. Consistency allows meaningful comparability, and the performance of an organization may be observed over a defined timeframe. This is a vital feature, especially with analyzing a company's performance.

Reporting as a regular activity requires the commitment of resources, including time and effort of staff. Often, the resources needed for reporting may be used somewhere else for better gain. Hence, proper scheduling and timing of reports should ensure that staff time is used efficiently if they know when the reports will be required and what the standard reporting cycle is. For instance, if the financial year finishes in December, accounting staff will know that most of January (at least) will be used for preparing the financial statements for the past financial year. Good management should ensure that there is enough capacity in January (and February) to complete the process and prepare financial reports to be endorsed by the general annual shareholders' meeting, which is most likely scheduled for the first quarter of the next year.

A reporting system may be improved through a better segregation of duties and ensuring effective supervision. For instance, different people may deal with various payment instruments, ensuring that there is effective control. The reconciliation function also helps in creating a better reporting system. Reconciliation should be performed by a person who does not provide accounting services and does not make or approve payments. This should provide a framework that will ensure that any inconsistencies are spotted and timely addressed. A regular review of inventory, journal entries, and electronic transfers also provides the robustness of the reporting process. Reporting to governance bodies (board and annual general shareholders' meeting) also contributes to a better quality of reporting because, with their timely information, a senior management intervention may be triggered when and if necessary.

It should not be forgotten that setting the tone at the very top (senior/top management and board) is very important for the quality of reporting within an organization. If reporting is understood as a function that supports better decision-making and is not just about compliance with external legislation and regulation, the quality of reporting will be better. The creation of company-wide financial policies sets the framework for reporting and ensures that reporting meets a certain level of expectations.

Consistent messages from the top provide an incentive for employees to take reporting seriously and look for ways to improve the reporting process (i.e., by improving efficiency and effectiveness). Regular reviewing and updating of the policies is also required because all policies in a dynamic business environment have a limited life span. Usually, a company should review its policies every three to five years and ensure that they are reviewed by taking into account the development of the most recent leading (best) international practices. It should also not be forgotten that these policies, as internally generated documents, should promote the company's ethics, values, preferences, and procedures in a manner that will be accessible and attractive to its employees. If policies fail to deliver the expectations, if it becomes impossible to implement, and the implementation process generates substantially high costs of compliance, the policies have to be reconsidered, and, if necessary, modified. Modification of policies through collective efforts is always the best approach. A top-down change of policies usually yields bad results and adversely affects an organization's reporting and compliance records.

5.5 Check and Balance on Executive Management Compensation

Executive compensation has attracted much attention both in professional press and academic literature (Balsam, 2007; 2013; Bebchuk & Fried, 2004; Clifford, 2017; Ellig, 2002; Frydman & Saks, 2010; Murphy, 2011; O'Connor et al., 2006). The growth in executive compensation has grown rapidly in the last 40 years. It has been reported that executive compensation has grown 940% between 1978 and 2018, whilst worker's compensation mere 12% (Mishel & Wolfe, 2019).

The salary (i.e., pay differential) attracts attention on many levels. Firstly, from a social point of view, it contributes to deepening social inequalities, and, secondly, it initiates hazardous behavior where managers may accept unreasonable risks if they are rewarded with a large or exorbitant compensation. The pay differential is also a sign of (excessive) power because the managers are in a position to define their pay and impose solutions (Mishel & Wolfe, 2019). Excessive executive pay may be limited without much harm to society, either through policy (regulatory) action or progressive taxation. Due to their position, executives are able to extort economic concessions that contribute to an excessive growth in their total compensation. Although governments and regulators have attempted to control (i.e., limit) executive compensation growth, it had a limited effect (SEC, 2015; Staff of Congressman Keith Ellison, 2018). As executive compensation (remuneration) has many components, regulators face a major problem regulating it. Some of the benefits are sometimes difficult to define on the spot because they may be long-term, and their realization may be linked to some future event (context).

In analyzing the 2008 global financial crisis, excessive executive compensation was also to blame. Hence, regulators intervened, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. L. 111–203), often referred to as Dodd-Frank, was instituted. The act, amongst other benefits of providing a better financial system stability (Ayogu & Lewis, 2011), has also addressed the issue of executive pay (Mishel & Wolfe, 2019). Executive pay should not be a reason for reckless behavior by executives or serve as an incentive for hazardous and irresponsible decision-making. Dodd-Frank required publicly traded companies to report their CEO to a median worker pay ratio, and this has been implemented by the SEC as an executive agency (SEC, 2015). However, the SEC was not efficient in implementing the rule because it took over five years from the day the act was promulgated to publishing the implementation regulations. Now, companies in the US (i.e., listed ones) provide information on their CEO pay and the company's median pay. In some cases, the ratio is over 4,987% (Mishel & Wolfe, 2019).

The executive pay package has several elements, and some of them may not necessarily be captured by reporting due to the specifics when they are considered pay and when they can be realized. As a rule, these are the elements of an executive pay:

- salary
- short-term incentives
- long-term incentives
- guaranteed severance package

- perquisites (perks)
- insurance (health and other types of insurance for the executive and/or members of his/her immediate family)

Some of these elements may be merged. For instance, long- and short-term incentives may be considered as one element of the pay, although they are distinctive and behave in a different way. Not all executive packages may have all the elements. Usually, salary, insurance, and incentives will be negotiated as a must, whilst other benefits may be omitted. Short-term incentives usually revolve around an annual bonus. The bonus is usually linked to the executive's personal contribution to the success of the company. The ratio between personal and group contribution for executives is very high, where over three quarters of the performance bonus will be based on his or her own personal contribution to the success. In contrast, employees who are at the very bottom of the organizational pyramid will have their performance usually dominated by organizational success, rather than their own personal contribution. Executive compensation, despite regulatory interventions, is still largely market-driven. Factors that have traditionally affected executive compensation are

- the changing nature of work,
- investors' confidence in company's leadership,
- industry benchmarking,
- governance (effectiveness of governance),
- attracting and retaining high-quality executives, and
- triggering proper executives' behavior.

It is believed that executive compensation should be directly linked with the responsibility of executives. As they are responsible for the performance of an entire organization, they should be rewarded appropriately. The work itself is becoming more complex, and hence compensation has to be linked to their responsibility. If a company continues performing to the expectations of its shareholders, they are most likely to reward the executives for their contribution. Investor confidence and trust in a company's management is always directly proportionate to the senior management pay. When a company recruits on a market that is highly competitive, industry benchmarking is regularly done. Often, companies may hire professional help (i.e., consultants who specialize in collecting information on executive pay). These consultants will provide a guide on executive compensation. However, industry benchmarking and unhealthy competition may push rewards for executives beyond what they deserve.

Activist investor
This is an investor who acquires a significant minority stake in a publicly listed company in order to change how it is run and unlock value for investors.

The governing body of a company (i.e., the board) usually recommends the executives' pay to the annual general shareholders' meeting. Sometimes, too-close relationships between managers and the board may lead to excessive compensation, but this may be challenged at the shareholders' meeting, especially by **activist investors**. Activist investors are usually strong institutional investors (often specialized in hedge funds) that see high performance as a must and want to drive executive performance down. Activist investors have been successful in unlocking value at times, although not always. Sometimes, their efforts to quickly change the way a company is run in order to increase profitability may backfire.

In line with principal–agent theory, an attractive compensation package should motivate managers to behave in a desired manner and perform to the best of their abilities. So in a way, a good executive compensation package may be seen as “a carrot” to reward good behavior (i.e., performance). The package also sends a signal to the executive job market that a certain company appreciates senior management positions, making it an attractive employer. However, it is important to ensure that the executive compensation is balanced and risk-bound. If there is no control, then in order to optimize the package, an executive may take excessive risks and focus more on short-term gains, rather than having a long-term view of the company’s development. Therefore, an executive package that is unrealistically high may foster an environment in which fraud and financial manipulation may thrive because everybody will behave in a “short-termism” manner, and the future of the company in the long run may be compromised.

SUMMARY

Good governance, as well as internal control and audit, contribute to the prevention and early detection of (financial) fraud. If the right questions are asked early by the governing body and if internal control systems are developed, fraud risk levels will most likely drop. External auditors express their opinion on the quality of financial statements developed by the company and submitted by its senior management. Although detecting financial fraud has not been the task of auditors, they are often exposed to court cases where damages are sought because the damage was experienced due to false, manipulated financial statements. Court cases are dropping, but class action court cases are on the rise in Europe where this practice is rather novel. A recent case is Ernst & Young being sued for its failures auditing the Wirecard company. Fraud cases and financial crises often trigger changes in the reporting system and support changes in legislation and regulations. More integrated reporting may be required to eliminate a silo mentality and the shortcomings that such practices generate. Financial fraud is, as a rule, perpetrated by or with the knowledge of senior management who are well-paid to perform their fiduciary duties. However, good executive pay does not necessarily guarantee performance. This is especially true in the cases of recently bankrupt companies (e.g., Wirecard).

UNIT 6

MARKET CONSEQUENCES OF FINANCIAL STATEMENT FRAUD

STUDY GOALS

On completion of this unit, you will be able to ...

- understand the importance of the loss of investors’ confidence.
- discuss the need for new accounting standards and other standards.
- appreciate the regulatory and supervisory changes in the modern world.
- understand the new context in which financial fraud may be perpetrated.
- describe and critically evaluate the major approaches to financial statement fraud from an innovative perspective.

6. MARKET CONSEQUENCES OF FINANCIAL STATEMENT FRAUD

Case Study

After several years as an "angel investor" and active investor in shares, Ms. X has expressed an interest in better understanding the nuances reported in the annual reports developed and submitted by the respective companies in which she has invested but is usually a minority shareholder. She has learned about active investors and has decided to be more active in asking questions to the management and ensure that they are always ready to respond, not only to her questions but also those posed by other minority investors that may have been marginalized. Ms. X is a fast learner. Every time she was not sure that she understood the annual reports of the companies in which she invested, she solicited support of her accountant who explained to her how to read them, the importance of (quick) financial ratios, relative changes in values, vertical and horizontal analysis, etc. Over time, Ms. X's confidence grew, and she was not only able to read and understand the financial reports well but was also showing increasing interest in accounting standards and national accounting regulation. She has appreciated the difference between the countries that endorsed the International Financial Reporting Standards (IFRS) and the national accounting standards like the US Generally Accepted Accounting Principles (GAAPs). She has also learned that there are IFRS standards for large companies (i.e., listed entities) and those that can be voluntarily used by micro, small, and medium enterprises (MSMEs). Being increasingly versed in the issues of accounting standards, Ms. X has also realized that accounting (i.e., financial reporting) standards evolve over time and need (re)adjustments. She knows that new accounting and reporting standards will take a long time to be developed, but it is a process that has to be triggered. If the standards fail to achieve the desired transformative changes, their use to improve the trust in financial reports will be limited, if at all. International comparability of statements is also an important feature, as the investors are increasingly global and work cross-market. National regulatory interventions may now have cross-border consequences, far more than just a few years back. Creating a learning organization is a must, Ms. X believes, so that investment in training and education of employees is a *sine qua non* of ensuring that financial-statement-specific fraudulent behavior is effectively controlled (either prevented or detected early). Ms. X, having been a victim of financial fraud, knows that vigilance is needed to prevent fraud from happening, and she hopes that future regulations and standards will ensure that the (minority) shareholders are protected from (financial) fraud (i.e., manipulation of financial statements).

6.1 Loss of Investor Confidence

Loss of **investor confidence** happens when investors do not believe in the organized stock exchange (stock market), financial information disclosed, or any other information that is publicly provided. With the loss of confidence, the level of trust diminishes to zero, or close to it. If there is a lack of confidence in the system, the investors will stop their activities, and, ultimately, the financial system will fail to deliver its services to the economy.

Investor confidence
This is the readiness of investors to consider investment opportunities based on their risk profile and risk preferences.

Investor confidence is one of the indicators that is measured. When investors lose confidence, they will refrain from investing, especially in large undertakings, and will then usually observe the market and wait for better a performance. Investor confidence in general is influenced by a number of factors, such as the following:

- company news and performance
- industry performance
- (macro-)economic factors

Economic or macroeconomic factors are interest rate, inflation (rate), foreign exchange rate (FOREX)/rate of domestic currency, national (and global) economic outlook, changes in economic policy, etc.

Investor confidence may be lost either in a firm or in the market. Investor confidence in a firm may be lost (or shaken) if the company fails to deliver the expected level of results, especially compared to their preliminary announcements. In cases like these, investors may hold shares and wait for the performance to improve or “vote with their feet” and sell the shares in the open market. In the case of an individual company’s loss of confidence, investors can invest in another company inside or outside the given industry, or the company itself may introduce measures to improve their standing. In the case of the loss of confidence in the market, investment activity will decline, having a negative effect on the economy, and only strong and timely regulatory response and government intervention may restore some level of confidence (at a market level). The Securities and Exchange Commission (SEC) sees investor confidence as twofold (Ko, 2017, p. 1):

1. Optimism about the “fundamental” risk and return of their investments
2. Trust in protections provided to investors in financial markets against potential losses from expropriations by other market participants

Theoretically, market returns should be commensurate with the level of risk exposures, and an investor should expect a certain return on his or her portfolio. If he or she is an active investor, they can manage the portfolio proactively or just follow the market and secure market returns. If they are active and invest, then it is likely that their confidence in the market is high, and vice versa. A government must provide an enticing environment for investment and intervene, if necessary, to protect the interests of well-behaving, law-abiding market players.

Investor confidence is about their perception of opportunities and their associated risks. Investors may not always be right, and they may see a particular investment as risky and may not invest and lose a potentially lucrative deal. Sometimes, these errors may come

from their own prejudices and past experiences, or they may simply follow the overall market sentiment (i.e., "follow the crowd"). Investors' trust is usually measured through the collection of views and opinions and, again, may be somewhat subjective. In the US, investor sentiments are measured by the RAND American Life Panel and the Financial Industry Regulatory Authority's (FINRA) National Financial Capability and Investor Study (NFCS). Both use the scale from 1 to 7 when asking investors to express their views. There is also a survey by the market research company Cerulli Associates (2023) and the Chicago Booth/Kellogg School Financial Trust Index (2017) developed by Sapienza & Zingales (2013).

The surveys capture the views of the investors about the market, opportunities for investments, and their sentiments on the returns on their investment. However, they do not capture the sudden shocks, like the bankruptcies of Enron, WorldCom, Wirecard, etc. due to financial manipulation and fraud. In these instances, the investors were not aware of wrongdoings within the company and thus could not predict it. However, the failure of these large companies has sent waves of fear across the markets. The companies were heralded as beacons of success and good investment, whilst in reality their performance was inflated and liabilities were hidden.

A company's stock underperformance should be seen differently from a collapse of the stock price due to discovered fraud. In the case of underperformance, a company and its management may undertake some measures to regain the investors' confidence. This may be challenging because they will have to improve their performance even when market conditions are not in their favor (high inflation, business cycle contraction, etc.). A suggestion may be to improve communication with investors (Govindarajan et al., 2022). This offsets the declining interest of business and market analysts in the company.

When market research interests are declining, it is necessary to improve communication and keep the interests of investors in the company, rethink the strategy and prioritize the winners (i.e., business products and services that may be attractive and performing in the new business environment). Managers themselves have to send a message of confidence in the company's price, and it should have a positive impact on overall confidence. When a company is down, attracting and retaining talent is a must, so the information that new talent is recruited and that employees are not leaving the company sends good news. Mergers and also delay in share offering can also send positive signals to the market and improve confidence in the company.

In the case of fraud and fraudulent financial reporting, the challenge is more complex. If a company survives a scandal, it will take some time before investors look at it as an investment opportunity, even if all managers and staff who were involved in the fraud have left the company. As the company returns to the market, business analysts will be very careful in analyzing its performance and will certainly consider various options to test the reports. After fraud has been perpetuated, it will take a long time to regain the trust and confidence of both investors and the market (Gurun et al., 2015). Furthermore, it should not be forgotten that, ultimately, trust plays a critical role in the financial intermediation industry.

6.2 New Accounting Standards

Accounting standards are an authoritative professional guide for the preparation of financial statements. They set standards for financial reporting and provide accounting principles. Accounting regulations can be imposed as standards (which traditionally has been an Anglo-Saxon practice) or by (corporate/commercial) law (which has been a continental European practice). At the technical level, accounting/financial reporting standards explain how transactions and accounting events are recognized, measured, presented, and disclosed in the respective financial statements. Accounting or financial reporting standards provide standardized information for external and internal stakeholders of the company – shareholders, governments (national, regional, local), tax authorities, banks, other creditors, debtors, suppliers, business partners, etc.

Accounting standards
These are authoritative standards for financial reporting in the private or public sector.

Accounting standards allow interested parties to compare the financial performance of different business entities, allowing them to make the necessary decisions. Investors, using published accounting information, will decide on their investment; tax authorities will deliberate the (final) tax obligation; creditors (banks) will be able to decide on crediting; and rating agencies will take the financial performance information in setting the entity's credit rating. Accounting information will be just one of many pieces of information that the analysts will consider in creating a profile of a company.

Accounting standards determine policies and practices of financial accounting and establish the guiding principles that the business entities have to follow. Although double-entry bookkeeping/accounting has been known for centuries (Brown, 1905; Edwards & Walker, 2020), there are improvements and innovations that have happened over time. For instance, in medieval accounting, there was no accounting for leases and derivatives. However, business life has developed new instruments, and their accounting treatment has been developed further. Often, accounting was delayed, responding to the needs of business, but, ultimately, the standard setter addressed the problem and appropriate standards were developed.

Historical value (book value) in accounting has been a rule from the very beginning. However, in the 20th century, fair value accounting has been introduced with the argument that the market value should be in fact reflected in books, rather than the historical one. During times of volatile markets, this logic looks fine. However, this volatility may lead to a value being lost overnight, and many business agents may suffer losses. Fair value accounting has been the cause of some of the accounting scandals (most notably Enron, amongst the other issues), but not because of the concept but rather the abuse of the concept.

Both the IFRS and national accounting standards (regulations) evolve over time, addressing the emerging needs of businesses and taking into consideration the development of new instruments and practices. In the case of future development and improvement of financial reporting, a project on integrated financial reporting has been launched by the IFRS Foundation. Integrated reporting should improve asset allocation, and in doing so, it aims at the following (Integrated Reporting, 2023):

1. Improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital
2. Promote a more cohesive and efficient approach to corporate reporting that draws on different reporting strands and communicates the full range of factors that materially affect the ability of an organization to create value over time
3. Enhance accountability and stewardship for the broad base of capitals (financial, manufactured, intellectual, human, social and relationship, and natural) and promote understanding of their independencies
4. Support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium, and long term

The integrated reporting framework is about bringing together the existing financial reporting standards and sustainability standards as well as facilitating companies reporting on both (IFRS, 2021). The growing interest in sustainability and socially responsible green accounting has been reflected in the integrated reporting framework. This is a relatively novel approach to financial reporting and will have to be tested in practice before it will be endorsed generally.

As a major EU/European lobbyist for the quality of financial reporting, the European umbrella professional accounting association Accountancy Europe has emphasized the importance of defining fraud and taking measures to contain fraud (Accountancy Europe, 2021). It proposes the following (Accountancy Europe, 2021):

- require companies to have and publicly report on a fraud risk management system,
- pay specific attention to senior management fraud,
- mandate an audit committee in all public interest entities,
- make early warning mechanisms for auditors effective,
- clarify auditing standards for a common understanding of the auditor's role,
- improve auditors' access to knowledge and awareness about fraud,
- auditors to clearly communicate their work and conclusions about fraud

The focus here has been on strengthening existing structures, focusing on internal control and ensuring that the audit function supports fraud prevention and detection. Communication (nonfinancial data transfer) is also important in ensuring that the agenda is shared. Developing new financial reporting/accounting standards to deal with fraud may not necessarily be something that will be done in the near future. However, a growing capacity of practicing accountants suggests that the profession itself may be able to respond to the challenges of on-the-go regulatory shifts. At the same time, if there are further corporate collapses, it is likely that the standard setters may strengthen the framework, make standards more rigid, and insist on a compulsory application (IFRS with GAAP and vice versa).

6.3 Regulatory and Supervisory Changes in the Global Context

Major financial fraud cases usually trigger an immediate legislative reaction where the lessons learned are incorporated into the new legislation, ensuring that similar challenges may be handled appropriately in the future. As crises are becoming global, the collaboration between regulators in different jurisdictions is not only encouraged but also required. When an entity operates in multiple jurisdictions, it may operate in a way that does not comply fully with either jurisdiction. In the case of fraud, this "competition of jurisdictions" may not work, as fraud and fraudulent behavior is punishable worldwide. The only issue that may remain is the extent of the fine that may be imposed.

Some international organizations may work on the development of certain aspects of governance mechanisms and ultimately contribute to the success of a global framework to tackle financial and related fraud. For instance, the International Finance Corporation (IFC), which is a private finance arm of the World Bank Group (WBG), has developed corporate governance standards for developing countries. The IFC has developed a series of corporate governance tools to facilitate the introduction and application of good governance principles in various business entities, from listed companies to micro, small, and medium enterprises (MSMEs). In fact, the IFC (n.d.) offers its methodological tools for

- listed companies,
- family and founder-owned,
- financial institutions,
- state-owned enterprises (SOEs),
- funds, and
- small and medium enterprises (SMEs).

The IFC is engaged in supporting the development of the private sector in developing countries (low- and medium-income countries). The development of stock markets in developing countries has required the introduction of good governance principles and practices, and the IFC has filled in the gaps by providing technical assistance and advising on early developments of financial markets (IFC, 2020). Good governance in turn improves internal resilience and reduces the probability of financial fraud and other fraudulent behavior. In fact, good corporate governance strengthens internal control mechanisms that address fraud prevention and (early) detection.

The IFC's work has been based on the framework by the Organisation for Economic Co-operation and Development (OECD), which developed a framework for corporate governance for G20/OECD countries, entitled *G20/OECD Principles of Corporate Governance* (OECD, 2015a). The principles that the OECD has put forward are the following (OECD, 2015a):

- the rights and equitable treatment of shareholders and key ownership functions
- institutional investors, stock markets, and other intermediaries
- the role of stakeholders, disclosure, and transparency
- the responsibilities of the board

The OECD has also developed a framework for state-owned enterprises (SOEs), which was supposed to improve the framework for corporate governance in state-owned, public enterprises, which are often under very strong political influence. The specialist guidelines were published as: *OECD Guidelines on Corporate Governance of State-Owned Enterprises* in 2015 (OECD, 2015b). The guidelines call for the professionalization of management in state-owned entities and is largely derived from the G20/OECD Principles (OECD, 2015a).

Due to political influence and links, SOEs are more likely to be misused for political purposes and may be more exposed to fraud and fraudulent behavior. In a number of political systems, especially in the developing countries (with a high corruption index), SOEs are seen as a reward for winning elections (a specific kind of bounty), which in itself increases the risk of misuse and malpractice. Hence, strengthening the corporate governance system and both internal and external control in SOEs is an undeniable priority.

The OECD guidelines (OECD, 2015b) are drafted to address SOE ownership, providing recommendation to policy makers and public officials who are responsible for exercising ownership of state-/publicly owned companies. They are not fully legally binding, so in other words, no government is legally expected to enforce them. However, their "moral suasion" power or prestige is very high, and governments across the world endorse them and comply with them, although to varying extent. The OECD guidelines are not only prepared for OECD members but may be endorsed by any other country, following the initial corporate governance framework assessment (OECD, 2015b). Also, the OECD itself encourages governments of nonmember countries that endorse the guidelines to participate fully in the OECD work on the SOEs sector.

The OECD guidelines have been built on a few priorities (OECD, 2015b). SOEs have to be subjected to the same regulations and rules as other enterprises. They are to compete on the same level playing field as other economic agents and should not distort competition. The government should exercise the SOEs ownership on a "whole-of-government" basis. The state ownership function should be separate from the regulatory function to avoid any potential conflict of interest. All shareholders must be treated equally, whereas the state should not have any undue advantages over other investors in SOEs. Objectives and performance of SOEs have to be disclosed and reviewed. A state-owned enterprise and its shareholders should treat employees, creditors, and affected communities fairly and equitably. The board of directors of SOEs must exercise their powers free of political interference.

The OECD model, stipulated in the OECD guidelines (OECD, 2015b), implies that a government should treat ownership of SOEs differently and separately from regulation, and each ownership decision has to be taken at an appropriate level. Ideally, a government should set the ownership policy and coordinate it at the cabinet level. It should also define the objectives for individual SOEs and regularly monitor their performance. These additional safeguards should reduce the probability of fraud in public economic entities as well as facilitate early detection of fraud.

Besides strengthening corporate governance, the international cooperation on preventing money laundering and the financing of terrorism is also important. Financial institutions have been tasked to know their clients well and ensure that the transactions meet certain

requirements. However, from time to time, even reputable financial institutions somehow fail to spot irregular activities and prevent payments to be made. Banks are required to develop anti-**money laundering** (AML) policies and enforce them. AML legislation and regulation must be observed through good compliance and the development of a system where banks will know their clients well (i.e., optimize the Know-Your-Customer [KYC] process) and update information on them regularly. This should be part of the general customers' due diligence process, and also training staff, investing additional resources in technology, and regularly reviewing and updating security within the institution (Grigaitė et al., 2021).

Money laundering
This is any activity undertaken to make proceeds of crime or illegal activities that appear legal.

In the context of the European Union (EU), banks have to observe the Sixth Directive on Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT), often referred to as AMLD 6. The EU has been very active in updating and developing new AML regulations and has also been observing current best practices (European Commission [EC], 2021). Money laundering goes, more or less, hand in hand with financial fraud, as legalizing otherwise illegal financial transactions requires efforts that would be classified as financial fraud and crime. For instance, money laundering may happen through the issuance of fictitious invoices, money transfers that do not have a legal cover, or through false insurance claims that are paid. Sometimes, linked fictitious transactions between the linked legal persons can serve money laundering purposes as well.

Further international work harmonizing AML/CFT rules is expected in the future, as the countries that do not comply with the standards may be excluded from international payments or be subjected to other sanctions. This should also affect their inclusion in international economic and financial flows. Countries that have been ostracized internationally almost do not have any country rating and may be excluded from international financial markets and have their borrowing literally stopped.

SUMMARY

Financial fraud and related irregularities/crimes may have long-term adverse impacts on the economy, both nationally and globally. The failure of Enron, although primarily a US national issue, has had a spillover effect on several countries, as the company operated internationally. Financial fraud and financial statement manipulation (even if not technically illegal) does lead to the loss of investors' confidence, which affects financial markets and economies. Strengthening the enforcement of rules and regulations, better legislation, and the development of a stronger risk management culture are just some of the steps that may be taken to prevent fraud, or, if fraud is perpetrated, to detect them before it leads to detrimental consequences. Strengthening accounting standards (both international and national) as well as corporate legislation which relates to accounting are also activities that countries and international standard setters (such as the IASB) undertake. The issues that have been faced prior to and during crises influence the way legislators and standard setters conduct their business. Enron triggered an interna-

tional wave of legislative efforts to ensure better corporate governance, more responsible corporation, and more effective external audits. The convergence of standards is also important because it allows better transparency and comparability, so any irregularities may be easier to spot and ultimately addressed. Regulatory and supervisory changes are ongoing, as both individual economic agents and regulators are developing themselves as learning organizations, ensuring that they do not repeat the same mistake twice. However, unfortunately, errors often need to appear before one may learn and react. Predicting the challenges and addressing them before they ever appear is still not standard practice. However, over time and through better research and regulatory collaboration, this may become a new normal.