FRAUDULENT FINANCIAL REPORTING IMPACT ON THE STAKEHOLDERS

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Abstract: Accounting is the language of business using which its performance and financial status are communicated to the outside world. Financial statements are to be prepared by both private as well as public sector undertakings irrespective of their size and operations, according to the provisions of the company act. Financial statements are supposed to provide a true and fair view of the financial transactions that take place in an organisation. The reports are said to be true if they are prepared according to International Financial Reporting Standards (IFRS) that were issued by International Accounting Standard Board. A true report is free from errors, misstatements, omissions of transactions and other mistakes that effect the authenticity of financial statements. Fair indicates the unbiased record keeping practices that are followed in the organisations. Accounting concepts and conventions that come under Accounting Principles guide the accountant in preparing financial statements in a systematic and scientific manner which are universally accepted. The organisations which are supposed to project a true and fair view of financial reports are sometimes indulged in fraudulent financial reporting that is misleading the stakeholders of the respective organisations. The stakeholders include potential investors, creditors, suppliers, banking and financial institutions, government, income tax department etc. Financial frauds take many forms like asset misappropriation, fraudulent statements or corruption. These sort of fraudulent practices may arise due to large number of cash transactions, poor documentation, poor internal control, inadequate recruitment process and so on. In order to check these practices anti-fraud strategies like prevention, detection and deterrence are to be adopted. An attempt is made to identify the areas where there is a scope for fraudulent reporting and how to identify the methods to detect and control them.

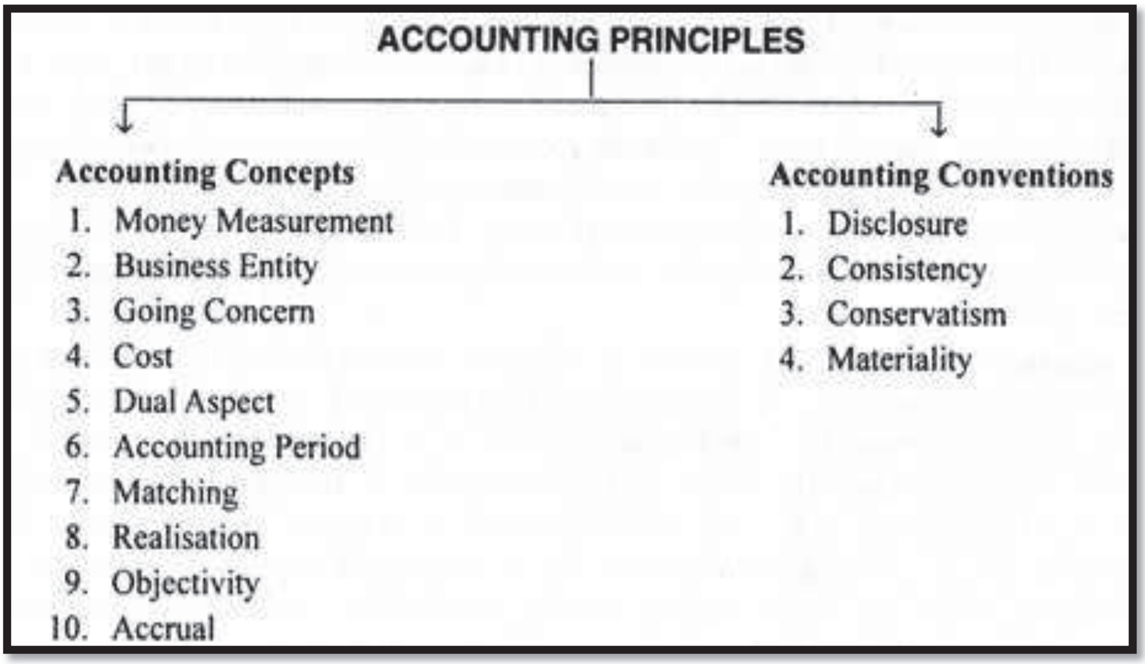
Key Words: Financial reports, IFRS, Fraudulent reporting, Accounting statements, Misappropriation

Introduction: Adverse Effects Of Misleading Financial Reports: Accounting is the language of business using which its performance and financial status are communicated to the outside world. Financial statements are to be prepared by both private as well as public sector undertakings irrespective of their size and operations, according to the provisions of the company act. The records thus maintained are to be cross checked by an auditor. The main aim of financial statements is to provide a true and fair view of organisation's financial affairs to all its stake holders. The financial reports are often reviewed and analysed by the board of directors, financial analysts, managers, government agencies, investors and others. The companies have to disclose the details of their financial statements at the Annual General Meeting (AGM) and also attach a copy to the Companies Registration Office (CRO). The Financial statements include

- Balance sheet
- Income statement / Profit & Loss Statement
- Cash flow statement and
- Statement of changes in equity

In preparation of these financial statements, certain standards are to be maintained by the organisations to have universal acceptability. The accounting standards that are followed universally are named as Generally Accepted Accounting Principles (GAAP) which include the accounting concepts and conventions that accountants follow in recording, classifying, summarising, analysing and interpreting the financial information. Many countries follow International Financial Reporting Standards (IFRS) that were established by the International Accounting Standards Board (IASB) so that the statutory reports can be compared internationally by the Multinational Corporations and other globalised business units.

The Accounting standards include certain accounting concepts and conventions. Accounting conventions are those customs or traditions which guide the accountant while preparing the accounting statements. Accounting concepts are those basic assumptions or conditions upon which accounting is based upon.



Objectives of the study:

1. To identify the areas where the accounting principles can be violated or misused
2. To identify the companies that have violated the accounting principles and the consequences of such violation
3. To suggest some precautions to prevent fraudulent financial reporting.

Methodology: The data required is collected through secondary sources. Information is gathered from various websites to gather the necessary data. Case studies of some organisations that have adopted the fraudulent reporting were studied and presented in the paper.

Glance at Accounting Principles and possibilities of fraudulent financial reporting:

a. Business Entity concept explains that an organisation have two separate entities for accounting purposes which include the business and its owners. The business is identified by the common seal it has and which is attested by its owners. The main significance of this concept is that the true profit of the concern is to be revealed to the stakeholders of the business without including the personal assets or liabilities. The concept restrain accountants from recording of owner's personal transactions.

b. Money Measurement concept assumes that only financial transactions are to be recorded in the books of accounts and there is no scope for recording non-monetary transactions. This concept guides the accountants as to what to be recorded and what need to be ignored. It helps in maintaining uniformity in business transactions and can also be understood by the accountants and the stakeholders of the business. It also helps in comparison of accounting statements of various time periods and take correct and timely decisions.

c. Going Concern concept assumes that the organisation will run for a fairly longer period and for that reason all the books of accounts are to be maintained in proper manner in order to compare the results with the previous with that of preceding years and there by facilitate easy comparison by the owners. This is an important assumption of accounting , as it provides basis for showing the value of the assets in the balance sheet. On the basis of this concept, depreciation is calculated on the fixed assets. In the absence of this concept, the cost of the asset will be treated as an expense in the year of purchase. A business is judged by the future profit earning capacity of the business in most of the cases.

d. Cost concept states that the assets are to be recorded with the value that is paid to acquire that asset and not the market value. The purchase price of an asset includes cost of acquisition, transportation and installation and not its market price. The cost concept in accounting is also called as historical cost concept. For every asset that is acquired, the supporting documents must be produced at the time of auditing. This concept also helps in calculation deprecation on the fixed assets. If an asset is acquired without paying anything it should not be shown in the books of accounts.

e. Dual Aspect concept stands as the basis of accounting. The monetary transactions of the business are recorded according to this concept. For every transaction, two effects must be shown. One debit effect and one credit effect. In order to divide a transaction into a debit and credit, all the accounts are classified under three heads namely, personal account, real account and nominal account. This concept helps the accountant to detect errors in recording. Here, the total value of the assets should be equal to the sum of outside liabilities and the owners' equity. The dual aspect concept is commonly expressed as:

Assets = Liabilities + Capital

f. **Realisation Concept** states that the revenues should be recorded in the books of accounts only after realising the amount. Realisation refers to the legal right to receive money. An agreement to sell do not create a realisation right where as actual sales creates right to receive money. Thus, the goods or services when purchased on cash or credit, the amount can be realised legally. It also refers to inflow of assets in the form of receivables. This concept creates the objective of the accounting information clear.

g. **Accrual Concept** means that the revenues or expenses are to be recorded in the books of accounts when they are actually due and not when they are actually received. Thus, this concept clearly distinguishes between actual receipt or payment and right to receive cash or obligation to pay cash for respective expense. It helps in identifying actual expenses and incomes during a particular accounting period which inturn helps in calculating the actual profit or loss of the business for that period and helps owners and management take correct and timely decisions.

h. **Matching Concept** guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period. It helps in calculating accurate profit or loss during a particular accounting period. The revenues and the expenses to earn the revenues should be recorded in the same accounting period.

Accountingconcepts may be violated by treating company's assets as their own which leads to misuse of funds by the owners and that may lead to bankruptcy of the organisation in the long run. The expenses incurred by the company may sometimes be treated as business expenditure or vice versa. The ultimate effect of such bankruptcy is on the stake holders of the company mainly investors, creditors and shareholders.Financial frauds stands as a key issue in the corporate sector. Out of every ten companies, at least three of them have been targeted to fraudulent accounting practices. Despite of this condition many companies fail to review their fraud prevention process. Nearly 36% of the financial profession have not reviewed their processes during the previous year and 18% of the professionals have never reviewed their processes of fraud prevention. Frauds are inevitable and treated as occupational hazards. But the costs of such frauds are very devastating and all the stakeholders of the organisation become victims of them. so it is inevitable to create a fraud management mechanism in every organisation to reduce the implications of the financial frauds.

Fraudulent Financial reporting types: The financial frauds can be broadly categorised into

- Fraudulent Financial Reporting
- Misappropriation of Assets
- Revenue and Assets obtained by fraud
- Expenditure and liabilities for an improper purpose

Fraudulent Financial Reporting: Fraudulent financial reporting schemes include earnings management which is defined by Securities and Exchange Commission(SEC) as the use of gimmicks to distort a company's true financial performance in order to achieve a desired result. Categorised Earning management can be of two ways. They are:

Techniques permissible under GAAP – Called "The Grey Zone"

- Changing method of depreciation
- Changing useful life or the estimated salvage value of the asset
- Determining the temporariness or permanency of the market value of an investment
- Estimating the write downs required for the investment
- Determining the actual life of the asset to be written off

- Techniques not permissible by GAAP
- Big bath charges
- Cookie Jar liability charges
- Revenue recognition irregularities
- Recording intentional misstatements in the financial statements

Misappropriation of Assets: The most common type of fraud that is often committed in the organisations is misappropriation of assets. Within this, misappropriation of cash is seen in most of the cases. Various methods in which assets can be misappropriated include:

- **Misappropriation of cash**
- Skimming and larceny of cash
- Understating or not recording full or partial amount of sales or receivables
- Fraudulent disbursements
- Billing Schemes
- Creation of fictitious vendors or use of shell companies
- False credits, refunds, rebates and kickbacks
- Over billing
- Pay and return scheme
- Theft of company checks
- Payroll Schemes
- Payments to fictitious employees
- Falsified working hours

- Expense reimbursement schemes
- Check theft and tampering of checks
- Register disbursement schemes

Misappropriation of inventory

- Conversion of inventory
- False write offs and other debits to inventory
- False sales of inventory

Revenue and Assets Obtained by Fraud: Revenue misappropriation is the other side of asset misappropriation. Financial statement auditors consider these types of frauds to be beyond their scope because the financial audit does not inquire to the quality of the operations even though they highly influence the investor's interests. These types of fraud are to be checked while conducting internal audit and operational audits.

Expenditure and liabilities for an improper purpose: The expenses that are spent by the organisation for illegal or unauthorised purposes comes under this head. They include bribery of government official or committing to pay some some future expense of the same government official etc. The financial auditors considers these sort of frauds are not under their purview.

Examples of Companies that were involved in violation of Accounting Principles:

- The executives of **Adelphia Communications** misappropriated the firm's assets for personal use which is against the business entity concept. Nearly $2.3 Billion dollars of loans were acquired by them to fulfil the personal commitments of them and their family members and finally its effect is on the financial stability of the company. The company became bankrupt in January 2002.
- **American International Group Inc. (AIG)** steered clients into expensive mutual funds. AIG is a multinational insurance corporation which indulged in massive accounting fraud who involved in bid rigging and stock price manipulation. It is a case of violating business entity concept.
- **Waste Management company** has increased the time length of the depreciation. Under GAAP, depreciation is to be provided on the tangible capital assets after deducting the salvage value of those assets over the estimated useful life of the assets. The company showed unsupported charges to the estimated useful lives of assets which included vehicles, container, equipment and landfills.
- **AOL – PurchasePro**artificially inflated revenue through secret side deals, back-dated contracts and revenue swaps. Six individuals were accused who include four former executives of purchase pro and two former executives of America Online Inc.
- **Enron,** the world's biggest financial scam ever recorded became bankrupt affecting the lives of thousands of employees and shook Wall street to its core. Such a powerful business named as best innovative company y disintegrated almost overnight and fooled the regulators with fake, off-books corporations for so long. It overstated income by intentionally understating liabilities and concealing deblat through creation of balance sheet entities.
- **Cendant Corp** after merging with HFC revealed that the revenues of the former company were overstated by using assorted techniques such as recording fictitious revenues and understating liabilities. As a result the former CEO, VP and controller pled guilty to numerous other charges.
- **Xerox** overstated revenue for over four years by accelerating the revenue on its office copier leases too early in their cycles. SEC sued three current KPEG partners and former partner of the securities fraud in the claiming the firm fraudulently let th company manipulate its accounting practices to fill the gap and make it appear to be meeting the market requirements.
- **Satyam computer's** CEO RamalingaRaju admitted to overstate the company's cash reserves. The investigation says that the assets of the company are not inflated but they were instead siphoned off by RamalingaRaju. He is charged under the cases of fraud, forgery, cheating, embezzlement and insider trading.

Cost of the financial fraud: Fraud is the greatest business cost and the significance of such cost is felt with its size and quantum. In the present day scenario, it is very important to find possible solutions to reduce the financial reporting frauds to the maximum extent. Otherwise the cost of such frauds become unbearable to the organisation which effect all its stakeholders directly or indirectly. It is the biggest challenge that the corporates are facing at this juncture.

- In any organisation at least 3 % to 6% of the financial transactions turn to be fraudulent and in some cases it may be more than 10%.
- Any typical organisation loses 5% of revenues each year to fraud.
- Occupational frauds account for a greater share in the total financial fraud loss.
- Occupational frauds can be classified into three categories namely,
- Asset misappropriation
- Corruption and
- Financial statement fraud
- 85% of the financial frauds occur due to asset misappropriation but the losses from such fraud are very minimal or not severe.

- In contrast, only 9% of the cases are involved in financial statement fraud but they account for heavy or unbearable losses.
- Corruption schemes fell in the middle of asset misappropriation and financial statement frauds.
- Most of the cases involve more than one category of occupational losses.
- Most of the times frauds will be commited by the individuals working in the organisation or working for the organisation.

Suggestions:

1. The companies have to establish a good fraud management mechanism to prevent the fraud or to detect the frauds at an early stage so that the financial losses to the companies may be minimised or nullified.
2. The employees of the organisation should not be kept in the same post or place of work for the longer periods. Job rotation strategies may be adopted to minimise corruption and other types of frauds.
3. A good internal audit mechanism helps in detecting the frauds at an early stage so that the financial losses may be minimised.
4. Operational audits can be taken up to review the effectiveness, efficiency and economy of operation. It helps in identifying the risks faced by the organisation and has an opportunity to improve controls.
5. The external auditor should also try to obtain sufficient and appropriate audit evidence to be able to draw reasonable conclusions using which audit evidence is provided.
6. Sudden checks have to be planned by the management to keep the staff alert and updated.
7. The audit unit should be established separately and proper vigilance and guidance is to be provided to them in order to check the frauds at an early stage.
8. The staff, management and the executive officers of the organisation have to work for the common good of all the stake holders of the organisation and should follow moral and ethical values while carrying on the business operations.

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