CHAPTER 3
FINANCIAL STATEMENT FRAUD: CAUSES AND CONSEQUENCES

3.1 Introduction

3.2 Definition of Fraud

3.3 Classification of Fraud

3.4 Financial Statement Fraud

3.5 Causes of Financial Statement Fraud

3.5.1 The Fraud Triangle

3.5.2 Reasons behind Fraudulent Financial Reporting

3.5.3 Methods of producing Fraudulent Financial Statements

3.6 Consequences of Financial Statement Fraud

3.7 Flowchart of Financial Statement Fraud

3.8 Summary

3.1 INTRODUCTION

In the present age of scams, 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 chapter explain the
causes, methods and consequences of financial statement fraud. In order to understand the concept, Section 3.2 defines fraud. Section 3.3 explains different classification of fraud. Section 3.4 introduces the concept of financial statement fraud. Section 3.5 elaborates the causes of financial statement fraud by explaining fraud triangle. This section also explains the reasons behind financial statement fraud, followed by the tricks used by the management for achieving their aim of fraudulent financial reporting. Section 3.6 explores the consequences of fraudulent financial reporting. Section 3.7 elucidates the flowchart for producing fraudulent financial statements followed by summary of the chapter under Section 3.8.

### 3.2 DEFINITION OF FRAUD

Fraud encompasses an array of irregularities and illegal acts characterized by intentional deception. Webster’s New World Dictionary defined fraud as “The intentional deception to cause a person to give up property or some lawful right”. 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”.

Fraud is defined in many scholars and dictionaries. [Singleton06] defines fraud as: “intentional deception, lying, and cheating are the opposites of truth, fairness, and equity. Fraud consists of coercing people to act against their own best interests”. [Hopwood09] opines: “Fraud (false pretence) involves intentional and material misrepresentation of one or more material facts with the intent of taking of property from a victim. American heritage dictionary (second college edition) defined fraud as “a deception deliberately practiced in order to secure unfair or unlawful gain. 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”.

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.

[Davia00] identified a number of items that must be identified, when articulating a case of fraud:
CHAPTER – 3
FINANCIAL STATEMENT FRAUD: CAUSES & CONSEQUENCES

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 behaviour 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

3.3 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 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 (Figure 3.1). [Bologna95] classifies fraud on the basis of relationship of the perpetrator 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 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.

Figure 3.1: Classification of Fraud
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.

[Davia00] 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. [Bologna95] 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 [Jans09].

![Fraud Classification Overview](image-url)
A last distinction [Bologna95] 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. Figure 3.2 represents an overview of the different classifications and their relations to each other, hereby making some assumptions.

Different types of frauds along with different perpetrators and victims have been given below as Table 3.1 [Shukla12].

<table>
<thead>
<tr>
<th>Type of Fraud</th>
<th>Perpetrator</th>
<th>Victim</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee</td>
<td>Employee</td>
<td>Employers</td>
<td>Employees directly or indirectly steals from Employers</td>
</tr>
<tr>
<td>Embezzlement or</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Occupational Fraud</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management Fraud</td>
<td>Top Management</td>
<td>Stockholders, lenders and other who rely on financial statements</td>
<td>Top management provides misrepresentation, usually in financial information</td>
</tr>
<tr>
<td>Investment Scams</td>
<td>Individuals</td>
<td>Investors</td>
<td>Individuals tricks investors into putting money into fraudulent investments</td>
</tr>
<tr>
<td>Vendor Fraud</td>
<td>Organisations or individuals that sells goods or services</td>
<td>Organisations that buy goods or services</td>
<td>Organisations overcharge for goods or services or no shipment of goods, even though payment is made</td>
</tr>
<tr>
<td>Customer Fraud</td>
<td>Customers</td>
<td>Organisations that sells goods or services</td>
<td>Customers deceive sellers into giving customers something they should not having or charging them less than they should</td>
</tr>
</tbody>
</table>
3.4 FINANCIAL STATEMENT FRAUD

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 [Razaei10]:

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.

3.5 CAUSES OF FINANCIAL STATEMENT FRAUD

The management of an organisation may use financial statement fraud as a strategic tool in spite of the corporate governance or environmental pressure because of its own characteristics in terms of loyalty, aggressiveness, control ineffectiveness and lack of moral principles. These characteristics are explained below in terms of fraud triangle.

3.5.1 FRAUD TRIANGLE

Financial statement fraud is a deliberate, wrongful act committed by the top management of publicly traded companies. Fraud usually includes three characteristics namely, opportunity, attitude or rationalisation, and motive or pressure. These three factors constituted the Fraud Triangle (Figure 3.3) and are present in various forms in the characteristics of a firm that is engaged in fraudulent financial reporting [Cressey86]. The elements are as follows (in no particular order):

a) Opportunity is the circumstances that provide a chance for the management to perform material misstatement in the financial statement. The opportunity that may lead to financial statement fraud may include: weak or non-existent internal control, Absence of proper audit committee, improper oversights by board of directors and complex organizational structure.

b) Rationalisation is the ability to act according to self-perceived moral and ethical values. Fraudsters find a way to rationalize their actions and make it acceptable for themselves. Management can think of financial statement fraud just for being...
in competition with other organisations or to meet the company goals. Top level managers may rationalize their act of fraud by saying that they are trying to protect shareholder by manipulating financial reports to increase the share price.

![Figure 3.3: Fraud Triangle.](image)

c) Motive (incentive) is pressures that management experiences to materially misstate the financial statement. These pressures can be classified as "psychotic" (related to habit), egocentric (related to personal prestige), ideological (believing that the cause is morally superior) or economic (related to a need for money). Management of an organisation usually feel pressured to do fraudulent activity because of a poor cash position, a loss of customers, declining market etc.

### 3.5.2 REASONS BEHIND FRAUDULENT FINANCIAL REPORTING

The upper management of a company may choose to engage in fraudulent financial reporting if:

a) The personal assets or capital of the management is closely associated with the performance of the company in terms of profit sharing.

b) Enough opportunities are present for the management to commit the financial statement fraud.

c) The management is willing to maximize shareholder value for handling some internal or external pressure.

d) Top level executives are ready to take personal risk for corporate benefits.

e) The chances of detection of fraud are negligible.
3.5.3 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 judgement 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 misrepresent or omit certain information in the financial statement to mislead the users of financial statement about the operations of the organisation.

3.6 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. [Rezaee02] gives the following summary of the potential harmful effects of financial statement fraud:

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

3.7 FLOWCHART OF FINANCIAL STATEMENT FRAUD

The primary aim of organisations indulged in fraudulent financial reporting is to overstate their revenue and income, so as to disguise losses and avoid punishment from the regulatory bodies. Such firms boost their revenue by creating fictitious transactions. Overstating revenue would jointly raise account receivables and/or cash (or the other way round), as income is the primary source of shareholders' equity, both income and shareholders' equity can be exaggerated. Sometimes firms choose to understate expenses instead of overstate revenues, as understating expenses would jointly raise cash and/or inventory (or the other way round), the effect is just equivalent. In the view of the above, Figure 3.4 represent the flowchart of financial statement fraud [Belinna08].
3.8 SUMMARY

Financial statement fraud is a serious social and economic problem worldwide and more severe in growing countries. A company listed with any stock exchange is required to publish its financial statements such as balance sheet, income statement, statements of retained earnings and cash flow statements yearly and quarterly. Financial statements of a company reflect its actual financial health by analysing which, stockholders can form a wise decision about investing in the company.

This chapter provides a theoretical concepts and framework of financial statement fraud. Section 3.2 presents the concept of fraud. In order to have better understanding regarding the nature and category of financial statement fraud, Section 3.3 presents a brief overview of classification of fraud. Section 3.4 defines one of the management frauds – financial statement fraud.
Reasons behind fraudulent financial statements are explained along with fraud triangle, which helps in understanding different causes of financial statement fraud, is presented in Section 3.5. This section further explains different recipes of cooking the accounting books generally used by management. Section 3.6 elaborates the consequences of financial statement fraud. The framework of financial statement fraud is presented in section 3.7 as a flow chart for producing fraudulent financial statements. Overall this chapter provides a theoretical platform for understanding financial statement fraud.