INTERNATIONAL JOURNAL OF SOCIAL Sciences and Information Technology
ISSN 2412-0294 www.ijssit.com
http://www.ijssit.com

FINANCIAL STATEMENT FRAUD

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ABSTRACT

The paper addresses the concept and practice of Financial Statement Fraud. Fraud has been identified to take two forms which are theft (misappropriation of corporation assets) and Financial Statement Fraud (Misstatement of Financial Statements/Fraudulent Financial reporting). This paper addresses the later due to the fact that this kind of fraud is not emphasized until it has happened and at that point no recovery of the losses incurred. In this paper three questions have been addressed which are why people commit financial statement fraud? How do people commit financial statement fraud? And how can financial statement fraud be prevented? The Financial Fraud Triangle and fraud diamond have been used to explain why fraud is committed. Pressure, Rationalization and Opportunity, Capability have been identified as reasons people commit fraud. Financial statement Fraud takes the forms of inflating balance sheet/fund balance; Inflating Income statements and misrepresentation of facts and falsifying records. Prevention of Financial Statement Fraud is by Strengthening the Internal Audit Function and Internal controls, Establishment of independent audit committees, cultivation of best practices approach by corporations and enforcement of Fraud Prevention Policy.

Keywords: *Fraud, Financial statement fraud, Fraud Triangle/Diamond, Internal Audit/Control*

Introduction:

Financial statement fraud has attracted great attention in the recent past in parts of the world. There have been many cases of companies where there has been Financial statement fraud that has gone undetected by auditors, a fact that has left many with difficult questions regarding the auditing and accounting profession. Financial fraud is misstatement in the Financial statements(Colbert, 2000).

International Federation of Accountants (IFAC) and American Institute of Certified Public Accountants (AICPA) has provided specific guidelines to auditors as they search for financial statement misstatements. These misstatements are as a result of error or fraud. It is important to differentiate between error and Fraud (Hassink, Meuwissen, & Bollen, 2010). The main difference is in the intent, whereby errors are as a result of unintentional mistakes while fraud occurs due to intentional errors (Colbert, 2000).

The subject of prevention, detecting and reporting fraud has been and remains an elusive item in corporate governance. Financial statement fraud is a threat to the going concern status of an organization. Investors and lenders have specific interest on the going concern status of an organization. While the general public clientele expects auditors to detect fraud, the auditing standards do not put this burden entirely on the auditors. The auditors are caught on this dilemma where they are expected to do everything possible to prevent fraud then there is the minimum requirement of the audit just to express an opinion with reasonable assurance that Financial statements present fairly the financial position of an organization (Makkawi & Schick, 2003).

Fraud takes two forms; theft and Financial statement misstatement. Theft takes the form of the perpetrator taking the assets of an organization for personal use (Misappropriation of assets) while Financial statement fraud takes the form of a perpetrator(s) do fraudulent financial reporting like overstating assets and revenues and understate liabilities and expenses (Makkawi & Schick, 2003).

While the first form of fraud, misappropriation of a company's assets gets reported and perpetrators gets prosecuted on a more regular basis, the financial statement fraud is hardly reported and even perpetrators get prosecuted. Research has proven that whistleblowers are less likely to report; 1) financial statement fraud than theft, 2) immaterial fraud than material fraud, 3) When the wrongdoer is aware that his wrong doing is known, 4) when other people in the firm are aware of the fraud than when they are not aware (Robinson, Robertson, & Curtis, 2012).

Due to this factor this paper will concentrate on Financial statement fraud although at some point the two types of fraud may overlap as they are both fraud and the principles of dealing with them are more less the same. The paper aims at putting the point across that Financial Statement Fraud needs to be prevented as investigative and litigation expenses are high, meaning this fraud needs to be stopped at its earliest stage.

Theoretical and Conceptual framework:

In discussing this concept of Financial statement fraud, this paper will concentrate on three theories that deal with the Prevention and reporting of financial statement fraud. The three theories of models that will be applied in dealing with this topic are:

a) Fraud triangle/Diamond Model – This theory will deal with the question why people commit Financial statement fraud

b) Attribution theory – This will deal with the question of how Financial statement fraud is committed and justified by the perpetrators.

c) Theory of diffusion of responsibility – This theory will deal with the aspect reporting the financial statement fraud by the employees or any other whistleblower. This is also known as by-stander effect.

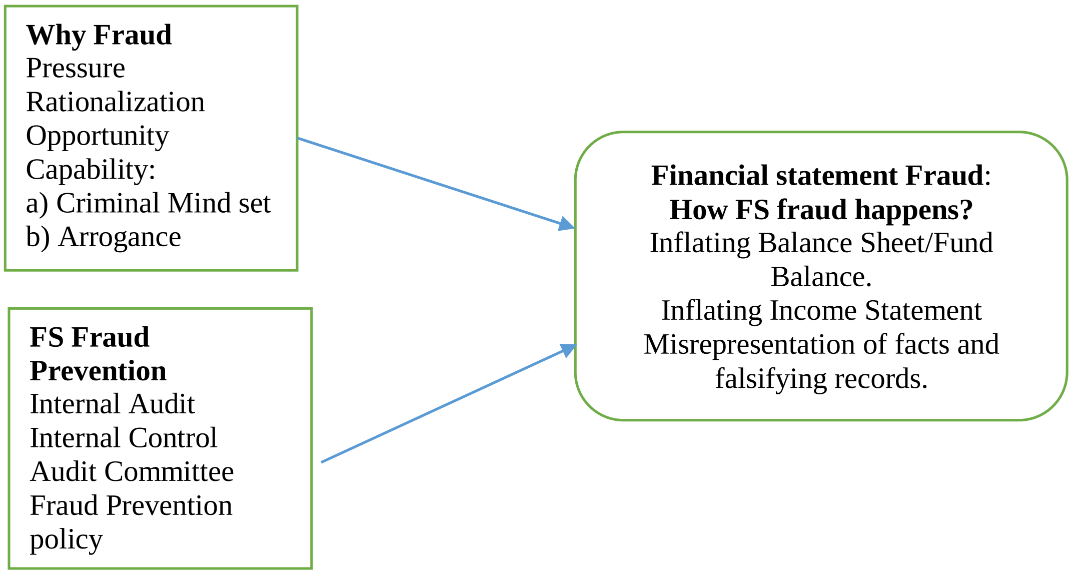
The research questions for this study are:

a) Why do people commit Financial statement fraud?

b) How do people commit Financial statement fraud?

c) What are the ways that can be applied in the prevention of the Financial statement fraud?

International Journal of Social Sciences and Information Technology
ISSN 2412-0294
Vol IV Issue X, October 2018

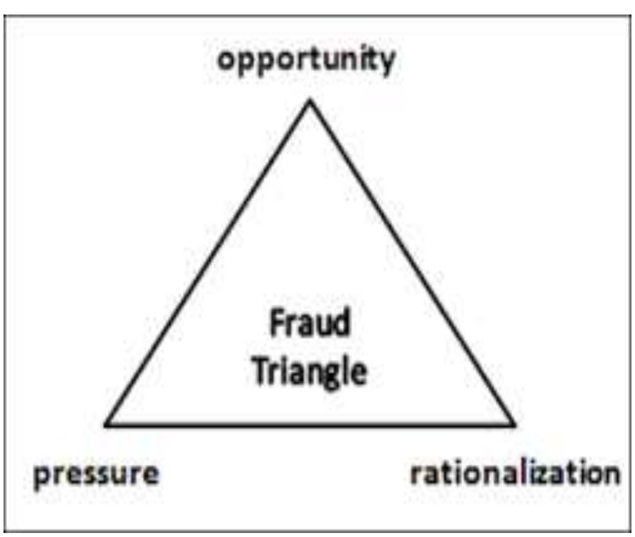


Why do people Commit Financial Statement Fraud?

A corporation that brings together different stakeholders for a common purpose is expected to be fair and transparent in its dealings. These corporations compete for resources and other business transactions in the market place requiring them to embrace ethical practices(Gupta & Gupta, 2015). The recent happenings in the corporate world locally and internationally has portrayed a different scenario. In Kenya for example three Commercial banks namely Dubai bank was placed on receivership on the 14th August 2015, Chase Bank was put on receivership on the 6th April 2016 and Imperial Bank on the 13th October 2015. All the three as an example found themselves on this unfamiliar ground due to among other things Financial statement fraud.

Dr. Donald Cressey in explaining the motive behind these unethical behaviors came up with the Fraud Triangle. This is response to explaining the false representations aimed at getting unjust advantage and criminal deception by the employees of an organization (Gupta & Gupta, 2015).

Fraud Triangle



Source: Gupta & Gupta (2015)

Opportunity – Perceived opportunity to commit fraud. An employee reaches a point of trust in an organization or when the internal controls are weak or non-existence. At this point the employee perceives an opportunity to commit fraud, conceal it, avoid detection and punishment for it(Hillison, Pacini, & Sinason, 1999). The best way to deal with this is to strengthen internal controls and the mitigation against overrides is the integrity of employees.

Pressure – Also known as motivation which is a perceived need that one has but not able to get means to satisfy it. Pressure relates to duress caused by an employee immediate need for assets that the employee is not able to satisfy with the available resources and usually takes the form of urgency and need(Hillison et al., 1999)

Rationalization – a mental state whereby one finds explanations to justify the criminal act of fraud. Employees commit fraud when they convince themselves that it is consistent with their code of ethics. The code of ethics observance depends on the integrity of the employee. Companies need to come up with a fraud prevention policy that guides employees in ethical conducts (Ilett & Ilett, 2010).

The debate behind the Fraud triangle is that for everything somebody is doing there is a reason behind it. Therefore, the fraud triangle came as a result of finding out why people commit fraud. He held that for fraud to occur the three factors must be present (Abdullahi & Mansor, 2015). Cressey was quoted by (Abdullahi & Mansor, 2015) states that "Trust violators, when they conceive of themselves as having a financial problem that is non-shareable and have knowledge or awareness that this problem can be secretly resolved by a violation of the position of financial trust. Also they are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property." (Abdullahi & Mansor, 2015).

Wolfe and Hermanson in the CPA Journal in December 2004 came up with the Fraud Diamond Theory. He added one more element into the Fraud Triangle known as capability. capability has been added to the three initial fraud components of the FTT. "Wolfe and Hermanson (2004) argued that although perceived pressure might coexist with an opportunity and a rationalization, it is unlikely for fraud to take place unless the fourth element (i.e., capability) is also present. In other words, the potential perpetrator must have the skills and ability to commit fraud." (Abdullahi & Mansor, 2015).

Capability refers to ability and potential to commit a fraud. Wolfe's argument that even if there is pressure, opportunity and rationalization, if the perpetrator must have skill and ability for fraud to happen. Capability goes with the personal traits of the perpetrator. The personal traits that go hand in hand with criminal mindset and arrogance. The Fraudsters also are of two kinds, the accidental fraudsters and the predators. Accidental fraudsters are first time offenders while predators are career criminals who are always on the lookout for easy prey(Gottschalk, 2014).

Rezaee & Riley (2010) came up with 3-C model to explain how fraud triangle can be used to predict corporation's unethical behavior, namely Conditions – This has to deal with business downturns. Corporation structure – Irresponsible or Ineffective corporate governance and

Choice – The personal choices on legal, ethical, illegal and unethical behavior (Wolfe & Hermanson, 2004) (Tauringana & Mangena, 2014).

Financial statement fraud is all about the ethical tone that exist within the organization. This tone is usually set by management and diffuses to the lower cadre employees. Apart from setting the tone they lead by example by themselves conducting the business of the organization ethically(Crawford & Weirich, 2011).

The general Motives for Financial statement fraud are:

Make the company's earnings look better on paper while that is not the case perhaps to give investors and other stakeholders a misleading perspective.

To cover up the embezzlement of company funds by just sweetening the financial position in omitting some critical entries.

To encourage investment through the sale of stock since the state of affairs as portrayed in the financial statement determines the value of stock in the market.

To demonstrate increased earnings per share or partnership profits interest thus increased dividend/distribution pay out.

To dispel negative market perceptions due to its real performance by misstatement of financial state of affairs.

To obtain financing or to obtain more favorable terms on existing financing. This is achieved through financial statement fraud.

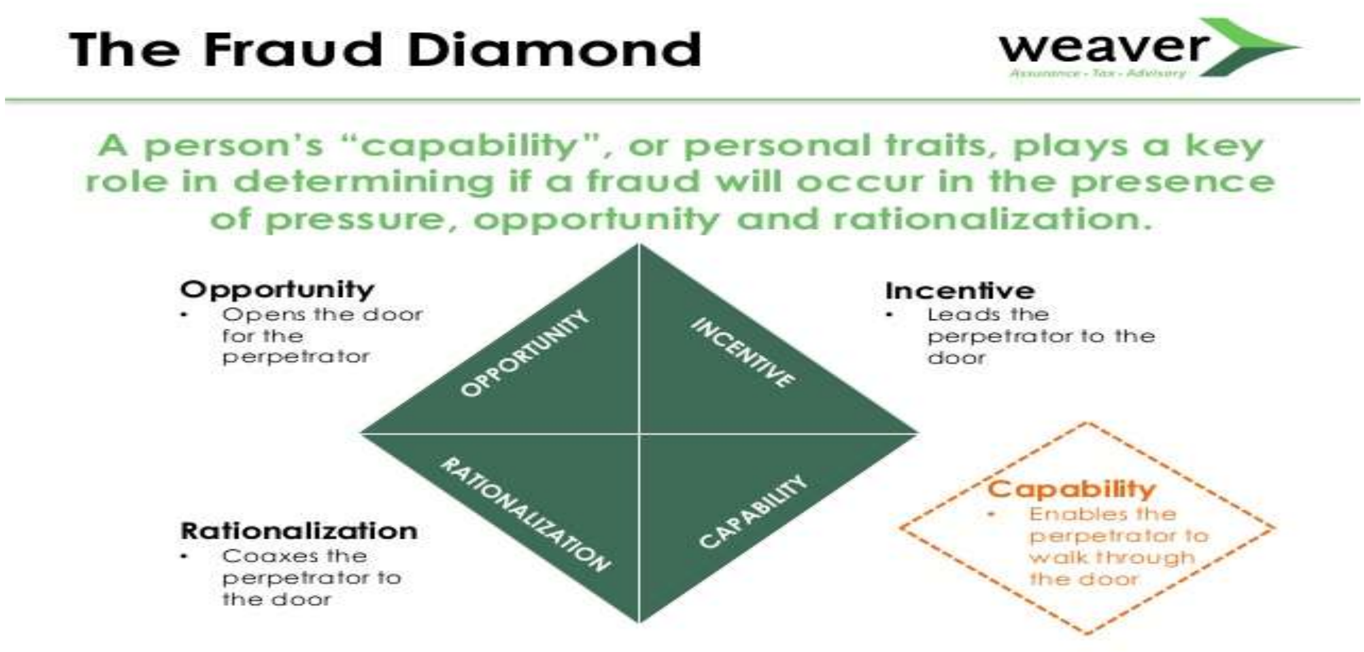
To receive higher purchase prices for acquisitions. Acquisition values are usually based on the Financial statement values. The Fund balances are usually overstated.

To demonstrate compliance with financing covenants. This is when the misstatement is aimed at deceiving that the firm is in compliance.

To receive performance related bonus. This is where bonus is based on the declared income and therefore when overstated means more bonus.

To meet company goals and objectives. The companies usually set targets that should be achieved, therefore they misstate the position so that it deceives readers and users.

Source:Weaver



Financial statement fraud takes place when a corporation performance is attached to the earnings of an employee (bonus), employee performance contracting, renewal of an employee's contract. All these factors may lead to an employee committing a Financial statement fraud.

Proposition 1 – Integrity of an employee determines whether one moves forward to take advantage of the opportunity and capability possessed to make good the rationalization mental process justifying the crime to ease the pressure encountered by committing a financial statement fraud.

How do people commit Financial Statement Fraud?

The financial statement frauds take many forms and each form is attached with an explanation as to what interpretation perpetrators give to the action. Each perpetrator form top management to lower cadre employees have a way to justify the financial crime. This is what is known as attribution theory.

On the other hand, human beings try to process in their minds why people do what they do the way they do those things. They process those explanations and attach them to individuals and their actions.

The perpetrators when the actions come to be known also look for ways to defend their actions and in most cases they blame somebody else for such kind of actions they undertake.

In the Enron case the management of Enron took advantage of the weakness of the US GAAP to avoid disclosures that could have saved its bankruptcy (Rich, Uni, & York, 2005). In fact, the Enron fall out has been termed as an accounting error that management took advantage of and concealed fraud. The trading and business relationships with companies who were related to Enron was not disclosed and the auditors did not catch this. Astute financial analysis and accounting was enough to reveal the instability of Enron to safe the renders from losses incurred(Rich et al., 2005).

Another area of financial statement fraud is the cyberspace fraud that is very common these days but very difficult to detect and prevent. Electronic trading (e-Commerce) operates beyond traditional business boundaries and also removes the market place from a temporal and geographic location(Fletcher, 2007).

The most common ways of financial fraud are now discussed briefly:

Recognition of revenue – According to studies done by the Committee of sponsoring organizations of the Treadway Commission (COSO), use of fictitious revenues is the most popular method of committing financial statement fraud (Intal & Do, 2002). It is estimated that over 50% of the reported cases of Financial statement fraud are those directly related to revenue recognitions.

Overestimation of assets – This is where assets are over estimated and the most affected assets are the accounts receivables which are over - valued to give wrong picture. The over valuation of assets gives a wrong impression of the state of affairs of the company. It may also take the form of improper capitalization of assets, asset valuations methods and proper accounting for assets.

Under-estimation of expenses – This is the understatement of expenses so as to give a wrong estimate of net revenue. This takes the form of shifting expenses to future periods. This deals with omissions, incomplete disclosures, misrepresentation of information in the notes and improper presentation of notes and exhibits to the Financial statements.

Under-valuation of liabilities – This is where liabilities are under-reported so as the liquidity and working capital of the company are not properly stated. (Colbert, 2000). The invoices are not posted into the system and therefore not reported.

All the frauds committed including the Enron case happened but the auditors still went ahead and issued an Unqualified opinion.

Proposition two: The work of auditors and accountants requires stringent professional guidelines that make detection of fraud a compulsory requirement and expectation by the clients and the professional board.

Prevention of Financial Statement Fraud

When dealing with financial statement fraud there has been debate on who is responsible for the detection and prevention of fraud (Rocco, Vanascco, 1998). The Auditing standards have an escape clause where auditors indicate in their letter of engagement that it is not the responsibility of the auditors to detect fraud and that it is the responsibility of management to detect and prevent fraud(Crawford & Weirich, 2011).

Apart from the Auditor and the client on one side, literature and corporate governance structures have introduced the corporate counsel as a party to the business of fraud detection and prevention. The counsel is required to be familiar with the prevention and detection of fraud in familiarizing themselves with the types of frauds and the red flags(Crawford & Weirich, 2011).

Internal audit function – The internal audit function that is strengthened in a corporation can serve to deter employees from engaging in fraud by way of enforcing internal controls on a daily basis in an organization. Prevention and detection of fraud should be the responsibility of this department (Hillison et al., 1999).

External auditor reliance on internal audit – the internal auditor is expected to continuously review the internal control procedures and conduct tests regularly to ensure they are working. The Internal auditor makes reports to management on the existence and adherence to internal controls by all in an organization. The external auditor conducts the audit one particular time in an organization and therefore not possible to do all tests meaning some of the works done by the Internal auditor works as pointers for the external auditor(Hassink et al., 2010).

The expectations of the public that the role of external auditors should be to detect fraud and the auditor’s disclaimer statement and ambiguous statement on giving reasonable assurance as to the Financial statements present the true fair view of the state of affairs of a company gives rise to a serious expectation gap (Kramer, 2015)(Hassink et al., 2010).

The conduct of Fraud Triangle helps save dollars lost to embezzlement or the necessity to restate the Financial statement.

Proposition three: A strengthened Internal control function that reports to the CEO/Board of directors is the answer to a larger extent to expectation gap that exist between the External auditor and the public/stakeholders of the corporation.

Audit committee – Fraud detection has been a hot subject for the last more than 30 years. Regulations after regulations are made, Parliaments and governments have made laws and acts of parliament to mitigate losses after mega scandals and frauds have happened with no hope of recovering the assets lost(Kaminski, Wetzel, & Guan, 2004).

One of the latest adoption by many corporations is establishment of audit committees as a way of mitigating the occurrence of misappropriation of assets in companies. A study in the USA of companies that established Audit Committees found that establishment of Independent and Competent Audit(Mustafa & Youssef, 2010).

The internal auditor remains an employee of the corporation and with the recommendation of an independent Internal Audit function attracts a limitation that at the end of the day the internal auditor remains an employee. The Internal Auditor may have little or minimal to do for Financial Statement Fraud when it involves BOD and/or the CEO (Colbert, 2000).

Proposition Four: Establishment of Professional, Independent Audit Committees is the sure way of mitigating the limitations of both the Internal Auditor and External Auditor in detection and prevention of Fraud.

Organizations just like individuals have cultures that define what they stand for and what they are existing for. These cultures act as paradigm, map, frame of reference, and cognitive approaches to reality that distinguish a particular group from the other (Adler & Jelinek, 1986). Matters of financial management and reporting have an aspect of culture.

The organizations are required to instill best practices approach to issues of fraud prevention. These best practices complement the enforcement of internal control procedures and the aftermaths. Examples of these best practices are like economical use of resources, prosecution of offenders, segregation of incompatible duties, Hotline to report fraud and investigative fraud tips(Zhou & Kapoor, 2011).

Organizations with strong best practices adopted as their culture will be dealing with fraud from a very strong front. The detection, prevention and reporting of fraud will be something that becomes a culture too. The organization's employees will be at all times know and feel obligated to report and avoid fraudulent practices at all times(Adler & Jelinek, 1986).

Proposition Five: Creation of entity-wide culture of integrity from the Boardroom, throughout the administration circles and beyond is a sure way of dealing with financial statement fraud.

Organizations have guidelines for every activity happening in the fulfilment of its mission. The guidelines define the expectation of each party in an organization. Institutions have rules and regulations that guide every aspect and relationship with the organization. The guidelines define boundaries and limits of each member of the community that makes the organizations. When the employees join an organization the expectations of each employee are well defined and the expectation of the employee from the employer are also given to the employee(Hird, 2005).

Policies in organizations make part of the internal controls. Organizational have policies guiding behavior in the work place, performance of particular duties in an organization, relationships in working places, standards of practice, and other general operations (Herath & Rao, 2009).

The employees and the world in general have adopted a culture of having guidelines on basically every aspect in life. That is why organizations make and draw Internal Control guidelines, Employment guidelines, Staff handbooks and the like.

Proposition Six: Organizations dealing with Financial Statement Fraud challenges should draw fraud prevention policy that every employee is required to follow in performance of their work.

This Fraud Prevention policy should define the enforcement of these guidelines and what are the consequences of not following the guidelines. This in my opinion will come up with a better method to ensure ethical behavior in organizations.

Conclusion:

Financial Statement Fraud is a practice many companies and other organizations engage in to sweeten their Financial statements for various reasons and motives. Financial Fraud takes different forms ranging from inflating balance sheet/fund balance, inflating income statement to misrepresentation of facts and falsifying records.

The pressure to give better performance so that one may earn more bonus or commissions or attract lenders and investors, the justification of the misstatement ranging from increased income to tax evasion and the available opportunity to do the misstatement as represented by the fraud triangle leads to Financial statement fraud.

These misstatements can be mitigated by strengthened internal audit function, emphasis on integrity, establishment of independent and professional audit committees, creation of entity-wide integrity culture and introduction of a fraud prevention policy by all corporations.

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