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Curbing Occupational and Financial Reporting Fraud: An Alternative Paradigm

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Abstract

The increasing rate and character of occupational fraud and in particular fraudulent financial reporting has continued to attract global attention. This virus appears to be evolving a more complex character and increasingly becoming immune to the global efforts at containing it. Various efforts have been evolved towards addressing this global challenge, especially the celebrated Sarbanes-Oxley Act which came into effect in 2002 in the USA and the extreme legal measures of life imprisonment and the death penalty in some legal jurisdictions around the world for fraudulent activities. All these measures have recorded various degrees of success, but none had been able to contain its mutation and spread. All forms of governments, public and private sector led business institutions, from the very small to the multinational corporations, have not been spared by its scourge, hence the continuous global effort at bridging this gap. Admitted that it is a human phenomenon necessitated by the vagaries of our world, its continuous mutation and spread cannot be allowed to go unchecked. It is against this background that we are proposing an alternative paradigm, not only to the existing financial reporting supply chain, but also at the accounting data capturing and gathering stage, of the accounting information system. This was predicated on a review of the existing frameworks for fraud prevention and control. This current study is proposing a post ante approach to dealing with the incidence of occupational fraud and in particular FFR. This is anchored on the philosophy of preventive maintenance for equipments or preemptive strikes in military warfare which are considered to be much better than the post mortem approaches which might have irreparable consequences as evidenced in several instances.

Key words: curbing, fraud, alternative paradigm, magnitude, fraudulent financial reporting.

1.1 Introduction

The menace of fraud in the corporate world by employees and management is manifested in various forms. Various studies (KPMG, 2003; Deloitte, 2007; Coenen, 2007 and 2008; Hogan et al., 2008; ACFE, 2008) have documented the various typologies of fraud by both employees and management in our corporate world. Of the various dimensions of fraudulent dealings (Ajie and Ezi, 2000; Karwei, 2002; Okafor, 2004 and Adeniji, 2004) by the operatives of our corporate world, there seems to be commonality in opinion that the most destructive typology, with very devastating effects is fraudulent financial reporting. This form which results in monumental damages, as a result of the multiple stake holders (Beasley et al., 1999; Karwai, 2002; Adesola, 2008; Reilly and Koppel 2008; Appah and Appiah, 2010: ACFE, 2010; and COSO, 2010) who rely on this information gateway for various categories of decisions will continue to attract scholarly efforts. The devastating effects of this kind of fraudulent behaviour dot our global market place. The exact impact, both direct and implied, cannot and has not been fully quantified (ACFE 2010; COSO 2010; Defund et al 2007 & Deloitte 2007).

It's devastating effects have led to the current global measures and therefore alternative paradigms (i.e. strengthening of regulatory frameworks, strengthening and harmonizing standards of reporting, prescribing corporate governance structures for public firms, introduction of forensic techniques for fraud investigations, improved sanctions etc) in an attempt at providing a solution to this global malady**,** which is fast destroying the very essence of our market economy-the pride of the capitalists' construct.

But these various alternatives (Hermanson et al 2006) have come with varying degrees of success, but none has succeeded in curbing and taming this wild and cancerous corporate virus necessitating further efforts or possibly a combined therapy. This gap informs the current effort at proposing, not only an alternative paradigm in the current study, but contributing in a modest way to the addressing a common plague, which has continued to undermine our concerted efforts.

1.2 Fraudulent Financial Reporting

Fraudulent Financial Reporting (FFR) is a major form of fraud that has haunted and will continue to characterize the business world. The magnitude and consequences of this type of fraud made the Treadway Commission (the National Commission on Fraudulent Financial Reporting in the United States) to note in 1987 that the damage resulting from fraudulent financial reporting was widespread with a devastating ripple effect. Sufferers ranged from the immediate (shareholders and creditors) to the more remote-investor confidence in stock markets and the credibility of the audit profession (Dechow et al 2007).

FFR is a deliberate misrepresentation of facts with an intent to deceive information users, gain anticipated benefits or cover up inefficiency and, or cover up other frauds such as asset misappropriation and corrupt schemes. It is the deliberate misstatement of numbers by either booking false accounting entries or deliberately misapplying accounting rules (ACFE 2010; COSO 2010; Coenen, 2007 and Garet & Lehn 1997). For instance, as noted by Healy (1985) managers manipulate earnings to gain bonus payouts. In particular, if year-to-date performance will exceed that required to achieve the bonus cap, managers will withhold effort and will attempt to inventorize earnings for use in a subsequent year. Similarly, if expected performance is far below the incentive zone, managers will again discount the bonus opportunity, especially near the end of the year when achieving the threshold performance level seems very unlikely. When expected performance is moderately below the incentive zone, the discontinuity in bonus payments at threshold yields strong incentives to achieve the performance threshold through counterproductive earnings manipulation. Later studies by Gaver, Gaver and Austin (1995) and Holthausen, Lacker and Sloan (1995) did confirm that managers manipulate earnings downward when the bonus cap is exceeded, but actually, manipulate earnings upwards when below the performance bonus threshold. When executives are rewarded for their work with cheap shares of stock that will likely reap them lots of profits down the road, it is more likely that the company will have faulty financial statements (Coenen, 2008; Erickson et al 2003; Beneish 1999 & Dechow et al 1995, 1996).

The Treadway Commission stated further that a major obstacle to addressing the problem of financial statement fraud promptly is related to the difficulty of identifying the fraud soon after its occurrence. Because it is often a management fraud, it is well hidden from auditors, investors and other stakeholders and it is usually only discovered by chance or once the company is in financial difficulty (Baucus & Near 1991; Gao & Srivastara 2008), which may result in a takeover or insolvency. Fraudulent financial reporting in the United State has cost investors more than $100 billion between 1999 and 2001 (Rezaee, 2002 & Cotter and Young 2007). Rezaee (2002) also documented that the Association of Certified Fraud Examiners, in its 2002 report to the USA on Occupational Fraud and Abuse, estimates that about 6 percent of revenues, or $600 billion will be lost in that year as a result of occupational fraud and abuse. This report also indicated that financial statement fraud is the most costly of occupational fraud, with median losses of $4.25 million per scheme. These are staggering realities of a system with available records. Our case in Nigeria has not been documented but as a very corrupt country in the transparency rating, the impact of fraudulent financial reporting if documented will be frightening. Recent developments in the banking and other industries in Nigeria have shown that executive manipulation of earnings' report is a common place event. This unfortunately is the global trend.

But in 2007, due to corrective measures taken by the USA which was necessitated by the collateral damages caused by the collapse of Enron and WorldCom (which filed for the biggest bankruptcy in US corporate history on July 21, 2002), Coenen (2007) reported a decline in the estimated median cost of each fraudulent financial statement scheme from $4.25 million to $2 million per scheme. FFR is the most expensive type of fraud perpetrated by an employee. This type of fraud is generally perpetrated by upper management, as they are typically the employees with the access and the influence to manipulate financial statements. Although, it occur the least often, however, upper management usually has the most to gain from financial statement fraud, through increased performance stock options and to lucrative job promotions (Coenen, 2007; Finkelstein & Hambrick 1996 and Healy 1985).

1.2.2 Magnitude of the incidence of fraud

There is a consensus of opinion in the literature that the magnitude of fraud cannot and has not been adequately captured. Most instances of fraud go undetected and most are not reported. But in an attempt at capturing the magnitude of the incidence of based on the US Economy, the Center for Audit Quality (CAQ) in its 2010 report observed that over the past few decades, multiple headline-grabbing cases of financial reporting fraud at public companies have rocked the capital markets. These frauds have had a negative impact on the capital markets and eroded the trust of the investing public. Financial reporting fraud can also have a devastating impact on a company's reputation, to the point of jeopardizing its existence. The corporate scandals of the late 1990s and early 2000s resulted in major losses for investors and a precipitous decline in investor confidence in the U.S. capital markets. Although it is generally accepted that the Sarbanes-Oxley Act (which was enacted in 2002) has improved corporate governance and decreased the incidence of fraud, recent studies and surveys indicate that investors and management continue to have concerns about financial statement fraud (Center for Audit Quality, 2010). The report of the Center for Audit Quality 2010 indicated that:

- The Association of Certified Fraud Examiners' (ACFE) 2010 Report to the Nations on Occupational Fraud and Abuse found that financial statement fraud, while representing less than five percent of the cases of fraud in its report, was by far the most costly, with a median loss of $1.7 million per incident.
- Fraudulent Financial Reporting: 1998–2007 from the Committee of Sponsoring Organizations of the Treadway Commission (the 2010 COSO Fraud Report), analyzed 347 frauds investigated by the U.S. Securities and Exchange Commission (SEC) from 1998 to 2007 and found that the median dollar amount of each instance of fraud had increased three times from the level in a similar 1999 study, from a median of $4.1 million in the 1999 study to $12 million. In addition, the median size of the company involved in fraudulent financial reporting increased approximately six-fold, from $16 million to $93 million in total assets and from $13 million to $72 million in revenues.
- A 2009 KPMG survey of 204 executives of U.S. companies with annual revenues of $250 million or more found that 65 percent of the respondents considered fraud to be a significant risk to their organizations in the next year, and more than one-third of those identified financial reporting fraud as one of the highest risks.
- Fifty-six percent of the approximately 2,100 business professionals surveyed during a Deloitte Forensic Center webcast about reducing fraud risk predicted that more financial statement fraud would be uncovered in 2010 and 2011 as compared to the previous three years. Almost half of those surveyed (46 percent) pointed to the recession as the reason for this increase.

In a related development, the Association of Certified Fraud Examiners (ACFE) reported in 2008 from the examination 959 cases of occupational fraud and abuse (between January 2006 and February 2008) found out that fraud is extremely costly, especially to smaller organizations. The median fraud loss is $175 thousand, and more than 25 percent of the frauds involve losses exceeding $1 million. Surveys are regularly carried out to estimate the true scale and cost of fraud to business and society. While findings vary and it is difficult to ascertain the full extent of fraud, all the surveys indicated that fraud is prevalent within organizations and remains a serious and costly problem. Fraud may even be increasing due to greater globalization, more competitive markets, rapid developments in technology and periods of economic difficulty (CAQ, 2010, and Adesola, 2008).

Furthermore Carcello and Hermanson, (2008) presented in their study that the Deloitte's Forensic Center recently completed an analysis of SEC AAERs from 2000 to 2006. The final sample included 344 individual AAERs involving FFR. Deloitte found that a single AAER often alleges multiple fraud schemes.

The main fraud schemes identified are: (1) aiding and abetting, (2) asset misappropriation, (3) bribery and kickbacks, (4) misstatement of goodwill, (5) improper disclosures, (6) misstatement of investments, (7) manipulation of accounts receivable, (8) manipulation of assets, (9) manipulation of expenses, (10) manipulation of liabilities, (11) manipulation of reserves, and (12) improper revenue recognition. Carcello and Hermanson, (2008) noted that these observations were consistent with the body of existing Knowledge (Beasley, Carcello, and Hermanson, 1999). Deloitte (2007) observed that revenue recognition schemes are by far the most common fraud schemes and recording fictitious revenue is the most common sub-type among revenue recognition frauds. Also, there is some evidence that revenue recognition schemes have become more common in recent years. The industries with the highest incidence of FFR are technology, media, and telecommunications, followed by consumer business (Bonner et al 1998; Beasley, Carcello, and Hermanson, 1999; Wolfe & Hermanson 2004; Deloitte, 2007; and Carcello & Hermanson, 2008.)

1.3 Current measures for dealing with occupational and financial reporting fraud

The devastating effect of fraud has necessitated the convergence of curious minds in practice, the academia and especially among policy makers, towards evolving of various means of dealing with the menace of fraud. As a result of the turmoil in the U.S. capital markets, loss of shareholder value, and, in some cases, bankruptcy of very major public companies, the Sarbanes-Oxley Act was enacted and came into force in 2002. The Sarbanes-Oxley Act of 2002 was enacted in response to the corporate scandals of the late 1990s and early 2000s. The Act mandated significant reforms to public companies' governance structures and the oversight of public company accounting firms (CAQ, 2010). Many of its requirements were intended to raise the standard of corporate governance and mitigate the risk of fraudulent financial reporting. In CAQ's 2010 report, the specific provisions of the Act were detailed as follows:

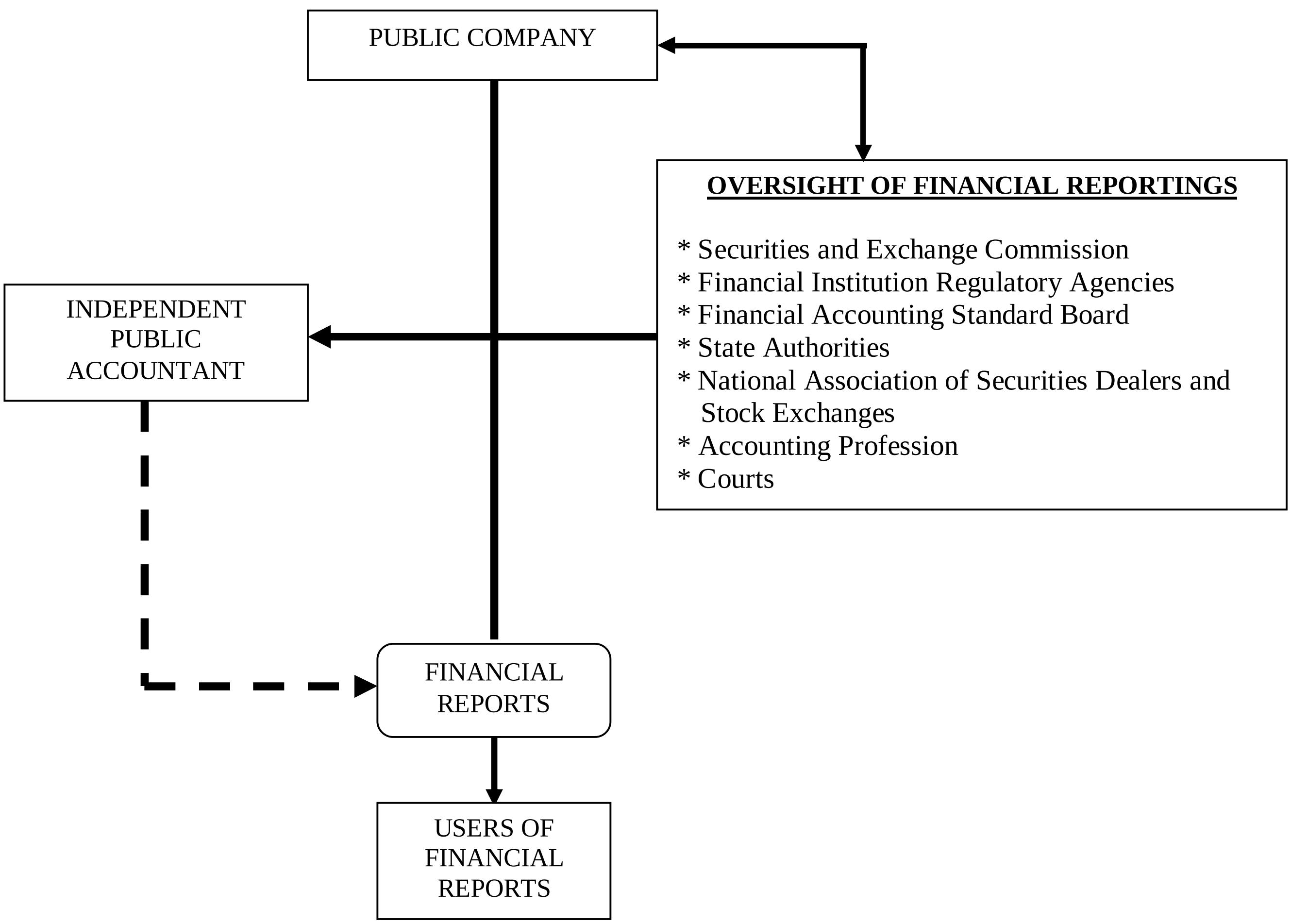
- Reinforces the responsibility of corporate officers for the accuracy and completeness of corporate financial reports, and adds a requirement for the public certification of each periodic report filed with the SEC that includes financial statements. The chief executive officer and chief financial officer must certify that each such periodic report complies with the requirements of the Securities Exchange Act of 1934 and that the financial statements are fairly presented.
- Established criminal penalties for a willful and knowing untrue certification.
- Provides for the disgorgement of the bonuses and profits of executives involved in fraudulent financial reporting.
- Requires evaluations and increased disclosures of a company's internal control over financial reporting by management, and a related report by the external auditor for certain companies.
- Requires other enhanced disclosures, including whether the company has a code of ethics for senior financial officers.
- Enhances the role of the audit committee, including requirements for financial expertise and responsibility for oversight of the company's external auditor.
- Requires companies to establish whistleblower programmes, and makes retaliation against whistleblowers unlawful.

These provisions are generally held to have helped reduce financial reporting fraud and to serve as an ongoing deterrent to such fraud (CAQ, 2010). The Sarbanes-Oxley Act of 2002 has done much - within the US - to improve corporate governance and deter fraud; however, financial reporting fraud—an intentional, material misrepresentation of a company's financial statements— remains a serious concern for investors and other capital markets stakeholders. Various regulatory agencies across the globe have initiated alternative measures towards addressing the menace of fraud. Some national governments have taken very serious political and legal measures specifying very stiff penalties as the case in China. Here in Nigeria most bank Chief Executive Officers are being prosecuted and some even sent to jail. The Arab spring has its root in fraud that did mar the capacity of the political leadership and therefore the public service to deliver good governance. The adoption of accrual based accounting in the public sector and International Financial Reporting Standards in most parts of the globe underscores the quantum of effort mobilized globally towards addressing this cancerous and deadly virus. The literature is replete with various measures directed at addressing the fraud challenge. A sound ethical culture and a sound internal control system have been identified as fraud prevention measures. In the same vein, CAQ's 2010 report highlighted:

- A strong highly ethical tone at the top that permeates the corporate culture (an effective fraud risk management program is a key component of the tone at the top)
- Skepticism, a questioning mindset that strengthens professional objectivity, on the part of all participants in the financial reporting supply chain
- Strong communication among supply chain participants

There is also a consensus of opinion that because of the inherent limitations on the effectiveness of controls and the possibility for the override of controls, the risk of fraud can be mitigated but not completely eliminated. CAQ submitted that there is no "silver bullet" for killing fraud. Other measures include; ongoing risk assessment, trend analysis, data matching, exception reporting, reporting mechanisms. These measures are predicated on the basis of the existing financial reporting supply chain presented below:

Figure 1: Financial Reporting System



Source: Report of the National Commission on Fraudulent Financial Reporting, October 1987

Management, Boards of Directors, Audit Committees, Internal Auditors, and External Auditors make up the public company financial reporting process or "supply chain" and have complementary and interconnected roles in delivering high-quality financial reports to the investing public, including the deterrence and detection of fraud. Management has primary responsibility for the financial reporting process and for implementing controls to deter and detect financial reporting fraud. While the Board of directors and audit committees are responsible for oversight of the business and the control environment. On its part, the audit committee oversees the financial reporting process, the internal audit function, and the company's external auditors. In this delivery chain, Internal auditors play a key role in a company's internal control structure and have a professional responsibility to evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.

1.4 Basis for an alternative paradigm

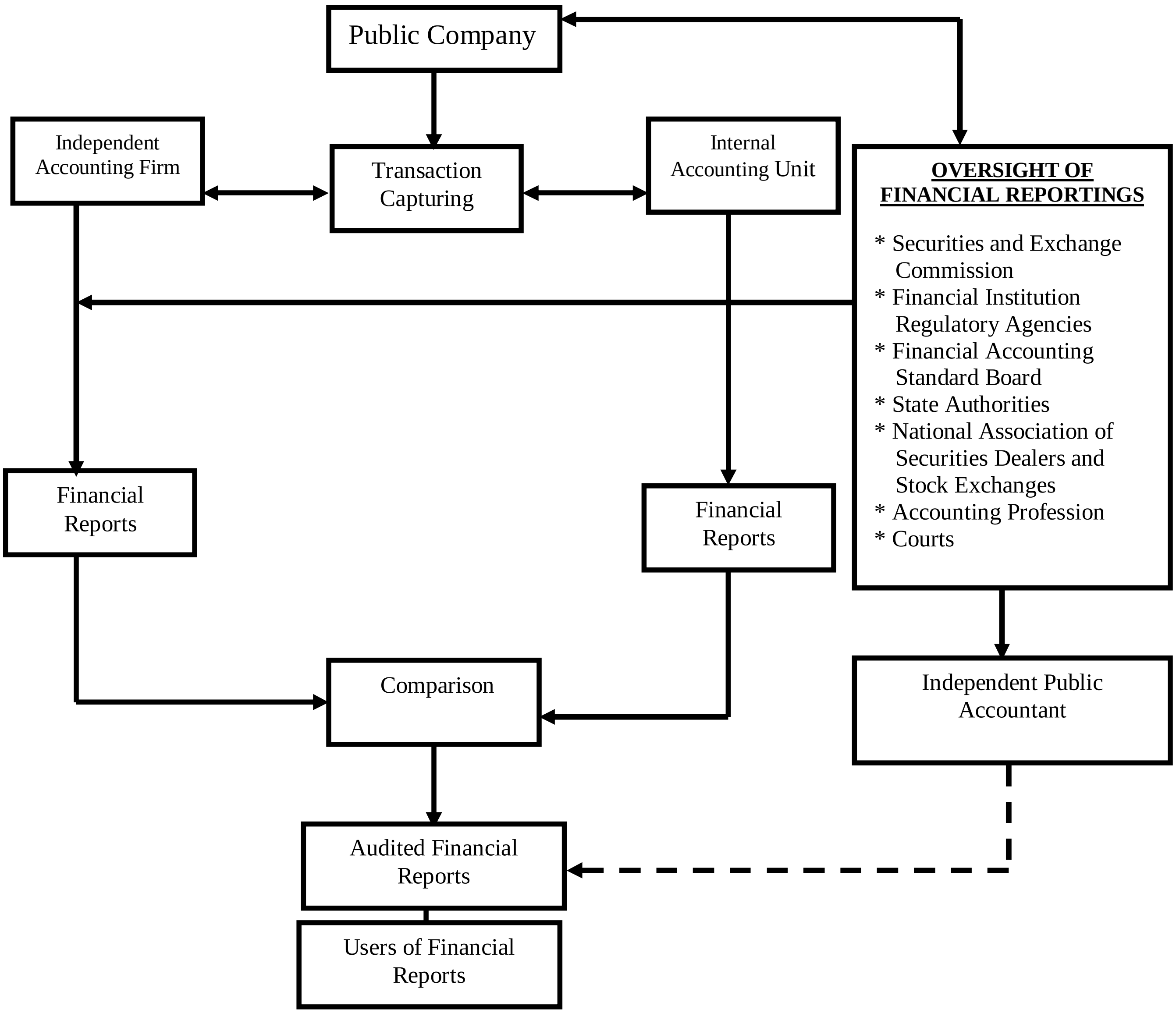
Carcello and Hermanson (2008) observed that FFR is strategic in nature – that is, perpetrators of fraud typically devise fraud schemes to minimize the likelihood of detection, and as auditors and other outside monitors change their technology to better detect fraud, the nature of the fraud schemes evolves to minimize the likelihood of detection. As a result, FFR is difficult to detect, especially for auditors and other outside monitors (Hirst 1994; Latham & Jacobs 2000). This inference found a common thread in the works of (Bloomfield 1997; Newman, Rhoades, and Smith, 1996; Wilks and Zimbelman, 2004). Also, ACFE (2008) and KPMG (2003) observed that, auditors, particularly external auditors, often are not effective in detecting fraud given fraud's strategic nature. As a result, the most effective mechanisms for detecting fraud generally are internal controls and tips from those inside, or connected to, the entity committing the fraud.

Because of the inherent limitations on the effectiveness of controls and the possibility that management could override controls, the conclusion is that the risk of fraud can be mitigated but not completely eliminated. Uncovering management fraud is a difficult task using normal audit procedures. This is because there is a shortage of knowledge concerning the characteristics of management fraud, and given its infrequency, most auditors lack the experience necessary to detect it. Finally, managers are deliberately trying to deceive the auditors (Knight 2002; Matsumoto 2002 & Mckendall et al 1997) thus making the task difficult to accomplish. Furthermore, given managers who understand the limitations of an audit, standard auditing procedures may be insufficient to deal it all instances of fraud. These limitations suggest the need for additional analytical procedures as espoused by Schnatterly (2003). This predicates the need for continued research towards uncovering alternative ways and means of addressing the fraud debacle.

1.5 Our paradigm shift

On the basis of the above submission we are proposing a model whereby share holders would employ the services of independent public accountants (accounting firms) that should be responsible for independently collecting data and preparing end-of-year accounting earnings' report. These reports should then be compared with those prepared by management and both should then be subjected to third party audit. Doesn't this appear to be too costly and a duplication of accounting information generation process? We believe that if the shareholders, creditors, and employees of Enron, WorldCom etc were asked to choose between increasing the cost of ensuring credibility in managements' financial reports, so as to monitor and sustain their stake or losing their investments, they would have wholeheartedly opted for an increased monitoring cost to preserve their investments. In instances of managements' prudence and credibility, our model would be costly and evoke the question of trust in management. But in our world of business, where trust as an attribute for both employees and managements, is fast becoming a scarce virtue, no effort should be spared at ensuring fraud prevention. The consequences of corporate collapse through fraudulently manipulations are too enormous. Hence our espoused model as presented below:

Figure 2: Financial Reporting System: An Alternative Paradigm



The existing financial reporting supply chain in the public company places absolute responsibility for the quality of financial reports on the Board of directors and Management. The kind of financial reports that would be produced at the end of the process is dependent on the character of the Board and Management (Knight 2002; Mckendall et al 1999, 1997 & Beasley 1996). A board and management characterized by lack of integrity and therefore greed would result in fraudulent and manipulated financial statements, but the opposite will be the case if integrity characterizes these two key organs of the corporation. Determining the character of a board and management is one task that is not too easy to handle. A large body of accounting research examines the relation between board governance characteristics and accounting outcomes (see Cohen et al. 2004; DeZoort et al. 2002; Cox et al 2002; Coles & Hesterly 2000; Finkelstein & Hambrik 1996; Duboub et al 1995; Daily & Dalton 1994). But in our model, except where there is collusion, it will always result in highly credible financial reports. The financial reports do not necessarily depend on the character of the board, but on the integrity of the accounting firm and its willingness to collude. The challenge of collusion by the independent accounting firm can be addressed by attaching a criminal responsibility (Reilly & Koppel 2008; Pittman & Cermoc 2008; & Treaster 1999) clause in the terms of the engagement contract. Furthermore, accounting firms engaged in capturing transactions and preparing financial reports should be precluded by law from rendering audit and allied services to the same clients. They may engage in such dealings with other clients provided they do not intend to enter into any contractual responsibility with the clients in the foreseeable future.

The benefits derivable from the application of this model far outweighs the cost, not only terms of curbing both management and employee fraud, but enhancing the credibility of reported earnings, assuring investors' confidence and boosting of stock market operations. This is because operationalizing this model requires that the third party accounting firm will be collecting and collating data on the spot independently alongside the internal accounting staff of the firm. The performance of this function has been made easy through online and real time operations that now characterize our world. Our thinking is that where a third party independently collects accounting data and prepares end-of-year financial reports, management's influence would be reduced to a barest minimum except in instances of collusion. This model would also reduce the huge financial outlay in fraud investigations and the reliance of forensic accounting tools for fraud investigation. This model evokes a post ante approach to dealing with fraud as opposed to the current models that are post mortem in design.

1.6 Conclusion

Allowing management to run public firms and produce end of year financial reports as a basis for assessing firm performance, as well as, rewarding corporate executives on the basis of accounting reports is akin to a student who evaluates himself via setting the examination questions and assessing same to give a report of the level of knowledge acquired. This is tantamount to self assessment which often is characterized by objectivity and credibility crises. We also contend that if judges can preclude themselves from handling cases were personal interest is apparently or implicitly linked to them, why can't the same principle guide the world of business in our assessment? We advocate a model where management of public firms would no longer assess and report on their firms' performance through employee accountants, but rely on an independent third party accounting firm (contracted by shareholders) to do so.

Furthermore, the model of third party audit has not provided the needed assurances as it was intended in the light of recent corporate collapses and their related accounting scandals (ACFE 2008 & O"Connell et al 2006), noting that fraud investigation is not the essence of this kind of regular audit. We are therefore advocating for a third party independent accounting firm to be engaged by shareholders to be involved in the whole process of collecting, collating and processing all financial transactions in public firms to produce end-of-year financial reports, which could then be subjected to a third party audit for improved assurances and quality control if the need arises. In this instance, fraud can only occur through serious collusion. This model has the added advantage of reducing both employee and management fraud, as well as, contributing towards enhancing the decision usefulness function of financial reports and the fulfillment the stewardship accounting objective as currently being advocated. Admitted that this model is not full proof, but its preemptive approach would yield better results in line with the philosophy of preventive maintenance as opposed to break down maintenance with often very devastating and irreparable consequences. This model is most relevant for the public company, although other privately owned companies can also adopt this model with its capacity for curbing non financial reporting fraud by employees given that the data generated by the independent accounting firm would serve as a safety nest against reckless employee manipulation of accounting entries and records.

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