PROACTIVE APPROACH FOR THE IMPACTS OF FRAUDULENT FINANCIAL INFORMATION ON ECONOMIC DECISION

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Abstract

In the last decade today's world has been affected by frauds and manipulation of the financial information. An investment decision based on false financial information causes the investors to suffer losses as was experienced in Enron and WorldCom cases. For this reason financial information manipulation is as important as other types of manipulations and must be prevented so that the investors make a rational decision. Financial information has, certainly, an important positive or negative effect in economic decisions. Positive or negative effects of financial information on economic decisions depend on reliability of the financial information.

Key words: decision, financial Information, fraudulent, manipulation

INTRODUCTION

In the recent years, the financial information manipulation has been debated by many economists and researchers especially in the developed countries all over the world. If we look at the negative effects of manipulated or fraudulent financial information on the economy it seems this issue will be debated for many years. Fraudulent financial reporting has become a very problematic issue which damages today's economy. As technological developments and expectations of people have caused the inevitable changes in the economic structure, whilst trying to provide the maximum benefit with limited resources. [9]

In the literature for the financial information has been given several names: earnings management, big bath accounting, creative accounting, income smoothing and window dressing. In order to manipulate the financial information have been used these technics using the flexibility of the Accounting Standards.

The collapse of Enron has caused about $70 billion lost in market capitalization which is devastating for significant numbers of investors, employees and pensioners. The WorldCom collapse, caused by alleged financial statement fraud, is the biggest bankruptcy in the United States history. [11] Loss of market capitalization resulting from the reported financial statement fraud committed by Enron, WorldCom, Qwest, Tyco, and Global Crossing is estimated about $460 billion.

Public Company Accounting Oversight Board (PCAOB) argues that the fraud detection is among the highest priorities for the accounting profession and standard setters. Securities and Exchange Commission (SEC), Commissioner Hunt Jr Isaac C remarks in his speech in April 2002 that the transparency, reliability and accurate information allow users of the financial information such as investors, creditors to make intelligent decisions. “Audited financial statements provide the foundation for securities markets. But Securities and Exchange Commission (SEC), Chairman Harvey L. Pitt. Remarks in his speech in 2002 April 25 that the audited financial statements allow investors to make decisions on whether to buy, hold, or sell a particular security”. “Accurate information also improves the quality of markets by allowing markets to discover the true price at which specific securities trade”. Fraudulent financial reporting has become a very problematic issue which damages today's economy. As technological developments and
expectations of people have caused the inevitable changes in the economic structure, whilst trying to provide the maximum benefit with limited resources. Financial scandals, indisputably, in recent years, have significant importance in the financial world. These scandals have shaken the confidence of the investors. And effects of these scandals have been felt, are being felt and will be felt all over the world. The recent reported financial statement fraud and resulting decline in the stock market show the importance of the quality of financial reports and audit functions as well as the understanding of what may have caused the occurrences of accounting scandals. [11] Scandals which took place in the beginning of the 20th century brought us the quality of financial reports and credibility of audit functions. Collapses of these big companies have raised the concern of whether the accounting standards are sufficient for producing the quality of financial information. Financial information manipulation mainly stems from the desire to influence the possibilities of wealth transfer between the various stakeholders. Active investors should be informed in time, and, properly and correctly in capital markets. The requirement of being informed is also important and necessary for money markets which consist of other financial system. However, investors` intentions of buying securities and taking decisions are based on financial information which is presented too, so this requirement of being informed is increasing the importance of financial information.

In this context, the purpose of the paper was to answer the following questions and find some solutions to satisfy the readers:

Why companies manipulate the financial information and commit the fraud in financial situation? Who benefits from the manipulated information and fraudulent financial situation? What kinds of reasons force the manipulators to commit the fraud and manipulate the financial information? If the all financial information’s fraudulent can be detected? If the financial losses can be calculated in real economy? If is there any measurement which have been taken by governors to prevent the manipulation in the financial information?

All these kind of questions have asked before and are being asked today.

MATERIALS AND METHODS

The paper is a critical review of the literature on the topic and presents the author's opinions about the causes and effects of the manipulation of the financial situation, the fraudulent and manipulated financial information, the financial losses caused by manipulated financial information, and the social effects of fraud or manipulated financial information.

It presented in a critical manner why the companies manipulate the financial information and commit the fraud in financial situation, who benefits from the manipulated information and fraudulent financial situation, what kinds of reasons force the manipulators to commit the fraud and manipulate the financial information, how the fraudulent financial information can be detected, how the financial losses can be calculated, how the governors could prevent the manipulation in the financial information.

RESULTS AND DISCUSSIONS

(i)Causes and effects of the manipulation of the financial information

In todays` conditions, rivalry in business is at a high level and the desire of companies to present the financial information of company is rationally approached. Capital markets in which there are many companies pass the information to the investors through reports which present the activities of the companies and these reports help the investors to provide necessary funds. Companies acting this way need means and an intermediary in order to present the financial situation. Some of the causes for manipulation the financial information have been detailed below.

Weakness Structure of the Company’s Management

Any weakness structure of the company management leads the manager to manipulate the financial information to show the
Why the management structure is so important for any company and why the weakness structure of the company’s management can be the reason to manipulate the financial information. According to the Dechow, Sloan and Sweeney (1996), [1] -CEO’s influence on the board is measured as follows: a) CEO chairs the board in about 64% of the control firms. b) The CEO belongs to the founding family in 26% of the firms. So the result is that Board members are at the same time general directors and top manager. -Most of the general directors are chairman of the board at the same time. -Most of the general directors are founders of the company at the same time -There are not independent audit committee in the most companies -Shareholders from outside have not important share in the company According to the Koch, the financial information can arises from organizational structure of the company. So we can say that the weakness management structure of the companies can be the reason for manipulation of the financial information.

**Managers' Interests and the Partnership Structure of the Companies**

Behind of the financial information manipulation can be the managers’ interests. Managers’ interest can affect the strategic decision for the company. Normally any decision is based on interests. Especially senior managers are aware of their interests and can keep their own interest for the first point on decision. Much more, that senior managers’ decisions for a strategy A or B are not (solely) based on an abstract strive for `profit-maximization` of `efficiency` (or whatever is portrayed as 'the interest of the organization’) but on what they regard personally as in their interest. Arens and Loebbecke define fraudulent financial reporting as: “intentional misstatements or omissions of amounts and disclosures in financial statements to deceive users.” Managers are always the manipulators in financial information manipulation whereas mainly the other investors are the manipulators in other types of manipulations. According to some economists; -Managers act for increasing their own interests -Dividend ratio is the norm to determine the stock price causatively -Managers’ interest depends directly on the stock price of the company Studies made by investigators indicate that companies are most likely to have fraudulent financial reporting perpetrated by top managers. These reasons above trigger the managers to manipulate the financial information in order to make stable profit. Besides this, efficiency and the size of the company is also an important factor. **Inadequate Internal Control System**

The aim of the independent audit committee is to monitor the financial reporting process which must produce the accurate, reliable financial information. Of course this monitoring process does not mean that the audit committee should stay all day in the company while controlling the accounting records. Inadequate internal control system is considered as an important cause for the financial information manipulation. Inadequate internal controls over financial reporting and accounting practices could lead to errors, which could adversely impact ability to assure timely and accurate financial reporting. On the other hand every public company must have the internal control department according to its size and should employ the experienced people who can control if the financial reports have been produced accurately and reliable. In Ernst & Young 2007 report it is expressed that is why managers invest in internal controls, in part, to prevent and detect fraud. Because these controls are costly, and fraud prevention and detection are difficult, these controls are generally incomplete. In ACFE Report to Nation 2006 it is expressed that; consequently, managers and academics recognize that employees who become aware of wrongdoing such as fraud can play an important role in its early detection. We can get some investigation results from the survey done by the Association of Certified Fraud Examiners (ACFE) 2010 Report to Nation. These surveys also express the importance of the weaknesses of the internal control system.
According to the survey the respondents have been asked to identify which of several common issues they considered to be the primary factor that allowed the fraud to occur. The answer was as follow; a lack of internal controls, such as segregation of duties, was cited as the biggest deficiency in 38% of the cases. In more than 19% of the cases, internal controls were in place but were overridden by the perpetrator or perpetrators in order to commit and conceal the fraud. Interestingly, even though hotlines are consistently the most effective detective control mechanism, and even though less than half of the victim organizations had a hotline in place at the time of the fraud, a lack of reporting mechanism was the control deficiency least commonly cited by the CFEs who participated in study.

Figure 1. Primary Internal Control Weakness Observed By CFEs
Source: ACFE Report to Nation

Figure 1 shows the difference between organizations according to their sizes. As we see in the chart that 47% of the small business do not have any internal control. But the number 33.7% is rather big for larger companies. Lack of internal controls shows the factor most contributed to the fraud. Small business do not override because there is nothing to override.

Figure 2 shows the difference between organizations small and more than $1 million. How the weaknesses of the internal control contribute to fraud.

**Accrual Accounting and the Flexibility of the Accounting Standards**

Generally Accepted Accounting Principles (GAAP) relies on accounting accruals to provide earnings information that is useful in business decision-making. Dechow and Skinner (2000) both emphasize that fruitful areas for future research is to first, identify firms whose managers practice earnings management and focus on their managerial incentives.[2] Second, document the magnitude and frequency of specific accruals and accounting methods used to manage earnings. The impact of discretionary accruals on the information content of earnings is subject to debate. On the one hand, these manipulations could enhance the value-relevance of reported earnings by communicating a manager’s private information regarding future profitability. On the other hand, the flexibility inherent in GAAP may result in opportunistic behavior that distorts reported earnings. To date, empirical research on managerial discretion and earnings in formativeness has been indirect and mixed, and the information effects of discretionary accruals in particular is relatively unexplored. [8]

Accounting principles have an international or national standard to produce the financial reports in regular and understandable mode by everyone. But as a matter of course every rules or laws can be flexible in order to adopt more easily. But ‘indisputably’ there are some
arguments in favor of accrual accounting and some against for accrual accounting. Models of non-discretionary accruals, i.e. Accrual models, are widely used by financial analysts to assess the level of discretionary accruals, an important indicator of earnings management practices, and, more importantly, a significant predictor of stocks returns. [4] Actually, one of the main reasons why accrual models have generated such attention in the finance literature is precisely the fact that the residuals of accrual equations carry valuable information about stock returns.4

(ii) Fraudulent and manipulated financial information

The term fraud is defined in some dictionaries as follows; an act using deceit such as intentional distortion of the truth of misrepresentation or concealment of a material fact to gain an unfair advantage over another in order to secure something of value or deprive another of a right. Fraud is grounds for setting aside a transaction at the option of the party prejudiced by it or for recovery of damages. But on the other hand the term fraud has been by scholars too as follows; in legal terms, fraud is a generic category of criminal conduct that involves the use of dishonest or deceitful means in order to obtain some unjust advantage or gain over another. In business terms, fraud is sometimes difficult to define as it extends, for example, from conduct as trivial as an employee having an extended lunch break without permission, to large-scale misappropriation of funds by a company accountant involving many millions of dollars.

Certainly the definition may differ from person to person and from country to country but the common thing of fraud is dishonesty. Starting from the definitions we examine the problem with some real evidence.

The recent reported financial statement fraud and resulting decline in the stock market show the importance of the quality of financial reports and audit functions as well as the understanding of what may have caused the occurrences of accounting scandals. [11]

Today’s one of the biggest problems we face is fraudulent in the financial situation. According to the Association of Certified Fraud Examiners (ACFE, 2008) the cost of fraud is difficult to quantify for a number of reasons: 1- not all fraud is detected; 2- of that detected, not all is reported; 3- in many fraud cases, incomplete information is gathered; 4- information is not properly distributed to management or law enforcement authorities; and 5- too often, business organizations decide to take no civil or criminal action against the perpetrator(s) of fraud.

In the survey done by Association of Certified Fraud Examiners (ACFE, 2010) given details in the “Report to the Nation on Occupation Fraud and Abuse” 2010 booklet have been declared the loss because of the fraudulent. In the survey has been asked the question to provide his or her best estimate of the percentage of annual revenues that the typical organization loses to fraud in a given year. The median response was that the average organization annually loses 5% of its revenues to fraud. The ACFE committee applying this percentage to the 2009 estimated Gross World Product of $58.07 trillion would result in a projected total global fraud loss of more than $2.9 trillion. But we should note that this estimation is based only on the opinions of 1,843 anti-fraud experts, rather than any specific data or factual observations; accordingly, it should not be interpreted as a literal representation of the worldwide cost of occupational fraud.

As we see above the subject „fraudulent” must be considered carefully by audit experts and should be prevented as much as possible. Otherwise the negative effects of the manipulated financial information will be bigger than previous year. This given example is just for U.S.A. but for the rest of the world cannot pass over. But we should note that the financial statements fraud is the least common but most costly form of fraud among cases investigated in the surveys.

Fraud can inflict significant damage at community, organizational or individual level and the potential consequences of fraud for organizations can be strategic, legal, financial or operational. Therefore, it must be an important issue for organizations. [10]
Fraud consists of knowingly making material misrepresentations of fact, with the intent of inducing someone to believe the falsehood and act on it and suffer a loss or damage. [5] Every country, specially developing and developed countries suffer from fraudulent and manipulated financial information. The losses from manipulated financial statements rather bigger than other types of fraud as corruption, asset misappropriation. The cost of fraudulent and manipulated financial information cannot be calculated. But some investigations show how big negative effect of the fraudulent has on real economy and undisputable because of fraud all people is effected all over the world.

An investigation study made by Committee of Sponsoring Organizations of the Treadway Commission in U.S.A. searching the „Fraudulent Financial Reporting“ between 1987-1997 years has declared some of the more critical insights. They are:

- The companies committing fraud generally were small, and most were not listed on the New York or American Stock Exchanges.
- The frauds went to the very top of the organizations. In 72 percent of the cases, the CEO appeared to be associated with the fraud.
- The audit committees and boards of the fraud companies appeared to be weak. Most audit committees rarely met, and the companies’ boards of directors were dominated by insiders and others with significant ties to the company.
- A significant portion of the companies was owned by the founders and board members.
- Severe consequences resulted when companies committed fraud, including bankruptcy, significant changes in ownership, and delisting by national exchanges.

The study above shows that audit committees should be stronger and the audit committees should not have any connection with the company members. If the founders of the company are members at the same time, it may encourage the directors to commit the fraud more easily. Committing fraud in the financial situations may bring to the company some benefit for short-term but consequences may be worse as bankruptcy, changes in ownership and delisting by national exchanges.

Preventing the fraud is also costly work for the companies or government agencies. As explained in section 1 the causes of fraudulent play an important role to commit the fraudulent in the financial situations. Al Capone's bookkeeper once said that he can steal more with a pencil than ten men with machine guns—the situation is much worse today, with computers that have increased the speed, the possible scope of criminal acts and the difficulty to investigate such crimes. [5] Furthermore, money in electronic form are much easier to steal: while US$1B in $100 bills occupies about 15 cubic meters, and in gold would weighs about 65 tons, in electronic form is just 32 bits plus some application-dependent headers. [7]

(iii) Financial losses caused by manipulated financial information

Detecting fraud is difficult because those engaging in fraud generally attempt to conceal their behavior, fraud is not a predictable event, and auditors often have limited experience detecting fraud. [6] It is very difficult to calculate the cost of the fraud losses. ACFE „Report to Nation-2010“ also expresses the danger on this issue. ACFE declares that „there is no way to precisely calculate the size of global fraud losses, the best estimate of anti-fraud professionals with a frontline view of the problem may be as reliable a measure as we are able to make. In any event, it is undeniable that the overall cost of occupational fraud is immense, certainly costing organizations hundreds of billions or trillions of dollars each year.

According to the ACFE researches there are three main types of fraud; asset misappropriations, corruption and financial statement fraud. Asset misappropriations fraud committed to steal or misuses an organization’s resources. Corruption schemes involve the employee’s use of his or her influence in business transactions in a way that violates his or her duty to the employer for the purpose of obtaining a benefit for him- or herself or someone else. Financial statement fraud schemes are those involving the intentional misstatement or omission of material information in the organization’s financial reports. Common methods of fraudulent financial statement manipulation include recording fictitious revenues,
concealing liabilities or expenses and artificially inflating reported assets. These three types of fraud have been illustrated in charts. As we see in the chart that the asset misappropriation is most frequent but least costly form of fraud besides the financial statement fraud is less frequent but most costly form of fraud. Corruption is in the middle of two fraud types.

![Chart of Occupational Frauds by Category — Frequency](source: ACFE Report to Nation)

![Chart of Occupational Frauds by Category — Median Loss](source: ACFE Report to Nation)

As indicated in charts above although the percentage of cases of financial statement fraud decreases in 2010 against 2008 but the losses increased significantly. So this situation raises the question that something should be done in order to prevent the financial statement fraud. Otherwise financial crisis will be inevitable and the financial system will be fatal. On one hand the flexibility is the method unblocking the economically development on the other hand flexibility of the accounting standards encourage the perpetrators to manipulate the financial information but the flexibility of the accounting standards should not misused in order to gain for short-term.

(iv) Social effects of fraud or manipulated financial information

Fraud is a serious social and economic problem that adversely affects a broad range of stakeholders, including audit committee and board members, top managers, employees, auditors, creditors, shareholders, and pensioners [3]. Effects of fraud have been debated by financial world from point of economy. But nobody can pass over the social problem of fraud. Expected function from taxation is to achieve the economic aims with taxes. In this situation the taxation laws have to be applied completely and correct. On the other hand, presenting the financial situation accurately the informal economy is being obstructed. Persons who evade tax can use the funds as they wish. This situation cause unfair competition and the consequences of evasion tax may affect the government plans. Indisputable fraud has a negative effect on every human being. We can classify few consequences:

- Economic decline due to direct physical damage
- Economic decline due to losses suffered by publicly used services such as transportation, police and fire departments
- Indirect economic losses endured by prominent corporations due to losses suffered by their clients
- Physical injury or death to innocent victims caught in the middle of a scam gone wrong
- Emotional and psychological burdens placed on the fraud victims

The impact of such theft can also have a social impact on the organization. It can allow the organization to lose the confidence of the stockholders of the organization. It can also contribute to a loss of confidence in the organization by its advertisers. The negative publicity from the media can also impact how the organization is perceived and supported by the local, national or international community in which the organization operates as well as the customer base of the organization. The cumulative effect on all of the negative circumstances may also have a major impact on the organization’s total reputation and stock value which could in some cases can lead to the closure of the business or an unprecedented loss of revenue (ACFE, 2007). In the ASIS (Advancing
Security Worldwide) report mentioned that due to the losses in the organization it can also have an impact on the confidence of the local, state or national economic conditions based on the size of the business affected by corporate fraud. Fraud has a negative impact on individuals, organizations, and communities. It can divide families and small communities and also has ramifications for society as a whole.

CONCLUSIONS

The fraud is a global problem. Managers are responsible for committing the fraud in financial information. Managers’ interests are playing very important role to manipulate the financial information. Company’s management structure should be strong and transparent. If in any company general director is the chairman or founder of the company at the same time, so the manipulating the financial information is inevitable. Internal control system makes the financial information more confident. According to the investigation is made by ACFE express the importance of the weaknesses of the internal control system. Lack of the internal controls shows the factor most contributed to the fraud. In the last decade preventing the fraud in the financial information and manipulated financial information is an important issue. Preventing the fraud is also costly work for the companies or government agencies. As indicated in the charts the financial losses are significant and should be taken measures to prevent the fraud. Otherwise the losses will cause to collapse the real economy as experienced before. Accuracy, transparency and reliability of financial information will give the opportunity to investors to make the correct decision on their investments. Otherwise the allocation of resources will not be efficient.

Nowadays there is no developed country without an accounting and audit system. Not only national financial results but also international financial results have to show the single aspect which is called reliability. Accurate, robust, reliable and real financial reports are provided only with audit. Reliable information has become more important as the community grows and gets more complex. From the investors’ point of view, the main measurement of the investments which have been made or planned is, obviously, reliable information. If disclosed information is not reliable so decision makers cannot take measured decisions on issues. Interest groups require the financial information explained to them and need that financial information to reflect the reality. Decision makers have to investigate if the disclosed information is reliable or not. The usual method is to take advice from an independent person. Integrity, accuracy and impartiality of the audited and verified information are considered to be reliable information in the decision process.

To protect the assets which belong to investors against risks, so to provide the confidence in the capital market is quite important. Otherwise, because of the losing the confidence in the capital market will not contribute to the growing of the economy of the countries.

Committing fraud in the company and presenting an erroneous financial situation will damage the companies. Every fraud and error has a cost to the economy. The consequences of fraud and errors are that sources are not directed to the necessary and most productive areas in the economy, so allocation irregularities appear in the economy. Fraud and errors committed in financial reports lead the users of financial information to make decision wrongly, thereby not allocating resources correctly, and because of this companies could be sanctioned by official authorities. Also investors who invest on the stock exchanges will be affected by errors in the financial information. Investors will be encouraged to invest in unproductive areas and this will have the cost to the economy. Companies would like to get a profit in the short period, but this ambition could lead to fraud and errors being committed in the financial information and consequently these companies could be dragged bankruptcy. Unless this ambition of companies ends there will not be any stability in their economy. Any fraud or errors could
trigger the committing of other fraud in the financial situation. If we look at the statistical numbers there is no period in which the fraud or errors were not detected.

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