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An Impact of Fraudulent Reporting on Financial Statement - A Conceptual Approach

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Abstract

In this an article author wishes to focus and expose the misstatement and misappropriation of financial statement. Financial statement fraud is deliberate misrepresentation, misstatement or omission of financial statement data for the purpose of misleading the reader and creating a false impression of an organization's financial strength. Public and private businesses commit financial statement fraud to secure investor interest or obtain bank approvals for financing, as justification for bonuses or increased salaries or to meet expectations of shareholders. Upper management is usually at the center of financial statement fraud because financial statements are created at the management level. Fraudulent financial reporting is a deliberate misstatement or omission of financial accounting information intended to deceive the investors. The reasons for fraudulent financial reporting includes (a) pressures from owners, creditors and the markets in general; (b) opportunities for fraud (due to lack of emphasis on business ethics), etc. and (c) incentives and personal conflicts of interests. Controls designed to prevent fraudulent financial reporting include external auditing, independent board of directors, active regulators, vigilant capital markets and overall ethical corporate culture.

Key Words: *fraud- misrepresentation-omission-financial-shareholders-pressures-opportunities-incentives*

Introduction

In the present age of scams (cheat), financial statement fraud represents enormous cost to the economy globally. Collapses of high profile companies have left a dirty smear on the effectiveness of corporate governance, quality of financial reports, and credibility of audit functions. An exponential increase in the use of technology has further aggravated the problem in 21st century and provides opportunities for crimes to be committed across borders. It has become a critical issue in the businesses around the world, which has significantly; dampen the confidence of the investors. The deliberate misstatement of numbers in the accounting books with the help of well - planned scheme by an intelligent squad of knowledgeable perpetrators in order to deceive the capital market participants is termed as financial statement fraud. This paper has two sections. Section one explains the Causes, methods and consequences of financial statement and fraud. In order to understand the concept more it defines fraud. It also explains different classification of fraud introduces the concept of financial statement of fraud. Farther elaborates the causes of financial statement fraud by explaining fraud triangle the reasons behind financial statement of fraud, followed by the tricks used by the management for achieving their aim of fraudulent financial reporting. Hence explores the consequences of fraudulent financial reporting. Section two focused on examples and measurements taken to overcome the problem. The paper finally shows conclusion on fraudulent financial statement.

Definition of Fraud

1. Webster‘s New World Dictionary defined fraud as ―The intentional deception to cause a person to give up property or some lawful right.
2. Fraud encompasses an array of irregularities and illegal acts characterized by intentional deception.
3. The legal definition of fraud states as-A generic term, embracing all multifarious

means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions by suppression of truth and includes all surprise, trick, cunning, dissembling and any unfair way by which another is cheated.

4. Fraud is defined in many scholars and dictionaries define fraud as- intentional deception, lying, and cheating are the opposites of truth, fairness, and equity.
5. Fraud consists of coercing people to act against their own best interests.
6. Fraud (false pretence) involves intentional and material misrepresentation of one or more material facts with the intent of taking of property from a victim.
7. American heritage dictionary (second college edition) defined fraud as a deception deliberately practiced in order to secure unfair or unlawful gain.
8. Black‘s law dictionary describes fraud as ―the intentional use of deceit, a trick or some dishonest means to deprive another of his/her/its money, property or a legal right.
9. Financial reporting fraud—defined for this report as “a material misrepresentation resulting from an intentional failure to report financial information in accordance with generally accepted accounting principles. (Center for Audit Quality, October 2010)

Therefore, Fraud may be defined as an intentional act meant to induce another person to part with something of value, or to surrender a legal right. It is a deliberate misrepresentation or concealment of information in order to deceive or mislead.

A number of items that must be identified, when articulating a case of fraud:

1. a victim
2. details of the deceptive act thought to be fraudulent
3. the victim's loss
4. a perpetrator (i.e., a suspect)
5. evidence that the perpetrator acted with intent
6. evidence that the perpetrator profited by the act(s)

Fraud always involves one or more persons, out of which one for his own enrichment act secretly to deprive another of something of value.

The symptoms of fraud can be differentiated from errors or mistakes with the help of fraud indicators. Fraud indicators are clues that may warrant further review of a specific area or activity. Fraud indicators can be broadly classified into three categories mentioned below:

a) Personal Shortcomings:

1. Person living beyond their means
2. High turnover of personnel
3. Uncharacteristic behavior by employees or co-workers.

b) Financial Shortcomings:

1. Unexplained entries in records
2. Unusually large amount or numbers of cash transactions
3. Altered inadequate or missing records or documents
4. Non serial number transactions

c) Operational Shortcomings:

1. Lack of internal controls
2. One person in control with no separation of duties
3. Inventories and financial records not reconciled
4. Unauthorized transactions

Classification of Fraud

The word fraud is a generic term used to describe any deliberate act to deceive or mislead another person, carry harm or injury. This intentional, wrongful act can be differentiated and defined in many ways, depending on classes of perpetrators. For example, frauds committed by individuals such as embezzlement (misuse) or theft, are distinguished from frauds perpetrated by corporations or top level management such as financial statement fraud. The former is known as employee fraud and later as management fraud. Fraud classifies on the basis of relationship of the perpetrator (performer) to the company as internal versus external fraud. There are several types of corporate fraud. The most prominent distinction one can make in fraud classification is internal versus external fraud. Fraud is external if victim is external to the organization, internal otherwise. For example, fraud committed by employees, internal auditors, executives, the board of directors, and

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managers, who may suffer a financial loss and or reputation loss, is termed as internal fraud. Fraud in which external such as investors, creditors, suppliers, customers, and external auditors are involved is known as external fraud.

Management

1. Financial Statement Fraud
2. Misrepresentation of material assets
3. Misrepresentation of assets
4. Concealment of Material Facts
5. Illegal Acts
6. Bribery
7. Conflict of Interest

Employee Fraud

1. Embezzlement of money of property
2. Breach of fiduciary duty
3. Theft of trade secrets of intellectual property
4. Illegal Acts

In addition to other classifications, another way of classifying fraud is: transaction versus statement fraud. Statement fraud may be defined as the intentional misstatement of certain financial values to enhance the appearance of profitability and deceive shareholders or creditors whereas transaction fraud is intended to embezzle or steal organizational assets. Distinguish two related types of fraud: financial statement balance fraud and asset-theft fraud. The authors state that the main difference between the former and the latter is that there is no theft of assets involved in financial statement balance fraud. Well known examples of this type of fraud are Enron and WorldCom. Give two more classifications of fraud - all classifying corporate fraud. A first classification is fraud for versus against the company. The former contains frauds intended to benefit the organizational entity, while the latter encompasses frauds that intend to harm the entity. Examples of fraud for the company are price fixing, corporate tax evasion and violations of environmental laws. While these frauds are in the benefit of the company at first, in the end the personal enrichment stemming from these frauds are the real incentives. Frauds against the company are only intended to benefit the perpetrator, like embezzlement or theft of corporate assets. The authors draw attention to the fact that not all frauds fit conveniently into this schema, for example arson for profit, planned bankruptcy and fraudulent insurance claims. A last distinction refers to is management versus non – management fraud, also a classification based on the perpetrator‘s characteristics. These different classifications all present another dimension and can display some overlap.

Table: 1

Different Types of Frauds Along With Different Perpetrators and Victims Have Been Given Below

Type of Fraud	Perpetrator	Victim	Explanation
Employee Embezzlement or Occupational Fraud	Employee	Employers	Employees directly or indirectly steels from Employers
Management Fraud	Top Management	Stockholders, lenders and other who rely on financial statements	Top management provides misrepresentation, usually in financial information
Investment Scams/cheat	Individuals	Investors	Individuals tricks investors into putting money into fraudulent investments

Vendor Fraud	Organizations or individuals that sells goods or services	Organizations that buy goods or services	Organizations overcharge for goods or services or no shipment of goods, even though payment is made
Customer Fraud	Customers	Organizations that sells goods or services	Customers deceive sellers into giving customers something they should not having or charging them less than they should

Financial Statement Fraud

Definition

Financial statement of fraud- ACFE (Association of Certified Fraud Examiners) defines financial statement fraud as ―The intentional, deliberate, misstatement or omission of material facts, or accounting data which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision.

A complete understanding of the nature, significance, and consequences of fraudulent financial reporting activities requires a proper definition of financial statement fraud. ACFE (Association of Certified Fraud Examiners) defines financial statement fraud as ―The intentional, deliberate, misstatement or omission of material facts, or accounting data which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision. When the managers of a company provide false financial information, it's called financial statement fraud. Financial statement fraud is usually committed with the aim that a financial statement audit ensures that a company's financial reports are free from material misstatement and fraud. In today's challenging economy, organizations need to be prepared to fight fraudulent activities. Business professionals may prefer to believe that fraud will never occur. Financial reporting fraud involves the alteration of financial statement data, usually by a firm‘s management, to achieve a fraudulent result. Financial statement fraud may be defined as a deliberate, wrongful act committed by publicly traded companies, through the use of materially misleading financial statement, that causes harm and injury to the investors and creditors. Falsifying financial statement is usually committed by top level management and thus also known as management fraud with the goal to artificially improve the financial performance and results of the company. Financial statement fraud may further be defined as a deliberate attempt by corporations to deceive or mislead users of published financial statements, especially investors and creditors, by preparing and disseminating materially misstated financial statements. Financial statement fraud involves intent and deception by a clever team of knowledgeable perpetrators (e.g., top executives, auditors) with a set of well-planned schemes and a considerable gamesmanship.

Financial statement fraud may involve the following schemes.

1. Falsification, alteration, or manipulation of material financial records, supporting documents, or business transactions
2. Material intentional misstatements, omissions, or misrepresentations of events, transactions, accounts or other significant information from which financial statements are prepared

3. Deliberate misapplication, intentional misinterpretation, and wrongful execution of accounting standards, principles, policies and methods used to measure, recognize, and report economic events and business transactions
4. Intentional omissions and disclosures or presentation of inadequate disclosures regarding accounting standards, principles, practices, and related financial information
5. The use of aggressive accounting techniques through illegitimate earnings management
6. Manipulation of accounting practices under the existing rules-based accounting standards which have become too detailed and too easy to circumvent and contain loopholes that allow companies to hide the economic substance of their performance.

Why Commit Fraud — the Seductive (attractive) Triangle

Three conditions typically are present when individuals commit fraud: pressure or an incentive to engage in fraud, a perceived opportunity, and the ability to rationalize fraudulent behavior. This "fraud triangle" was first developed by noted twentieth century criminologist Donald Cressey. These three conditions may exist whether the economy is strong or weak, and, accordingly, fraud can be committed in both good times and bad. How then do these factors motivate fraud?

1. **Pressure to commit fraud**. Pressure can be either a positive or a negative force. When goals are achievable, pressure contributes to creativity, efficiency, and competitiveness. However, temptations for misconduct arise when goals do not appear to be attainable by normal means, yet pressure continues unabated, with career advancement, compensation, and even continued employment at risk. When pressure is transformed into an obsessive determination to achieve goals no matter what the cost, it becomes unbalanced and potentially destructive.

That is when individuals are most likely to resort to questionable activities that may lead to fraud. Participants in the Center for Audit Quality **(CAQ)** roundtable discussions and interviews identified the top three motivators for fraud as personal gain (including maximizing performance bonuses and the value of stock-based compensation); achieving short-term financial goals (either internal targets or external analyst expectations); and hiding bad news from investors and the capital markets. Similarly, the 2010 COSO Fraud Report found that the most commonly cited motivations for financial statement fraud were "the need to meet internal or external earnings expectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results." Interestingly, academic research indicates that the desire to recoup or avoid losses is much more likely to motivate an individual to engage in activities that could lead to fraud than the desire for personal gain. Other research has found that executives and mid-level managers feel that they face continual pressure to meet business objectives as well as the short-term financial goals of analysts and investors. In the KPMG 2008–2009 Integrity Survey, 59 percent of managers and employees acknowledged feeling pressure to do whatever it takes to meet business targets; 52 percent believed that they would be rewarded based on results rather than the means used to achieve them; and 49 percent feared losing their jobs if they missed their targets. Consistent with comments from multiple CAQ discussion participants, several recent academic studies have found that executives at companies accused of financial reporting fraud face greater financial incentives to increase stock price, in the form of stock or option holdings, than executives at companies where fraud was not found.

Perceived Root Causes of Misconduct (a survey of 5,065 working adults)

1. Pressure to do "whatever it takes" to meet business targets 59%
2. Believe will be rewarded for results, not means 52%
3. Believe code of conduct not taken seriously 51%
4. Lack familiarity with standards for their jobs 51%
5. Lack resources to get job done without cutting corners 50%
6. Fear losing job if miss targets 49%
7. Believe policies easy to bypass or override 47%
8. Seek to bend rules for personal gain 34%

KPMG LLP (U.S.) Integrity Survey 2008–2009

The studies indicate that the motivation for fraud is often to increase or prevent a decrease in stock price.

Financial misstatement or manipulation often starts small, intended as "just a little adjustment" to meet earnings targets or give the company time to improve results. Initially, the individual involved may not even consider what is done to be unacceptable or fraudulent. But as the need to maintain the deception continues, one adjustment leads to another and the scope of the fraud expands until the perpetrator is locked in and headed down the "slippery slope" to major fraud.

2. **Opportunity for fraud** -Even when pressure is extreme, financial reporting fraud cannot occur unless an opportunity is present. Opportunity has two aspects: the inherent susceptibility of the company's accounting to manipulation, and the conditions within the company that may allow a fraud to occur. The nature of the company's business and accounting can provide sources of opportunity for fraud in the form of significant related- party transactions outside the ordinary course of business; a large volume of estimates of assets, liabilities, revenues, or expenses that are subjective or difficult to corroborate; and isolated, large transactions. Some large transactions, especially those close to period-end, can pose complex "substance over form" questions that provide opportunities for management to engage in fraudulent reporting.

The opportunity for fraud is also affected by a company's internal environment, which is largely influenced by the entity's culture and the effectiveness of its internal controls. Strong controls can significantly limit possibilities for the manipulation of results or for fraudulent transactions. It is important to maintain a sharp focus on controls in both good and bad economic times. When results are strong and markets are up, there can be a tendency toward complacency, with diminished focus on internal controls and reduced scrutiny of results. In tough economic times, companies trying to do more with less may cut budgets in areas that compromise the effectiveness of internal controls. Both the PricewaterhouseCoopers 2009 Global Economic Crime Study and the Ernst & Young 2009 European Fraud Survey indicated that staff reductions were likely to lead to inattention to normal financial control procedures and thus result in a greater risk of fraud.

3. **Rationalization of fraud** -Individuals who commit financial reporting fraud possess a particular mindset that allows them to justify or excuse their fraudulent actions. CAQ discussion participants emphasized that personal integrity is critical in determining whether an individual will be prone to rationalize fraud. However, as the pressure or incentive increases, individuals may be more likely to construct some rationalization for fraudulent actions. For instance, in an environment of extreme pressure to meet corporate financial goals, members of management or other employees may conclude that they have no choice but to resort to fraud to save their own jobs or the jobs of others, or simply to keep the company alive "until the turnaround comes." Where the motivation for fraud is more altruistic than personal—to save jobs or keep the company afloat—the pressure to commit fraud also can become the rationalization for it. The process of

rationalization, like the slippery slope to fraud, often starts with justifying a small nudge to the boundaries of acceptable behavior but then deteriorates into a wholesale loss of objectivity. However, discussion participants noted that if employees understand that violations of the company's ethical standards will not be tolerated and if they see senior management living by strict ethical standards and consistently demonstrating high integrity, fraudulent behavior becomes difficult to rationalize.

Different Comments Regarding Fraudulent Financial Statement

There is a pressure at an individual level which I think is significantly associated with compensation arrangements in the organization. There is also pressure at a corporate level, when there is a negative economic environment that makes targets much harder to achieve. Both can create powerful incentives for financial statement fraud.
Ian Ball, Chief Executive Officer, International Federation of Accountants
I think most people who come unstuck in this context of accounting misstatement are basically honest people who get caught up and then they get desperate.
Jonathan Fisher QC, Barrister,
23 Essex Street Chambers; Trustee,

Fraud Advisory Panel

When we are talking about material financial statement fraud, it is likely that senior management either knows about it or has caused it by putting so much pressure on employees.
Scott Taub, Managing Director,
Financial Reporting Advisors

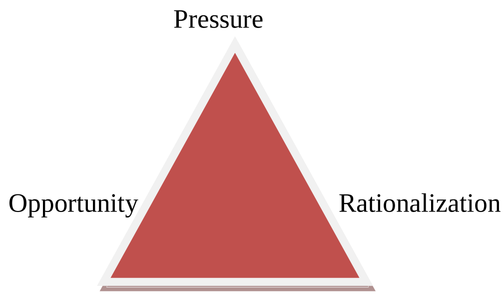
The greatest risk of manipulation of financials is when management creates an impression that [the manipulation] is needed or expected . . . Most of the people committing fraud are not doing it for personal gain. They are doing it because they feel it is necessary and appropriate.
Norman Marks, Vice President, Governance, Risk and Compliance,
SAP Business Objects

The presence of a process to deter fraud doesn't eliminate the threat of people acting fraudulently.
Charles M. Elson, JD,
Edgar S. Woolard, Jr. Chair,
Professor of Law and Director of the John L. Weinberg Center for Corporate
Governance, University of Delaware

Most financial statement fraud involves senior management of the company—either directly, because they are the perpetrators, or, indirectly, because they have imposed difficult-to-reach performance goals. Michael Oxley, Former Member of Congress; currently Of Counsel, Baker & Hostetler LLP. It's quite plausible for senior management to rationalize fraudulent behavior: "We are not hurting anybody, we are not spending any money, we are protecting jobs, and we think the business is going to turn around next year. We are just making sure that we are still here next year when the turnaround comes."David Alexander, Director of Forensic Services, Smith and Williamson

The Fraud Triangle

Theoretically, anyone has the potential to engage in financial reporting fraud; indeed, some individuals who commit fraud had previous reputations for high integrity. Three factors, referred to as the "fraud triangle," often combine to lead individuals to commit fraud: pressure or an incentive to engage in fraud; a perceived opportunity; and the ability to rationalize fraudulent behavior. Participants in the CAQ discussions identified the top three pressures for fraud as personal gain (including maximizing performance bonuses and stock-based compensation); the need to meet short-term financial expectations; and a desire to hide bad news. Opportunities for fraud usually are greatest when the tone at the top is lax or controls are ineffective, although even the best controls cannot completely eliminate the risk of fraud. Finally, individuals who commit financial reporting fraud must be able to justify or explain away their fraudulent action



Who Commits Fraud?

The three sides of the fraud triangle are interrelated. Pressure can cause someone to actively seek opportunity, and pressure and opportunity can encourage rationalization. At the same time, none of these factors, alone or together, necessarily cause an individual to engage in activities that could lead to fraud. Son what exactly is the profile of the person who commits fraud? Theoretically, anyone has the potential to engage in fraud, and in fact some individuals who commit fraud previously had reputations for high integrity and strong ethical values. When pressures make individuals desperate and opportunity is present, financial reporting fraud becomes a real possibility. As one of the CAQ discussion participants observed, most people who commit fraud do not start with a conscious desire to do so: "They end up there because the world they are operating in has led them to a challenge beyond their capabilities." Participants in the CAQ roundtable discussions also underscored that the greatest risk of financial reporting fraud relates to what has been called the "Achilles' heel" of fraud—the possibility of management override of controls. 7 Management is in a unique position to perpetrate fraud because it possesses the power to override controls, manipulate records, and facilitate collusion by applying pressure to employees and either enlisting or requiring their assistance. In some situations, senior leaders do not perpetrate a fraud directly, but instead are indirectly responsible because they put inordinate pressure on subordinates to achieve results that are impossible without "cooking the books." At lower levels in the organization, individuals may not initially realize that they are committing fraud, but instead see themselves as simply doing what is expected to "make their numbers" or responding to the request of a supervisor.

Participants in the Financial Reporting Supply Chain and Their Roles in Mitigating (Justifying) the Risk of Financial Reporting Fraud

Management, boards of directors, audit committees, internal auditors, and external auditors are all key players in the public company financial reporting process, or "supply chain,"8 with complementary and interconnected roles in delivering high-quality financial reporting, including the deterrence (prevention) and detection of fraud.

Management

Members of management have the foremost role in the financial, reporting process, with primary responsibility for the deterrence and detection of financial reporting fraud. They are responsible for the maintenance of accurate books and records and the design and implementation of an effective system of internal control over financial reporting. They are also responsible for evaluating and managing the company's business risks, including the risk of financial reporting fraud, and then implementing and monitoring compliance with appropriate internal controls to mitigate those risks to an acceptable level. In the case of financial reporting fraud, critical controls start with the ethical tone at the top of the organization and include a strong code of ethics, fraud awareness training, hotline reporting mechanisms, monitoring tools, and processes to investigate, evaluate, and, where necessary, punish wrongdoing. Senior management reports to the board of directors, with specific reporting to the audit committee on matters related to financial reporting and the risk of financial reporting fraud. While members of management have the foremost role in preventing and detecting fraud, they typically are involved when material financial reporting fraud does occur. According to CAQ discussion participants, in these situations, management is usually found ignoring the company's code of conduct and overriding internal controls. As a consequence, the roles of other parties in the financial reporting supply chain are critical in adequately addressing the risk of financial reporting fraud.

Boards of Directors and Audit Committees

As discussed in detail in several publications from the NACD, the board of directors and audit committee of a public company have ultimate responsibility for oversight of the business, including risk management and the financial reporting process. The report of the NACD Blue Ribbon Commission on Risk Governance, like the Internal Control Framework developed by COSO, recognizes that the foundation for effective governance is board members who are objective, capable, and inquisitive, with a solid knowledge of the company's industry, business, and control environment. CAQ discussion participants stressed that audit committee members should have industry and entity knowledge, including a strong understanding of the economics of the business, in order to identify and understand business and financial risks that may increase the likelihood of fraud. The audit committee is responsible for overseeing the financial reporting process and controls, the internal audit function, and the external auditors, including the appointment of the company's external auditor. It oversees management's implementation of policies that are intended to foster an ethical environment and mitigate financial reporting risks. In this process, the audit committee has the responsibility to see that management designs, documents, and operates effective controls to reduce the risk of financial reporting fraud to an acceptable level. The Sarbanes-Oxley Act also makes the audit committee responsible for establishing mechanisms for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or audit matters, and confidential, anonymous submissions by employees of concerns regarding questionable accounting and auditing matters (generally referred to as the ethics or whistleblower program). In addition, it is increasingly common for the audit committee to have a link with the compensation committee through overlapping members, joint meetings, or attendance of the audit committee chair at certain compensation committee meetings. The objective of this process is to satisfy both committees that the executive compensation structure provides sound incentives for achieving corporate strategies without unintentionally providing motivations for fraud or other unethical behavior. The focuses on compensation structures will likely increase as a result of legislation and regulatory rules; regarding corporate compensation policies and practices.

Internal Audit

Not all public companies have an internal audit function. However, where companies have an internal audit department, that group is described by The IIA as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations."10 According to IIA standards, internal auditors should be independent of the activities they audit and free from interference in the conduct of their activities, and should exercise due professional care. Functionally, the chief audit executive commonly reports to the audit committee, with administrative reporting most often to the chief executive officer, general counsel, or chief financial officer. Under IIA standards, internal audit is responsible, among other things, for evaluating the effectiveness of the company's risk management, control, and governance processes. CAQ discussion participants noted that internal auditors with such responsibilities should have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization. Internal auditors also are responsible for evaluating risk exposures related to the reliability and integrity of financial information, and specifically "the potential for the occurrence of fraud and how the organization manages fraud risk." In this process, internal audit's role typically includes communicating to the board, audit committee, and management that internal controls, including controls to deter and detect fraud, are sufficient for the identified risks, and verifying that the controls are functioning effectively.11 Internal audit also may assist management in identifying and assessing risks and the control environment. In addition to these duties, internal audit may be involved in monitoring the whistleblower program, assessing compliance with the entity's code of ethics, and other activities in support of the organization's ethical culture.

External Audit

External auditors are independent of the organization they audit and provide a public report on the company's annual financial statements. Generally, for U.S. listed companies with $75 million or more in capitalization, the audit also includes an opinion on the effectiveness of the internal controls over financial reporting that management has implemented to address the risk of material misstatements in financial statements.

External auditors report directly to the audit committee, which engages them and oversees the conduct of the audit. Under PCAOB auditing standards, an audit is a detection mechanism specifically designed to assess fraud risk and detect material fraud: "An [external] auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."12 Due professional care and skepticism are fundamental principles in everything an external auditor does. As part of their professional responsibilities, external auditors are required to discuss with the audit committee, as applicable, matters such as, but not limited to, those that may enter into the evaluation of the risk of financial reporting fraud, the adjustments that resulted from the audit, the auditor's judgment on the quality of the entity's accounting principles, significant accounting estimates, material weaknesses or significant deficiencies in internal controls identified during the audit, and disagreements with management, if any.13 Because of their experience with a variety of companies, external auditors also are often in a position to provide useful perspectives on best practices in financial reporting and controls, including the mitigation of fraud risks.

Themes (subject) Related to Deterrence (prevention) and Detection

The participants at the CAQ roundtable discussions and in-depth interviews agreed that pressure, opportunity, and rationalization are indeed key catalysts for financial reporting fraud. They also agreed that senior management has the primary responsibility for deterring and detecting fraud, working in concert with the board of directors and audit committee and the internal and external auditors. A fundamental underpinning of any company's efforts to deter and detect fraud is a robust system of internal control. All key players in the financial reporting supply chain have some responsibility with respect to internal control systems. However, the risk of management override of internal controls and other factors means it is not enough to focus only on the design of a company's system of internal control.

Thus, the crucial question is how the key players in the financial reporting supply chain, both individually and collectively, can effectively mitigate the risk that the three forces in the fraud triangle will lead to financial statement fraud. Three themes or categories of fraud deterrence and detection measures emerged from the CAQ's discussions and interviews. These themes highlight the actions some companies already are taking to address the risk of financial reporting fraud and stimulate thinking about other potential approaches that may counter one or more of the motivators in the fraud triangle. These same themes are also reflected in recent research on the deterrence and detection of financial reporting fraud.

1. First, the tone at the top, as it is reflected throughout a company's culture, is the primary line of defense and one of the most effective weapons to deter fraud
2. Second, skepticism, or a questioning mindset on the part of all key participants in the financial reporting process, is a vital tool in evaluating fraud risk and in deterring and d
3. Third, strong communication and active collaboration among all key participants are essential to a thorough understanding of the risks of financial reporting fraud and to an effective anti-fraud program In developing specific next steps to advance efforts to deter and detect financial reporting fraud, it is instructive to focus on how each of the

key groups in the financial reporting supply chain can embrace these themes in order to help mitigate the risk of financial reporting fraud.

Deterring and Detecting Financial Reporting Fraud

Because of the inherent limitations on the effectiveness of controls and the possibility for the override of controls, the risk of fraud can be mitigated but not completely eliminated. Therefore, companies typically employ two strategies to mitigate fraud risks: controls that focus primarily on deterring potential fraud and controls to detect fraudulent activity. Controls to deter fraud, such as a strong ethical tone at the top and a proactive fraud management program, are highly visible in the organization and are designed to ascertain and mitigate the forces that can enable fraud. Detective controls generally operate in the background and focus on the timely identification of fraud that has occurred.

Examples of detective controls include:

1. Process controls such as reconciliations and physical count
2. Technology tools to identify anomalies in accounting entries or activity
3. Regular management or internal audit reviews of areas of activity (such as accounting estimates) susceptible to manipulation

Some controls, such as a whistleblower program, both deter fraud by their presence and help detect incidents of fraud.

Methods of Producing Fraudulent Financial Statements

Once, the management has decided to be engaged in fraudulent financial reporting then they may use any of the following recipes for cooking the accounting books.

1. **Overstatement of Revenue** – Revenue may be overstated by inflated sales. This can be achieved by entering fictitious sales or by entering a sale before the revenue is earned actually in the financial statements.
2. **Understatement of Expenses** – Holding expenses incurred during the current period over to the next financial period is termed as understatement of expenses. This can happen by wrongly capitalizing an expense over a number of periods, rather than properly expensing it immediately.
3. **Overstatement of Assets** – Assets could be overstated by not booking down the accounts receivables or by not writing down the assets with impaired values or obsolete inventory.
4. **Understatement of Liabilities** – Liabilities may be understated by improperly recording liabilities as equity or by moving them between short term and long term.
5. **Improper Use of Reserves** – Reserve accounts such as reserves for accounts receivables, warranties, inventory obsolescence and sales returns are intrinsically risky because a great deal of judgment is required to determine their balances at the end of the financial period.
6. **Mischaracterization as one – time expenses** – The management of an organization may remove one - time expenses from the accounting books for giving a false impression about the organization‘s operating results to the capital market participants.
7. **Misapplication of Accounting Rules –** Financial statement fraud may be perpetrated by exploiting loop holes present in the accounting rules.
8. **Misrepresentation of Information –** Management deliberately misrepresents or omits certain information in the financial statement to mislead the users of financial statement about the operations of the organization.

Consequences of Financial Statement Fraud

In general, financial statement fraud is only a means to improve results. Financial statement fraud has larger implications than many managers realize

Financial statement fraud, no doubt is going to harm the company in which it is perpetrated, but it can also affect economic markets. Gives the following summary of the potential harmful effects of financial statement fraud:

1. It undermines the quality and integrity of the financial reporting process;
2. It jeopardizes the integrity and objectivity of the accounting profession;
3. It diminishes the confidence of capital markets and market participants in the reliability of financial information;
4. It makes the capital market less efficient;
5. It adversely affects a nation's growth and prosperity;
6. It may result in litigation losses;
7. It destroys the careers of individuals involved in the fraud;
8. It causes bankruptcy or economic losses by the company engaged in the fraud;
9. It encourages a higher level of regulatory intervention; and
10. It causes destructions to the normal operations and performance of the alleged companies.

An Example of Fraudulent Financial Reporting

The SEC's Accounting and Auditing Enforcement Release No. 923, "Securities and Exchange Commission v. Joseph C. Allegra, David Hersh, J. Ledd Ledbetter and H. Flynn Clyburn . . ." (AAER 923), issued June 11, 1997, provides an example of fraudulent financial reporting carried out by the president and chief executive officer; the chief financial officer, treasurer, and secretary; the chief operating officer and senior executive vice president; and another executive vice president of a national provider of alternate site health care services. According to the SEC, the four officers overstated the company's net income for the quarters ended December 31, 1992, and March 31, 1993, by taking the following "cooking the books" actions:

1. Recognizing January 1993 revenues in December 1992 and April 1993 revenues in March 1993, and artificially accelerating product delivery schedules at the end of both quarters, an artifice termed channel stuffing.
2. Deferring writeoffs of uncollectible accounts past the end of the appropriate quarter. Also, according to the SEC, the chief financial officer (a CPA) overstated quarterly income by:

a. Recognizing in the quarter ended March 31, 1993, a gain from the sale of an asset during the quarter ended June 30, 1993.
b. Recognizing as assets certain expenses incurred during the quarters ended December 31, 1992, and March 31, 1993.
c. Making fictitious journal entries in connection with business combinations accomplished in March 1993, the effect of which was to understate doubtful accounts expense.

In a "consent decree" in which the four officers neither admitted nor denied the SEC's allegations, they agreed to numerous monetary and other penalties.

Ethical Standards for Preparers of Financial Statements and Financial Reports

Many past efforts to develop ethical standards for accountants focused on CPAs in the practice of public accounting-primarily auditing. For example although the first code of ethics of the American Institute of Certified Public Accountants (AICPA) was adopted in 1917, prior to 1988 few of its provisions applied to AICPA members in industry. The Institute of Management Accountants (IMA), an organization devoted primarily to the interest of accountants in industry, first issued its Standards of Ethical Conduct for Members in 1983. The Financial Executives International (FEI), an organization of financial vice presidents, controllers, and treasurers of business enterprises, first issued its Code of Ethics in 1985. Presumably, the lack of formal ethical standards for management accountants and financial executives prior to 1983 stemmed from the view that the first line of defense against financial reporting was provided by independent CPAs, subject to ethics codes of their states of licensure, who audited financial statements of business enterprises, and that preparers of those statements had only a secondary role in assuring quality financial reporting.

This view was prevalent even though the AICPA had long included statements such as the following in its pronouncements on auditing: The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining an internal control structure that will, among other things, record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements. The internal control structure should include an accounting system to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. The entity's transactions and the related assets and liabilities are within the direct knowledge and control of management. The auditor's knowledge of these matters is limited to that acquired through the audit. Thus, the fair presentation of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility. The independent auditor may make suggestions about the form or content of the financial statements or draft them, in whole or in part, based on information from management's accounting system. However, the auditor's responsibility for the financial statements he has audited is confined to the expression of his opinion on them.

Significant Events in the Establishment of Ethical Standards for Management Accountants and Financial Executives

The Sea view Symposium Of 1970

An early effort to establish ethical standards for preparers of financial statements occurred at a 1970 symposium of members of the AICPA, the FEI, the Financial Analysts Federation, and the Robert Morris Associates (an organization of credit grantors), which took place at Seaview Country Club, Absecon, New Jersey. Papers and discussions at this symposium criticized the lack of a code of ethics for members of the FEI, given that the other three participating organizations had such codes.

The Equity Funding Fraud Of 1973

In 1973, a major fraud, of about nine years' duration, was discovered at Equity Funding Corporation of America (Equity), a seller of mutual fund shares that were pledged by the investors to secure loans to finance life insurance premiums. During the nine-year period, at least \$143 million of fictitious pretax income was generated—a period in which Equity reported a total net income of \$76 million, instead of the real pretax losses totaling more than \$67 million.5 The fraud was carried out by at least 10 executives of Equity, including the chief executive officer (CEO), chief financial officer (CFO), controller, and treasurer; several of the executives were CPAs with public accounting experience. The fraudulent conduct of these CPAs, all of whom presumably had at one time been subject to the

AICPA's Code of Professional Ethics during their public accounting careers furnished clear evidence of the need for ethics codes for management accountants and other financial executives.

Action by the IMA

In 1983, the IMA issued Standards of Ethical Conduct for Practitioners of Management Accounting and Financial Management, the third in a series of Statements on Management Accounting. The current IMA standards cover the management accountant's obligations as to competence, confidentiality, integrity, and objectivity, and they provide guidance for resolutions of ethical conflict. Noteworthy in the preamble to the standards is the management accountant's obligation not to condone violations of the standards by others in the organization.

Action by the FEI

The **Code of Ethics** first promulgated by the FEI in 1985 and as subsequently amended. Although briefer than the IMA standards, the FEI's code covers essentially the same areas of professional conduct as do the IMA standards.

Treadway Commission Recommendations

The National Commission on Fraudulent Financial Reporting (Treadway Commission), which had been sponsored by the AICPA, the IMA, the FEI, the American Accounting

Association (composed primarily of accounting educators), and the Institute of Internal Auditors, issued its report in 1987. Defining **fraudulent financial reporting** as "intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements,"6 the Treadway Commission made 49 recommendations for curbing such reporting. The recommendations dealt with the public company; the independent public accountant; the SEC, financial institution regulators, and state boards of accountancy; and education. Stating that "the responsibility for reliable financial reporting resides first and foremost at the corporate level,"7 the Treadway Commission included the following among its recommendations for the public company:

Recommendations: Public companies should maintain accounting functions that are designed to meet their financial reporting obligations.

A public company's accounting function is an important control in preventing and detecting fraudulent financing reporting. The accounting function must be designed to allow the company and its officers to fulfill their statutory financial disclosure obligations. As a member of top management, the chief accounting officer helps set the tone of the organization's ethical conduct and thus is part of the control environment. Moreover, the chief accounting officer is directly responsible for the financial statements, and can and should take authoritative action to correct them if necessary. He generally has the primary responsibility for designing, implementing, and monitoring the company's financial reporting system and internal accounting controls. The controller may serve as the chief accounting officer, or the chief financial officer also may perform the functions of a chief accounting officer. The chief accounting officer's actions especially influence employees who perform the accounting function. By establishing high standards for the company's financial disclosures, the chief accounting officer guides others in the company toward legitimate financial reporting.

Moreover, the chief accounting officer is in a unique position. In numerous cases, other members of top management, such as the chief executive officer, pressure the chief accounting officer into fraudulently manipulating the financial statements. An effective chief accounting officer is familiar with the company's financial position and operations and thus frequently is able to identify unusual situations caused by fraudulent financial reporting perpetrated at the divisional level. The chief accounting officer has an obligation to the organization he serves, to the public, and to himself to maintain the highest standards of ethical conduct. He therefore must be prepared to take action necessary to prevent fraudulent financial reporting. His efforts may entail bringing matters to the attention of the CEO, the CFO, the chief internal auditor, the audit committee, or the entire board of directors. The Financial Executives [International] (FEI) and the [Institute of Management Accountants (IMA)] play active roles in enhancing the financial reporting process by sponsoring research, technical professional guidance, and continuing professional education and by participating in the shaping of standards. Both organizations also have promulgated codes of conduct that strongly encourage reliable financial reporting. Public companies should encourage their accounting employees to support these organizations and adhere to their codes of conduct.8

Revision of AICPA Ethics Rules

In 1988, the members of the AICPA approved a revised Code of Professional Conduct to replace the Code of Professional Ethics that previously had been in effect. This action was triggered by the 1986 Report of the Special Committee on Standards of Professional Conduct for Certified Public Accountants (Anderson Committee), which recommended restructuring the AICPA's ethics code to improve its relevance and effectiveness.9 A key element of the Anderson Committee recommendations was extension of applicability of the Rules of Professional Conduct of the revised Code of Professional Conduct to AICPA members who are not practicing in a CPA firm.10 Thus, Rules 102, 201, 202, 203, 302, and 501 of the Code of Professional Conduct in Appendix 3 (pages 11 through 20) apply to all AICPA members, including those in private industry, governmental entities, nonprofit organizations, and academia.

Authority of the Public Company Accounting Oversight Board

Title I of the Sarbanes-Oxley Act of 2002 authorized the Public Company Accounting Oversight Board to establish ethical standards for audits of publicly owned companies. As of the date of this writing, no such standards had been issued.

Analysis of Ethical Standards for Management Accountants and Financial Executives

A review of the contents of the IMA, FEI, and AICPA ethics pronouncements in Appendixes 1, 2, and 3 reveals several similarities. All three require members of the respective organizations to be competent, act with integrity and objectivity, maintain confidentiality of sensitive information, avoid discreditable acts, and avoid conflicts of interest. Only the IMA and FEI codes specifically require communication of complete information to users of their members' reports; AICPA members indirectly are comparably obligated by Rule 202. Rule 203 of the AICPA code requires compliance with generally accepted accounting principles. One might prefer that both the IMA and the FEI codes had comparable explicit provisions, given management accountants' and financial executives' primary responsibility for financial statements and financial reports. Another difference among the three ethics codes is that the IMA and FEI standards in essence require members to report violations of the standards by members of their organizations to responsible officials of the organizations. The AICPA code has no such requirement. The issues of conflicts of interest and discreditable acts are discussed further in the following sections.

Conflicts of Interest

Conflicts of interest result when individuals reap inappropriate personal benefits from their acts in an official capacity. For example, a chief accounting officer might cook the books to overstate pretax income of the employer corporation in order to obtain a larger performance bonus. Alternatively, the controller of a publicly owned corporation might engage in insider trading11 to maximize gains or minimize losses on purchases or sales of the employer corporation securities. For example, in Accounting and Auditing Enforcement Release (AAER) 344 (December 10, 1991), the SEC reported the permanent disbarment from practice of the controller, a CPA, of a publicly owned company, who had allegedly engaged in insider trading and thus avoided losses of more than $73,000 on sales of the employer company's common stock. According to the SEC, the controller had acted with senior management of the company to overstate the company's earnings by more than $38,000,000 over a two-and-one-half-year period. The controller was ordered to disgorge the $73,000 and pay a penalty of the same amount.

Discreditable Acts

None of the three ethics codes presented in appendixes to this chapter defines discreditable acts. Probably the term cannot be adequately defined or circumscribed; what is a discreditable act to one observer might not be so construed by another. For example, might a member of the IMA, FEI, or AICPA observing another member's substance abuse construe the act as discreditable to the abusive member, the member's employer, the organization, or other entities? Such questions are difficult to answer in a society in which some condone personal actions that are condemned by others.

Conclusion

In considering episodes of cooking the books, described in subsequent chapters, the reader should keep in mind that, although the Tread way Commission stated, "The incidence of fraudulent financial reporting cannot be quantified with any degree of precision,"12 it also gave the following data:

1. The number of SEC proceedings against reporting companies from 1981 to 1986 was less than 1% of the number of financial reports filed with the SEC during that period.
2. The chairman of the Federal Deposit Insurance Corporation contended that management fraud (presumably including cooking the books) contributed to one-third of bank failures.

3. Ten percent of total bankruptcies in a study authorized by the Treadway Commission involved fraudulent financial reporting.
4. Former SEC chairman John Shad estimated that all fraudulent securities activities amount to a fraction of 1% of the $50 billion of corporate and government securities traded daily.

Thus, cooking the books episodes, though serious and despicable, apparently do not indicate a wholesale breakdown of ethical conduct by management accountants and financial executives of business enterprises.

An important question to consider is: Can the codes of conduct for management accountants and financial executives established by the IMA, the FEI, and AICPA help those key players in corporate financial reporting to resist pressures, often from top management but sometimes from within themselves, to falsify financial statements and financial reports? Or is it too much to expect such individuals, whose livelihoods and careers depend a great deal on what is in those statements and reports, to be completely impartial in their preparation? Ralph E. Walters, CPA, former director of Professional Conduct for The California Society of Certified Public Accountants, has considered this thorny question: An obligation to be impartial seems to me to place a new and possibly unrealistic burden on the management accountant. Traditionally, most employees have felt an obligation, within the bounds of honesty and integrity, to put the best face upon their employer's affairs. For example, there is still some latitude in selection and judgment in the application of GAAP [generally accepted accounting principles]. Some managers consistently opt for the most aggressive principle or application. The aggregate effect is to bias the financial statements. They may be in accordance with GAAP, but the quality of earnings is suspect. They are not impartial. This condition is not uncommon in practice (it is a principal reason we need independent auditors). An accountant associated with this condition is literally violating the AICPA Code. The [IMA] Code is less clear. Is this interpretation realistic? Do management accountants generally understand this? I doubt it. In fairness to their members and to the public, the AICPA and the [IMA] need to put their heads together and agree how much objectivity management accountants can be expected to live with, including some examples in real-life situations. The positions should be consistent and must be made clear to all management accountants. The questions raised in the foregoing paragraph are difficult to answer. However, the SEC has emphasized the importance of objectivity as follows, in rejecting the "good soldier" rationalization of unethical conduct by a corporate controller (a CPA): The Commission cannot condone [the controller's] conduct. [The controller] has or had available to him more than sufficient information to be aware that the financial statements he prepared and the periodic reports he signed were materially inaccurate. Under the circumstances, and as a senior level financial officer and the highest level CPA within [the corporation] involved in the financial reporting process, [the controller] owed a duty to [the corporation] and its shareholders not to assist in, or even acquiesce in, [the corporation's] issuance of such financial statements. Although [the controller] may have made the appropriate recommendations to his corporate supervisors, when those recommendations were rejected, [the controller] acted as the "good soldier," implementing their directions which he knew or should have known were improper. In like vein, the SEC commented as follows on the behavior of a corporate controller who, despite his knowledge of cooking the books activities directed by the company's former CEO and former CFO, took no remedial actions: As controller, [the CPA] had a duty to satisfy himself that [the company's] financial statements were properly stated under GAAP. [The controller] knew or recklessly disregarded facts indicating that, as a result of the fraudulent entries; [the company's] reported financial statements during fiscal year 1990 . . . were materially false and misleading. Although [the company's] former CEO and CFO devised and directed the improper practices resulting in [the company's] false recording and reporting, in the Commission's view, this does not justify [the controller's] failure to take sufficient steps to satisfy himself that the transactions were properly recorded . . . This failure was inconsistent with his duties as . . . controller.16 At the beginning of their professional careers, students of advanced accounting might well reflect on their sense of ethical values and decide on a course of action if they find themselves in a position such as the foregoing ones.

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