THE CONSEQUENCES OF FRAUDULENT FINANCIAL REPORTING

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Abstract:
Financial reporting frauds are a serious threat for the investor's confidence in the financial information. The side effects of the financial frauds are affecting the integrity, quality and confidence in published financial reporting. Criminals who carry out such fraud, from management to employees, must understand that the interference of records is a crime that will be judged. Qualitative financial reporting, including reliable financial statements without mistakes, can be made when there is well planned corporate governance. Although participants in corporate governance responsibilities vary depending on their level of preparation and on the presentation form of financial reporting, a well-defined working relationship among these participants should reduce the probability of financial fraud.

Keywords: financial reporting frauds, frauds, financial reporting

JEL Classification: M10, G21, G24, G32

1. FRAUD AND FRAUDULENT FINANCIAL STATEMENTS

Broadly speaking, fraud may be defined as an intentional act to gain an advantage by an unfair or unlawful gain. It may include: (Rubin G. A., 2007) fraudulent financial reporting; misappropriation of assets (inside or outside the system, such as: embezzlement, payroll fraud and theft); revenue or assets acquired from illegal or unethical activities (excessive customer billing or fraudulent sales practices); costs for illicit purposes (commercial and public bribery as well as other improper payment systems); income received fraudulently or intentionally avoided costs (systems in which an entity commits fraud against its employees or to third parties, or when an entity intentionally avoided costs such as income taxes and sales taxes); fraud against the company (e.g. counterfeit producers knowingly violates intellectual property rights). The Department for Institutional Integrity, which investigates allegations of fraud and corruption within the World Bank Group and the Bank's financed projects, specifies the actions that might be considered fraud or corruption in the banking system: (Banca Mondială, 2009) auction fraud, understandings among participants in the auction, fraud during the execution of the contract, audit avoidance, setting inappropriate prices and partnerships, miscalculation of costs and work, acceptance of gifts or bribes, soliciting or receiving bribes, incorrectly using the World Bank funds or its positions, fraud in the case of movements, theft and deception. Although all categories of fraud are major and worthy to be debated, only fraudulent financial reporting is handled in the following sections. (Rubin G. A., 2007)

Fraud in financial reporting is based on conscious intent of the perpetrator (directors, auditors, employees, etc.) to wrongfully present the reality. But the intended act to wrongfully presenting the reality may be the cause of either fraudulent financial reporting either of undue assets reclaims. Therefore, "fraudulent reporting only refers to intentional misrepresentation, including omissions of amounts designed to mislead the users of the financial statements" can be translated as (Popa I., Man Al. Rus A., 2009): manipulation, forgery, counterfeit or alteration of records or supporting documentation, misstatements/omissions regarding events/transactions/information, intentional misapplication of accounting principles related to values/classification/manner of presentation/delivery of information, fictitious entries records (towards the end of the year) to manipulate operating results or achieve other objectives, improper adjustments of the assumptions and changing in judgments used to estimate account balances, omissions/advances/delays in recognition of events/transactions that occurred during the reporting period, concealment or non-disclosure of facts that could affect the amounts recorded in the financial statements, engaging in complex transactions designed to distort the entity's financial position or performance; changing the records or conditions of significant transactions. Opposed to fraudulent financial reporting, an undue asset reclaims concern (Popa I., Man Al. Rus A., 2009): revenue dilapidation (revenue coming from unwarranted claims / diverting income), theft of physical assets or intellectual property, payments to fictitious suppliers, without the entry of goods / services, use of assets in personal interest (including also personal loan guarantees), false records to cover the deficit. These abuses are often minor and are usually committed by employees, although sometimes, the managers themselves are involved in such activities. Misappropriation of assets may also include expenses incurred for illicit purposes, in the form of bribery, whether for commercial or official purposes. Although improperly acquiring assets often is not significant for financial statements, „it may continue to result in substantial losses for the organization. (Soltani B., 2008)

2. FACTORS THAT ENHANCED FRAUDULENT FINANCIAL REPORTING

According to studies conducted by the National Commission on Reporting Financial Fraudster in America (or Treadway Commission) fraudulent financial reporting usually occurs as a result of certain environmental forces and opportunities, institutional or individual. These forces and opportunities add pressures and incentives that encourage individuals and companies to engage in fraudulent financial reporting. When the right mix of forces and opportunities is reached, it can produce fraudulent financial reporting (*Report of the National Commission on Fraudulent Financial Reporting*, 1987). Ever since 1950, Professor Donald R. Cressey, has studied the factors that lead to committing fraudulent acts. According to his studies, he concluded that when fraud does occur, there are three factors that act together: intent (premeditation), opportunity and pressure, known as the „fraud triangle" (see Figure 1).

Although the factors above are forming the "fraud triangle", it's sufficient that one to take place at a time, for fraud to occur. The sequence steps in order to exercise the act of fraud are recounted below (Soltani B., 2008)

Incentives or pressures are the first factors that influence individuals to commit fraud and it refers to excessive pressure to achieve financial targets, to induce optimistic and unrealistic messages in annual reports. In addition, a firm may be threatened and pressured also by intense competition, by market saturation or sudden changes, acquisitions (mergers), the financing need or cash flow problems. Even otherwise honest individuals can commit fraud in an environment that imposes such threats.

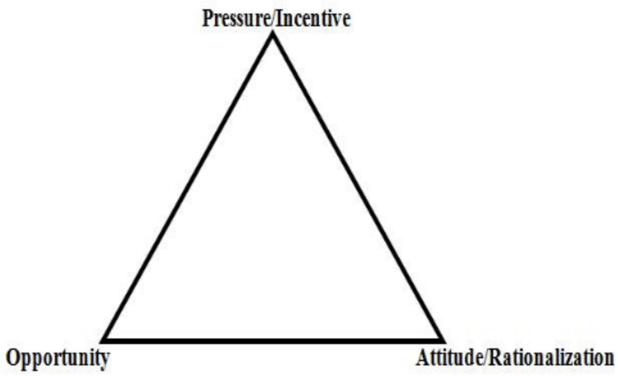

Figure 1. Fraud risk

Source: Dent P., *Beware of fraudulent financial reporting*, 2009, available http://www.deloitte.com/view/en

Opportunity refers to those factors that enable "fraud to be more easily committed and detection less probable (Hooper J. M., Forneli C. M, 2010).Therefore, ineffective controls or absence of control favors fraud intentions. These factors can be related directly to inadequate monitoring by management or the ineffectiveness of the board of directors or of the audit committee to oversee the reporting and the internal control.

Attitude or premeditation is the trigger factor of the fraud act and refers to the fact that the perpetrator must have a mindset that would justify or premeditate the act of fraud. Detection of risk factors that determine board members, management, employees to be predisposed to such intent may be quite difficult. So when a company monitors people and processes to discourage and detect fraud, it must follow the three aspects, because fraud involves incentives or pressure to commit a fraudulent act, a perceived opportunity to do so, and some reasoning.(Soltani B., 2008)

3. WHO AND HOW COMMITS FRAUDULENT FINANCIAL STATEMENTS

According to the Report of the USA National Commission on Fraudster Financial Reporting in the majority of the studied cases, the company's management, such as chief executive, president and chief financial officer, were the fraudulent perpetrators. In some cases, it was found that there were made intentional false disclosures from the accountant throughout falsified documents and records Furthermore, the committee studies have shown that while the authors of fraudulent financial reporting have used different means, the effect of their actions is almost always consist of overestimating or smoothing earnings in order to exaggerate the company or its assets. In addition, fraudulent financial reporting does not always begin with an openly recognizable act of distortion of the financial statements. In many cases, fraudulent financial reporting is the peak point of a number of acts intended to address operational difficulties. Initially, the activities may not be fraudulent, but in time they may become probable, especially when the tone set by management permits or encourages such activities in order to have fraudulent financial reporting. Thus, we can say that potential criminals involved in fraudulent financial reporting can be both in senior management and among mid-level employees, but we can think also on organized criminal organizations for this purpose. To describe ways in which fraud is committed on the financial statements, the literature (Zabihollah R., 2005) uses the term „fraudulent financial reporting schemes" or „earnings management" (Nguyen K., 2008). However the term "earnings management" does not always refer to an illegitimate action. The accounting policies (U.S. GAAP) or other accounting standards (IFRS) make the difference between legitimate and illegitimate gains. When companies engage in legitimate administration of earnings management within their financial statements, they are submitted as true and are treated in accordance with applicable accounting standards. We can say that earnings management is a fraud when it "involves gains arising from improper revenue recognition, overstating of assets or undervaluation of liabilities" (Zabihollah R., 2005). In order to manipulate the earnings, managers use different aggressive accounting techniques, which have as effect the artificially increase or decrease in revenues, profits, or earnings per share. They use these tactics, hoping to cope with the pressures that are on the market. In general, companies that are traded most often feel the pressure, either from securities analysts who expect them to disclose as much information as possible, either from shareholders who expect, based on their investments, for companies to obtain bigger profits in a short period of time. Failure to obtain expected dividends by investors and hence earnings per share can cause a significant decline in the capitalization of a company. Therefore „earnings management" may be motivated by the pressure or the desire to maximize performance based payments. However, managers do not always aim for the purpose of overestimating management earnings. They are also interested in the opposite situation, to reduce these gains, especially when the intention is that of evading the payment of fees.

A practical case of committing fraud in financial statements is „time uniformization of revenue"(Alexander D., 2007). This technique is used by managers to hide some bad periods and involve a manipulation of earnings to show that there was a steady increase over time, although not stated by facts. Given the fact that investors react negatively to the earnings of companies which they perceive as unsafe and risky, standardization of revenue finally meets the satisfaction of investors and maintains a high price of the shares.

Another form of fraud known as „big bath behavior" (Hooper J. M., Forneli C. M, 2010), occurs when companies manipulate the profit and loss account, to make the years in which the situation has been very good to seem worse than it really is. Therefore, taking into account the significant losses, they hope to consolidate and to wipe them all at once. As a result of this action, future costs are reduced and natural profits implicitly increased. In other words, the company takes a „big bath" in one year so it can show that the profit will be increasing in the future. Handling can cause either an increase in the prices of stocks or an increase in performance bonuses for management.

Zabihollah Rezaee studied in 2005 which are the most common methods of fraudulent financial statements and found that "the majority of fraudulent financial statements are caused by overstated revenues and assets while 20% were due to underestimation of liabilities and expenses.

4. VICTIMS OF FRAUDULENT REPORTING

Financial statements are prepared and presented at least once a year and aim to meet the information needs common to a number of potential users. Many visitors take the financial statements presented as the main source of financial information and therefore a misrepresentation may affect decisions. (See figure 2)

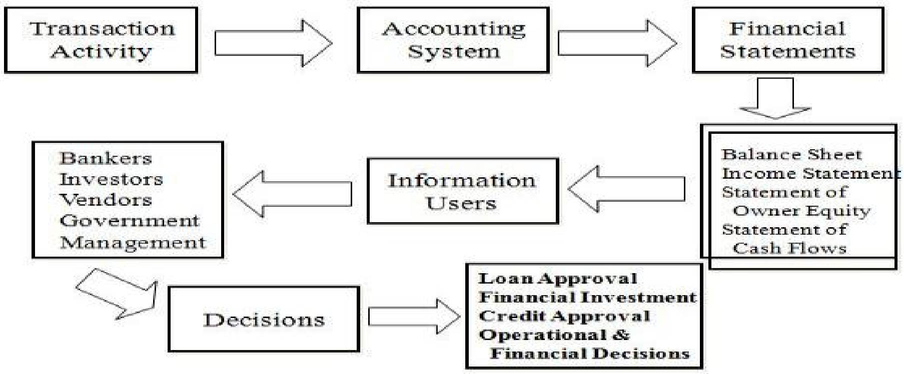

Figure 2. Users of Financial Statements

Source: Hanna C Quffa , *Financial Statement Fraud*

Investors are of course the first victims of fraudulent financial reporting. If company earnings are overstated, investors who buy are deceived and if earnings are understated, the buyers are those who will lose. However they are not the only ones that bear the immediate and harmful effects. The victim list includes others who rely on information from the company's financial reports: banks and other financial institutions lend funds to the company, suppliers, customers seeking to make performance on the company's contracts, partners, financial analysts providing investment advice about the issuer and its securities, lawyers for the issuer and probably for the issued insurance companies issuing insurance for directors and officers trust and then large claims. To avoid the victim position of fraudulent financial reporting, any user, whether a financier, a borrower, an insurer, investor or shareholder, can make a fraudulent statement when one asks himself around the possibility of achieving or identification of one of the following situations (Weir J.,2009): company reported profit but is not very good on cash flows; gross profit levels remain high, even if the company faces pressure from the market to stabilize prices; receivable accounts, debt and inventory accounts levels are rising, while sales are steady or declining; the company is close to breaching banking pacts; there is a significant year-end adjustments; there is substantial bonuses for top executives.

CONCLUSIONS

Although the achievement of financial reporting by so-called "fraudulent scheme" refers to short-term achievement of "management earnings ", they may draw the following consequences in time: undermines the credibility, quality, transparency and integrity of financial reporting process; endangers the integrity and objectivity of the auditing profession, especially auditors and audit firms; diminishes the confidence in the capital markets, as well as in market participants and in the reliability of financial information; makes capital markets less efficient; adversely affects economic growth; huge lawsuit costs; destroys the careers of people involved in fraudulent financial statements; they cause bankruptcy or substantial economic losses for companies involved in financial statement fraud; encourages regulatory intervention; erodes public confidence and trust in accounting and auditing profession.

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