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Fraud in Financial Statements

Julie E. Margret and Geoffrey Peck

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This book is dedicated to my family and my friends without whom life would be so empty. I thank you sincerely for your continued support, friendship, and love.

Julie Margret

This book is dedicated to Daniel, Jarrod, and Aaron, my three sons who still take the time to look after their 'old man.' To Jarrod in particular who helped me navigate the occasional computer dilemma during the writing of this book.

Geoff Peck

Preface

This book explores the question of why fraudulent endeavours can be so well hidden in financial statements. This is important as financial statement fraud (FSF) continues to be an increasingly challenging area for global business, financial accounting, and the law. Principally, this work reconsiders the constructs of financial accounting with particular regard to the problem of fraud in financial statements. Hence this study examines FSF that is sometimes referred to as management fraud.

This is notable. Firstly, it emphasises that management are responsible for the financial statements and their content. Secondly, that management generally are in a position to alter, enhance, or impair the accounts if they so choose, or deem it appropriate. Those in positions of authority and power have incentives to portray the business they direct or manage in a sound financial state. Sometimes this is done whether the financials are exact or not. Such motivation is heightened when the business is financially unsteady.

Fraud committed in financial statements is intentional, it distorts the reported financial position of a business entity and its financial worth. The deceit has the capacity to cause great harm to communities in both a social and economic context. So drawing on an array of national and international cases that have bewildered and confused many, we further explore this phenomenon. The underlying framework has regard for Cressey's theory of the fraud triangle that is used in conjunction with elements of stakeholder theory. This convergence provides the story with a practical and comprehensible foundation.

The aim is to examine fundamentals of accounting and financial accounting constructs that recur in circumstances of FSF and to explore the context in which those elements might enable FSF. The objective in that analysis is to reveal accounting dilemmas for directors and managers. A particular instance is with regard to business reconstructions in the face of financial distress. Hence, linkage between management concerns, financial accounting choices, and fraudulent behaviour are examined. The likely connections warrant scrutiny as the resulting actions can lead to error, mismanagement, or fraud.

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We also thank Transparency International for their permission to reproduce the Corruption Perceptions Index Map within this book. We thank Jou-juo Chu of the National Chung Cheng University of Taiwan for permission to reproduce his table of 'Port Reform Strategies and Union Reactions in New Zealand, Australia, and Taiwan' from his conference paper (2007) presented in Auckland, New Zealand. That diagram is included in our chapter six as Table 6.1. Sincerely we thank you all.

Julie Margret

I add my sincere thanks to the publishers Routledge and their staff for believing in this project. To Transparency International, thank you for your efforts in producing the Corruption Perceptions Index, which you kindly permitted us to reproduce and for your pursuit of transparency, accountability, and integrity. I particularly thank Dr. Julie Margret, who conceived the idea of this book and carried such a heavy load to make it a reality.

Geoff Peck

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1 Management and Fraud

> At the entity or micro level, the executives who run the business have a good deal of freedom to choose among alternative ways of presenting its operating results and its financial position.
>
> (Solomons, 1989, p. 1)

INTRODUCTION

This book examines financial statement fraud (FSF) sometimes called management fraud.[1] Fraud committed in financial statements fundamentally distorts the monetary position of a business entity and its financial worth. The deception has the capacity to cause great harm in both a social and economic context. There are numerous ways in which to commit fraud in financial statements of account. Drawing on an array of national and international cases, we explore this phenomenon. To elaborate necessitates a framework that herein we base on Cressey's theory of the fraud triangle.[2] It also requires a clear description of the fraud investigated. Hence we define FSF as:

> *Fraud in financial statements is an act of deliberate deceit that results in a misleading representation, material misstatement or intended exclusion in a business entity's financial accounts. The deception is committed with the intent to mislead shareholders and other stakeholders about the financial state of the business entity. The fraud may misleadingly relate financial circumstances, or an otherwise non-financial material fact.*

Previously the Treadway Commission (1987, p. 2) advised they 'defined fraudulent financial reporting as intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements.'[3] ASIC (2005, p. 3) stated: 'Definitions differ, but the common thread is that financial statement fraud involves deliberately misleading or omitting amounts or disclosures in financial statements in an attempt to deceive financial statement users, particularly investors or creditors.'[4]

That FSF may be called management fraud is notable. First, it emphasises that management are responsible for the financial statements and their content. Second, they are in a position to alter, enhance, or impair the accounts. Arguably those in positions of authority with a degree of power have an incentive to portray the business in a healthy, sound financial state—whether accurate or not. Such motivation is heightened when the business is financially unsteady. Hence those in senior positions are more likely to rationalise fraud in financial reports, and in all probability they have the opportunity to do so. The underlying pressure that motivates the fraud may or may not be evident.

Importantly it is not always senior management who solely commit FSF.[5] Others in positions of some authority (such as middle managers, department heads, or supervisors, who have the incentive and see the opportunity) are possible contributors. Bonus schemes based on increasing revenues, decreasing or stabilising costs, across the organization or by department, are likely motivators. Essentially anyone with the opportunity to commit fraud, especially if under some perception of pressure to do so, may well rationalise the act. The fact that pressure is *perceived* is significant. The perception of pressure will affect people in different ways. Some people will react adversely and subsequently their choices may not be well considered. Others may not be swayed or coerced.[6]

So not all people suffering pressure under similar or dissimilar situations will participate in or become perpetrators of fraud. In 2013 KPMG reported results of their international survey that revealed characteristics of a typical fraudster who would likely, among other things, be 36–45 years, acting mostly in fraud against their organization and employed in a middle management to senior/executive position.[7] Given the difficulty of amassing details of all fraudulent activity many argue there is no particular profile of a fraudster.[8] We believe the latter is a more realistic and impartial an approach. If organizations focus on a particular profile of a fraudster, actual occurrences of fraud may go unchecked.

Hence Cressey's theory of the fraud triangle is based on three fundamental factors: perceived pressure, opportunity, and rationalisation. The fraud triangle, though, has two parts, the factors or motivators to commit fraud and the elements of fraud. Fundamentally the elements of fraud are theft, concealment, and conversion.[9] This theoretical concept is expanded diagrammatically and discussed further with regard to stakeholder theory in chapter two.

In sum, for FSF to occur the perpetrator/s will suffer under some form of perceived pressure, and where the opportunity to relieve that pressure is evident, the perpetrator/s will rationalise the fraud. In that vein, the fraudster proceeds to steal from the company, conceal the theft, and convert what has been stolen into some other form. Hence, the framework to underpin the problem is established.

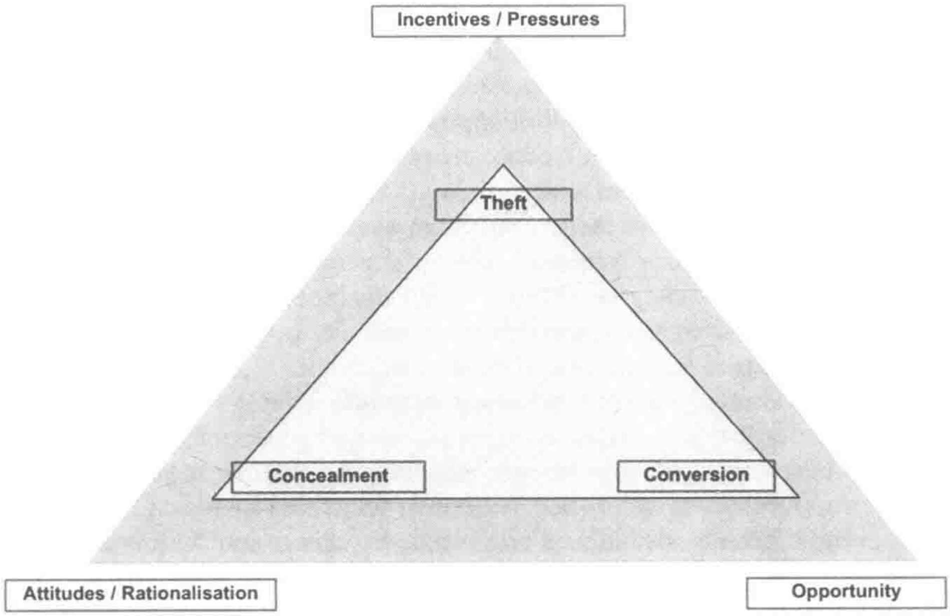

Diagram 1.1 The Fraud Triangle: Factors and Elements

Source: The diagram has been devised by the authors based on Cressey's (1919–1987) theory of the fraud triangle.

THE PROBLEM

FSF continues to be a topical and an increasingly challenging area for business, financial accounting, and the law. The problem of fraud is a global problem, particularly from a practical and public policy perspective, as the monetary cost of fraud escalates and the ensuing confidence in financial markets deteriorates.[10] In this environment, stakeholder demand for quality in financial statements intensifies. Debate about what constitutes quality in financial statements continues. This is not least because many business organizations throughout the world continue to collapse unexpectedly.[11] At times this occurs after the business has published financial statements that portray the entity as financially sound.[12] This is perplexing and the circumstances of each case warrant scrutiny.

Arguably shareholders and other stakeholders may expect an entity's published financial statements to be precise and informative, and that the financial details within the statements are serviceable to their needs. It is evident, however, as reportedly profitable and financially sound business organizations do collapse unexpectedly that seemingly uninformative, imprecise financial details are sometimes published. If the intent in those publications is to mislead the readers of those financial reports, then almost certainly FSF prevails. This is likely to occur where the entity's attention to governance and its internal control environment are lacking. In that context the culture generated throughout the organization is of concern.

An organization's culture grows from a combination of factors throughout the entity. Mostly it is a philosophy that emanates from the top and it is essentially that which drives the organization's culture, work ethic, and spirit. So the outcomes of decisions, actions, and behaviour of the directors, executive officers, and managers spread throughout the business. Consequently, that tone will affect the attitude and behaviour of all employees. If dishonesty is endemic, then the probability of fraud committed for the organization, as well as against the organization, will in all likelihood occur.

An act committed for the organization usually is intended to portray the financial state of the business in a much stronger position than it actually enjoys. There are many reasons why this may be done and many ways in which it may be achieved. On the one hand, assets and their financial equivalents might be intentionally misreported, expenses may be understated, liabilities might be undisclosed, and details in the notes to accounts could be uncommonly vague.[13] Alternatively relevant details about the organization's business activities and the outcome of some might not be disclosed or may be ill-defined. In which case the financial statements and accompanying notes published to inform shareholders and other stakeholders will be imprecise or false. As such the market is misinformed.

Sometimes fallacious accounts and erroneous stories radiate widely throughout business and are not ever discovered. Thankfully many are and the likelihood of discovery into the future increases, as awareness of FSF and unacceptance of its outcomes across communities increase. Progressively investors, regulators, and others realise the adverse social and economic outcomes of fraud and FSF to local, national, and international communities. Those interested seek further data, information, and explanation to enable their education and vigilance. To identify how best to combat the problem necessitates a heightened attentiveness to detail, awareness, and continued investigation. Evidence shows that experienced, well-educated, knowledgeable professionals and regulators and business participants generally can be deceived, and sometimes for a long time.[14]

Instinctively a business organization in an apparent healthy financial condition is unlikely to be questioned. It is most likely to enjoy a stable reputation, continuing business operations, and, if a listed company, a healthy market capitalization position. On the other hand, a business that is seen to be floundering financially is likely to be pursued by its creditors, experience diminishing support from its financiers, and observed with increasing caution by other investors. In which case, the management team or part thereof might be tempted to do something to augment the organization's published financial story. Given the incentive some managers may easily rationalise a necessity to fiddle the figures to help the financially challenged business to look good—even if it is for a short while.

The motivation to commit such fraud may stem for example from personal greed, coercion from others, or a misguided attempt to maintain the business' status.[15] In a bizarre form of perceived altruism, the focus may be to retain the reputation of the company, to sustain employment opportunities for staff, and to maintain or grow financial returns to and for shareholders. On the other hand, the latter may also constitute an element of personal greed whereby the perpetrators, through shareholdings, options, or the like, secure a financial reward and also retain their employment, reputation, and status.

Many cases of unexpected corporate collapse and fraudulent endeavour[16] indicate the necessity for further research into the constructs that underpin FSF. The reasons why perpetrators embark on the journey are at times exposed.[17] In other cases the actual reasons may not ever be known. Perceptions of why perpetrators commit FSF warrant further research but that is beyond the scope of this book. Herein we explore and analyse critically, elements of financial accounting that may contribute to FSF. In this vein we investigate how best to mitigate opportunities for FSF to persist into the future.[18] In that context we examine a particular construct sometimes utilized by business that facilitates asset transfers and off-balance sheet liabilities.

This activity is known as the phoenix phenomenon. Otherwise it is deciphered as a complex area of re-structuring companies under the guise of a phoenix. Interestingly it is a type of business reconstruction that can be legal or illegal. It is an area that is, in part, explained but it is not well defined in accounting or the law. It is also an area that is rife for fraud. Hence a major contribution of this work to the deliberations of FSF has regard for phoenix activity. This particular spectacle of business is explained and analysed with supporting case examples in chapter six.

ELEMENTS OF FRAUD IN FINANCIAL STATEMENTS

In financial reports there are many components to consider. Each part contains fundamental elements that may seem innocuous, but provide opportunities for fraud. Revenue (sales and revenue recognition), asset misappropriation (valuation, theft), expenses (periodicity, matching, capitalization), liabilities (obligations disclosed or non-disclosed), and inventory (valuation, COGS, units of work in progress, units obsolete) are the common subjects of fraud. They may also be the subject of error. So, to recognize anomalies that may exist in and between such accounts is imperative. A business and its attention to its internal control environment, its governance (culture), and its fraud risk management are crucial in helping to identify, mitigate, and prevent FSF.

Consider the circumstance where inventories of a business' physical assets say, its computers, were inaccurate. It is likely that the recorded details of its computers (stock on hand) would be wrong. Subsequently, details of the number of computers held and the total financials of all its assets as recorded would be incorrect. In which case, the internal controls and the accounting systems might well be considered lacking. In addition there may be inadequate supervision of staff or a scarcity of fraud-related training programs for employees. Furthermore there may not be an effective code of conduct documented, communicated, emphasized, and expected throughout the organization. In effect the employees responsible for accurate record-keeping might be inept. Alternatively they may be incompetent or lazy, or both; or there might be an absolute intent to mislead that indicates fraud. To differentiate is essential.

Irregularities in the accounts are anomalies.[19] Accounting anomalies can arise when, for instance, details on invoices, claims forms, despatch dockets, and such are incorrectly recorded. If so, the anomaly results in incorrect entries in journals, ledgers, and ultimately incorrect details in the financial reports. This can be of detriment to the business. The accounting anomaly, however, may be fraudulent; or it might be a mistake. The organization, for instance, might have a computer malfunction in terms of incorrect reporting due to incorrect data input and/or an accounting software problem. Within the system there may be missing documents or payments made on duplicate invoices. The latter again may indicate fraud, or incompetence, as well as a lack of internal control. Anomalies in an organization's financial statements diminish the quality of the financial details and as such they do misinform. To the extent that the misinformation is considered material may decide the extent to which the event is investigated. As fraud necessitates intent to deceive, if there is no such intent, there is no fraud.

Analytical anomalies refer basically to unusual relationships between accounts, or strangeness in events. For instance, if the relationship (connection) between relevant accounts (e.g. sales, revenue, inventory, cost of goods sold) does not make sense, given a certain set of transactions, this indicates that something is likely wrong. Any situation that appears out of the usual—too odd, too abnormal, unbelievable (an extreme departure from common sense)—is questionable. Examples of questionable anomalies include a somewhat inexplicable number of items missing from inventory, apparent excess purchases when sales are declining, and seemingly excessive expenses in an accounting period.[20]

A Critical View of Financials

FSF is intended to misinform. Accounting and analytical anomalies, although odd, may signal the possibility of fraud but may not be indicative of actual fraud. In that context, specific elements of financial statements are significant, and the manner in which financial statements are compiled matters. The way essentials within the financial statements are treated in the recording process is of concern. Partly because the suite of published financial statements of an entity's financial condition contains a conglomeration of pecuniary interests across time.[21] Gul et al. (1991, p. 532) further explained:

> [T]he financial statements . . . [are a] mixture of recorded facts such as cash at bank; accounting conventions such as use of the lower of cost or net realisable value rule for inventory valuation; postulates such as the going concern postulate . . . and personal judgements applied to estimate the provision for doubtful debts or select the method used in calculating depreciation of fixed assets.

Choices available in interpreting accounting standards also challenge management. In the case of the HIH group: 'misinterpretation of the [accounting] standards . . . [in part] allowed HIH to publish financial statements that did not truly or fairly represent the financial position or performance of the HIH group' (Justice Owen, HIH Final Report, 2003, p. 4, s. 7). In that context, conventional financial statements of account are in all probability questionable.

To illustrate further, consider the capitalization of expenses. Where, for instance, a sizeable expense incurred in a current period may arguably add value to the business by generating revenue across future accounting periods, and so the expense is capitalized. It is then called an asset, and the cost is spread across a designated number of future accounting periods. The number of accounting periods may well be wisely chosen based on past experience but, it is still problematic. This is not least because the future is unknown and so the reported revenue that may be generated from, or matched to, this "asset" is at best an estimate. The result sometimes is an inaccurate guesstimate or, with intent to de-fraud, an absolute nonsense.

On the other hand, in the case of the Burns Philp Group, who arguably rightly capitalized restructuring and rationalization costs and slotting fee expenses, soon found that decision to be destructive to their business. The procedures revealed 'reduced reported costs at a time when the Group's business expenses were actually rising' (Margret, 2012, p. 136).[22] Other wrongly applied instances arose in the circumstances of 'WorldCom's capitalisation of [its] operating expenditures, [and] Waste Management's lengthening of its truck fleet's assets' lives to decrease amortisation charges, [plus] Enron's and Xerox's front-end loading of revenues . . .' (Clarke et al., 2003, p. 329).

Recognition and measurement concepts that underpin financial statement content evidently require considered thought in application; and even then can be wrong. Generally accepted accounting practices can, and arguably do, exacerbate doubtful decisions and habitual behaviour of management in financial reporting. 'Traditionally financial reporting has not reported explicitly the risks and uncertainties associated with an entity's activities and financial position' (Loftus and Miller, 2000, p. 41). Yet, arguably, management are in a position to do better. They are in a position of trust, accountability, and responsibility and have a duty to exercise good business judgement. On that basis management 'must exercise their judgement responsibly; and this includes being able to provide an account not only of *what* they have decided, but *why*. This can be incorporated into reporting systems and systems of accountability' (Cohen and Grace, 2001, p. 118, emphasis in original).

Qualitative characteristics within accounting recognition and measurement concepts demand such attention. Importantly, the characteristics of relevance and reliability are given equal billing. Yet relevance is thwarted frequently in financial accounting; disregarded in favour of reliability. Kranacher et al. (2011, p. 413) explained: 'Relevance implies that certain information will make a difference in arriving at a decision [arguably important]. Reliability . . . means that the user can depend on the factual accuracy of the information.' Yet the factual accuracy as recorded on an invoice for instance may be incorrectly recorded, or made up—hence, completely wrong. In financial accounting we disregard (at times) that which may be relevant in favour of that which is considered reliable. Mainly because the former is likely subjective and the latter is verifiable by document. In the challenge to mitigate and prevent FSF both relevant and reliable characteristics of all data, financial and otherwise are vital. In forensic solutions to FSF this must be acknowledged.

To commit FSF seemingly requires knowledge, influence, and/or a position of power. Thus, individuals who hold positions of authority at senior levels of an organization are reasonably the most likely to commit or to be involved in the fraud. Possibly because they have the clout, the opportunity, the reason, and debatably they have the expertise to do so.

MISMANAGEMENT AS OPPOSED TO FRAUD

In numerous cases of unexpected corporate collapse, management and their mismanagement of a business organization's resources have been blamed for business failure.[23] Recall, business failure does not denote fraudulent behaviour necessarily; however, it does not wipe out the possibility. In the case of HIH (2001) a Royal Commission (HIHRC) into the company's collapse found mismanagement to be of particular concern. It is noteworthy that senior executives of HIH were charged, convicted, and sentenced to jail with regard to certain management decisions and subsequent actions taken. It was then stated: 'The charges relate to a series of transactions where the true financial position of HIH was hidden from HIH shareholders and the regulators for many years.'[24] The use of the word *hidden* implies intent to deceive. The latter may signal fraud but it does not prove fraud was evident. Circumstances of this case are examined later in this book.

Mismanagement and fraudulent behaviour are different, but there are dilemmas within the context of the two that may cross boundaries. Management and business stakeholders ought to be aware. Management are given many choices within international financial accounting standards in which to portray the financial state of the business they manage and its operational outcomes. Areas within the conceptual framework for financial reporting provide additional licence with regard, for instance, decisions on materiality, accounting procedures for industry-specific practice, and matters of conservatism. Management rightly needs flexibility in operating business and reporting on financial outcomes of those business activities. Therein, however, lay the opportunity for fraud. Consider Clarke et al. (2003, p. 327): 'evidence before [the HIHRC] and the ASIC investigation into One.Tel has revealed the flimsy foundation of many accounting practices . . . the ease with which the myriad Standards and rules of accounting practice are circumvented.'

When addressing mismanagement as opposed to fraud many emotive issues are likely to arise for stakeholders. One example in the case of a claims' corporate detailed that apparent: '"Management failings" were responsible for "facilitating" $57 million in fraud perpetrated against the Conference of Material Claims Against Germany over 16 years.'[25] The relevant ombudsman considered cultural problems with organizational behaviour were amongst the reported failings of management and the directors. Of course not all agreed. Lack of diligence in pursuing investigation and lack of appropriate controls appeared to be of much concern. Various officials including directors were targeted as lacking in attentiveness. A key point here is that mismanagement might be considered fraud. The circumstances of each case again are evidently and directly relevant in deciding the outcome. Further, they must be considered in the context of the prevailing conditions surrounding the case.

THE AIM OF THE STUDY

The aim of this study is to examine fundamentals of accounting and financial accounting constructs that recur in circumstances of FSF. Further, to explore the context in which elements of financial accounting and its procedures enable FSF. In analysis, accounting dilemmas for directors and managers are revealed. One such dilemma has regard for business reconstructions in the face of financial distress; in particular with regard to phoenix activity. Hence, linkage between management concerns, financial accounting choices, and fraudulent behaviour are examined. The likelihood of such connections warrant scrutiny as the resulting actions may lead to error, mismanagement, or fraud.

The objective is to bring attention to and develop practical solutions to continue to mitigate opportunities for FSF occurring into the future. This is important as the ever-increasing occurrences of FSF globally result in escalating financial loss, and heightened criticism of management, senior executives, and directors.

Principally, this work aims to reconsider financial accounting and forensic accounting solutions to the problem of fraud in financial statements. It demonstrates through case analyses that conventional and publicly available financial accounting statements are easily flawed. Without clarity, continued debate, and informed change it is unlikely that instances of FSF will diminish.

To Elucidate

In financial accounting, generally accepted procedures are sometimes of concern due to ambiguities perceived to be inherent in the financial accounting standards, which are backed by the law. West (2003, p. 2) explained: 'financial statements can only provide *representations* of the phenomena . . . The serviceability of these statements will be dependent on the extent to which they depict accurately the phenomena they purport to represent' (emphasis in original).

With regard to business failures and unexpected corporate collapses, Clarke and Dean (2007, p. 211) argued: 'Whereas most of those failures over many decades have entailed some devious behaviour, for the most part their accounting complied generally with the Standards . . . At the margin there is likely to be deviation. This is especially so as foozles [bungles] become frauds.'

This notion that there are problems inherent in conventional financial statements is not new. Previous studies have explored defects in traditional financial statements with regard to accounting fundamentals and quality (serviceability) of the content.[26] The following is a brief account through the literature.

An Historical View

Some thirty years ago Martin (1984, p. 392) asserted 'the balance sheet is not additive because it contains amounts representing different properties of the assets'; he further explained 'to add a current market value to a written down historic cost, a market value prevailing two years ago and a current market value . . . must be misleading for analytical purposes.' Vickrey (1970, p. 738) stated 'the logic and usefulness of measurements depend on the additivity of extensive properties . . . [and] all accounting calculations depend ultimately on addition'. The inference was that the business entity's financial condition as depicted in the financial statements may be in error. Currently, historical cost accounting methods are still used and, with regard to the rules of arithmetic, unlike items in the financial reports are still added. Hence in analysis of a business and its financial state the content of published financial statements warrant careful and continued scrutiny.

It seems reasonable to assert that directors, executives, managers, and all business stakeholders would want current details and clarity in reported