CORPORATE FINANCIAL STATEMENTS FRAUD: THE ROOT OF CAPITAL MARKET FINANCIAL CRISES.

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Abstract

Financial crises do come in many forms, including the financial or capital market crisis. This paper reviews a number of features of financial crises with special focus on financial statements fraud as the root cause of capital market financial crises. The paper draws from various sources including reported cases of financial statements fraud with the Securities and Exchange Commission (SEC – Nigeria) as well as interview of selected core investors of public limited companies (PLCs). It concludes that financial statement fraud is harmful not only to individual investors but also to capital markets and society as a whole. To resolve this particular root cause of capital market crises, this paper makes recommendations to independent auditors (external auditors), corporate executives in relation to excessive remunerations, corporate audit committee, policy makers (including regulators), fraud investigators, and the government.

The capital markets are components of a capitalist/ or mixed economy. They are the engines of growth and development for any economy because they accommodate certain institutions for the creation, custodianship, distribution and exchange of financial assets and management of long-term liabilities. An economy without capital market just cannot grow since the market is responsible for long-term growth, capital formation and allocation to development uses, efficiently (Osaze, 2007). The efficiency, liquidity and resiliency of these markets depend on the ability of investors, lenders, and regulators to assess the financial performance and financial position of businesses that raise capital (Zimbelman and Albrecht, 2012). Financial statements prepared and presented by such companies play a very important role in capital markets efficiency. They are expected to provide meaningful disclosures of where a company has been, where it is currently, and where it is going, as '**a going concern**'. The term '**a going concern**', means a company which does not intend or need either to go into liquidation, or to curtail the current level of operations significantly.

Most financial statements are prepared with integrity and present a fair representation of financial position and performance of the organisation issuing them. These financial statements are based on generally accepted accounting principles (GAAPs) which guide financial accounting for transactions. Unfortunately, financial statements are sometimes prepared in ways that intentionally misstate the financial position and performance of an organisation. Such misstatements can result from manipulating, falsifying or altering accounting records. Misleading financial statements cause serious problems in the capital market and can lead to financial crises in the economy. They often result in large losses for investors, lack of trust or confidence in the market and accounting systems, litigation and embarrassment for individuals and organisations associated with financial statements fraud.

This paper reviews selected literature on financial crises focusing on corporate financial statements fraud with the aim of proffering solution for its resolution. The paper draws from various sources including reported cases of financial statements fraud with the Securities and Exchange Commission (SEC – Nigeria) as well as interview of selected core investors of public limited companies (PLCs). The next section of this paper provides selected types of financial crises, followed by a review of the content of financial statements; the frameworks governing their preparation and financial statement fraud proper. The last section concludes with a summary and recommendations.

Types of Financial crises

According to writers and commentators, financial crises do come in many forms. A financial crisis is often associated with one or more of the following phenomena: substantial changes in credit volume and asset prices; severe disruptions in financial intermediation and the supply of external financing to various sector in the economy, large-scale balance sheet problems (of firms, households, financial intermediaries and sovereigns); large-scale government support (in the form of liquidity support and recapitalisation) (Claessens and Kose, 2013). As such, they are typically multi-dimensional events and can be difficult to characterize using a single indicator. Furthermore, Reinhart and Rogoff (2009) identified two classifications of financial crises – those dependent largely on quantitative and judgemental analysis. The first group mainly includes currency and sudden stop crises and the second group contains debt and banking crises. For instance, if local banks have large debts outstanding denominated in foreign currency, this may lead to a banking and currency crisis.

Banking crises are quite common because banks are inherently fragile making them subject to runs by depositors. A run occurs when a large number of customers withdraw their deposits because they believe the bank is, or might become insolvent or liquidated.

Other forms of financial crises having quantitative characteristics include foreign and domestic debts arising from inability or willingness to pay (i.e, default) on the part of government. In addition, the relatively huge increases in executive compensation in the past one and a half decade or so in Nigeria, especially in companies such as banks have also induced one form of financial crisis or the other.

What are corporate financial statements?

Corporate financial statements are 'statements in monetary terms, of the results of an accounting entity's transactions over a period, giving total for classes of transactions rather than details of individuals' transactions and presented in a commonly used form (French, 1991 and Omorokpe, 2009). The forms of financial statement commonly prepared are the statement of financial position (balance sheet), the statement of profit or loss (income statement) and the statement of cash flows (i.e, statement of changes in financial position). Each of these statements are usually accompanied by notes giving supplementary information as required by Companies and Allied Matters Act (CAMA) and related Accounting standards. In addition, section 334 of CAMA 2004 cap. C20 LFN, requires a Nigerian registered limited liability company to include the following to its annual financial statements; Statement of accounting policies; Auditors report; Directors' report; a five – year financial summary, and Group financial statements in the case of a holding or parent company.

The duty to prepare and present these statements is vested on the company's directors according to the Act. It is usual to prepare financial statements under the historical cost convention once in a year. However, the Securities and Exchange Commission (SEC) rules require public limited companies (PLCs) to also prepare and file quarterly financial statements with the Stock Exchange and SEC itself. SEC is the apex regulator of the capital market.

Underlying Assumptions for Preparation

Corporate financial statements are prepared based on the following assumptions:

Accrual basis, where revenues are recognised when sales are made or services rendered irrespective of when cash is received. Similarly, expenses are recognised when goods are used or services received, regardless of when cash is paid. The accrual basis of accounting is also the requirement of the International Financial Reporting Standard (IFRS). The '**going concern'** assumes that the enterprise or company has neither the enterprise or company has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

Frameworks for preparation and Preservation of financial statements

There are three frameworks that guide the preparation and presentation of financial statement – the conceptual framework, legal framework and regulatory framework.

In general terms, a conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for a particular field of enquiry. (Bonham, Curtis, Davis, Dekker, et al., 2004). In relation to corporate financial reporting, these theoretical principles provide the basis for both the development of new reporting practices and the evaluation of existing ones. Since the financial reporting process is concerned with the provision of information that is useful in making business and economic decisions, a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the users. Though theoretical in nature, a conceptual framework for financial reporting has a highly practical end in view. It should be a theory of accounting against which practical problems can be tested objectively, the utility of which is decided by the adequacy of the practical solutions it provides.

The '**legal framework**' is the legislation which governs financial reporting by limited companies – whether private limited or public limited. This legislation does of course differ from one country to another. In Nigeria for example, the Companies and Allied Matters Act 2004 contains rules relating to matters such as:

* The need for companies to keep proper books of accounts,
* The requirement to prepare annual financial statements,
* The requirement that these financial statements must give a 'true and fair view'.
* The requirement that the financial statements must be prepared in accordance with the relevant accounting standards e.g international standards and national standards),
* The circumstances under which group financial statements must be prepared,
* The circumstances in which an audit is required,
* The company's duty to circulate its financial statements to shareholders and to make the financial statements available for public inspection,
* The company's duty to file annual return with the Corporate Affairs Commission (CAC), and SEC (where it is a quoted company, i.e PLC).

In addition to CAMA 2004, public interest entities (e.g Banks, insurance companies and pension fund administrators) are also required to comply with the provisions of related laws such as the Bank and Other Financial Institution Act (BOFIA, 2004), Insurance Act 2003 and Pension Reforms Act 2014 as amended, respectively. An independent auditor attests to the financial statements only if these requirements are met.

The auditor is also required to provide assurance services that improve quality of information or its content for decision makers and capital market. Assurance services involve the lending of credibility to information whether financial or non- financial (Robertson and Louwers, 2002).

The term ‘regulatory framework’ refers to the collection of rules and regulations which govern financial reporting (Melville, 2014). It applies mainly to companies and consists of legislation, accounting standards and Stock Exchange regulations. The regulatory framework is needed so as to ensure that shareholders receive financial statements which faithfully represent the financial performance and financial position of the business concerned. The principal regulatory body is the Securities and Exchange Commission (SEC) especially for public limited companies, while the primary regulatory body is CAC. In addition, recognised professional accounting bodies set ethical standards for their members while the Financial Reporting Council of Nigeria, an independent standard setting body, sets procedural standards or issues directives to adopt international accounting standards for organisations. As a result of the SEC’s and professional bodies efforts, all or any organisation’s financial statements must meet minimum standards of disclosure and show a degree of uniformity in the reporting of transactions that are the same or similar (Bonham *et al*., 2004).

What is Financial Statement fraud?

Financial statement fraud, like other frauds involve intentional deceit and attempted concealment. Hopwood, Leiner and Young (2012) define **financial statement fraud** as ‘any undisclosed intentional or grossly negligent violation of generally accepted accounting principles (GAAPs) that materially affects the information in any financial statement. This definition is consistent with the classic legal definition of fraud, which includes three elements – intentional misrepresentation of fact by a perpetrator; reliance on the misrepresentation by a victim; and injury to the victim resulting from reliance on the misrepresentation

Mode of Concealment

Financial statements fraud may be concealed through:

a) Falsified documentation, including forgery;

b) Collusion among management, employees, or other parties.

Unfortunately, financial statement fraud is rarely seen. Rather, fraud symptoms, indicators or red flags are usually observed. Because of the difficulty of detecting fraud, investigators must exercise extreme care when performing fraud examinations, quantifying fraud or performing other types of fraud-related engagements.

Red flag as a single factor fraud indicator generates sufficient concern or suspicion to trigger an investigation. The list of possible red flags is endless. Examples for internal company misappropriation fraud include – a cashier who fails to record sales; a cashier who mishandles cash; an inventory clerk who is in the wrong place, at the wrong time;

and An accounts receivables clerk who fails to record a customer's payment on account (Hopwood *et al*., 2012)

Motivations for Financial Statement fraud

Motivations to issue fraudulent financial statements vary. Sometimes the motivation is to support a high share or stock) price or a bond or stock offering. The motivation may also be to increase company's share price or for management to maximize a bonus. In some companies that issued fraudulent financial statements, top executives owned large amounts of company shares or stock options, and a change in the share price would have enormous effects on their personal net worth.

Broadly speaking, management has various motives for committing financial statement fraud. Some of the identified motives according to researchers including Hopwood et al. (2012) and Zimbelman et al. (2012) are briefly discussed as follows:

1) **Poor income (or earnings) performance**

Most financial statements frauds, especially in large companies, are committed to make the income statement look better. Poor income or earnings performance can cause managers to lose their jobs and/ or salary bonuses as well as devalue managers' stock options or shares in the company.

2) **Impaired ability to raise capital**

Management produces fraudulent financial statements to facilitate capital acquisition. Poor financial results can impair a company's ability to raise capital through financing and other types of equity offerings.

3) **Product marketing**

Management seeks to hide financial problems to keep buyers, who tend to shy away from companies that are having financial problems. Buyers are often afraid of entering into long-term relationship with companies that could be going out of business.

4) **General business opportunities**

Everyone likes to do business with a winning company. This applies to opportunities such as joint ventures and mergers. Managers sometimes commit financial statements fraud to make their company look better and increase their access to business opportunities.

5) **Compliance with Bond covenant**

Fraud is performed to hide the company's inability to meet bond or other covenant conditions.

6) **Generic greed**

Management produces fraudulent financial statements as a way to get ahead or keep their positions, increase salaries and other management benefits and meet terms of incentives-based contracts.

7) Theft, Bribery, or other illegal activities

Management needs to cover up the misappropriation of large amounts of money by issuing fraudulent financial statements. For example, the Foreign Corrupt Practices Act of 1977 (USA) specifically requires companies to have proper internal controls and record keeping to prevent management from mischaracterizing bribes as legitimate expenses. Proper internal controls and record keeping are also requirements in both the Companies and Allied Matters Act 2004, Cap C20 LFN and the SEC Revised Code of Corporate Governance - (2008) - Nigeria.

Financial Statement Fraud Schemes

The Committee of Sponsoring Organizations (COSO) of the Treadway Commission studied financial statements frauds and developed a taxonomy of these schemes applicable to publicly traded companies (or listed companies). The COSO report identifies fraud schemes in the areas of improper revenue recognition; overstatement of assets (other than accounts receivable related to revenue fraud); understatement of expenses/liabilities; misappropriation of assets; inappropriate disclosure; and other miscellaneous techniques.

About half of all financial statements frauds involve overstating revenues and overstating assets, with overstating revenues being the most common type of financial statement fraud according to the report.

Fraudulent Schemes that overstate Revenues and Assets include the followings;

1. **Sham sales:** This scheme involves recording fictitious sales and frequently includes falsified sales, inventory, and shipping or delivery records. In some cases, company employees go so far to hide part of the inventory to make it appear that the hidden items have been sold.
2. **Pre-mature revenue recognition –** which is a Process by which company employees record sales after receiving customer orders but before shipping the goods
3. **Recognition of Conditional sales:** Process by which employees record sales for transactions that are not yet complete because of unresolved contingencies. In some cases, employees make secret agreements with the customer that alter the terms of sales. For example, a company could secretly agree that the customer can return all unsold goods.
4. **Abuse of cut-off date of sales:** Normally, a company's book are closed at the end of each reporting period, and sales that occur after the closing date do not appear on the current period income statement. Some companies keep the books open after the closing date and include the next period's sales on the current period income statement.
5. **Misstatement of the percentage-of-completion:** Revenue from some types of contractual work, such as construction, is considered to be earned according to the estimated percentage of the project completed. In this scheme, employees overstate the percentage of completion, and thus overstate revenues.
6. **Consignment Sales:** Employees ship goods to customers on consignment basis but record shipment as normal sales. This is usually done at the end of the accounting period to record the sales in the current period. When the goods are returned in the next period, they are charged against the next period's sales.

7. **Unauthorized shipments or channel stuffing:** Here, employees create sale orders at the end of the accounting period by shipping goods that have not been ordered to record the shipment in the current period's sales. When the goods are returned in the next period, they will be charged against the next period's sales. This process is similar to that of consignment sales above.

Channel stuffing is a similar process, but the company has a relationship with the customer to which it automatically ship goods according to the company's estimates of the customer's demand. The company takes advantage of the relationship and ships too many goods toward the end of the accounting period.

In addition to the above schemes, inadequate disclosures in financial statements are other forms of financial statement fraud scheme. **Inadequate disclosure fraud** involves the issuance of fraudulent or misleading statements in the disclosures. Somewhere in its annual report or through press releases or other media, management makes statements that are wrong but do not impact the financial information (figures) or line items, on the financial statements. Disclosure fraud can also include statements that should have been, but were not, made by management (misleading because of what is not said - fraud by omission).

The fraudulent schemes that inadequately disclose financial statement information can be categorized into the following three groups:

- Misrepresentations about the nature of the company or its products usually made through news reports, interviews, annual reports, and elsewhere.
- Misrepresentation or omissions in the Management's Discussion and Analysis (MD & A) or in other non-financial statement section of Annual reports.
- Misrepresentations or omissions in the **notes to the financial statements,** such as failure to disclose related -party transactions.

The International Accounting Standards (IAS) No. 24 on '**Related Party Disclosures' defines a** 'related -party transaction' as a transfer of resources, services or obligations between related parties regardless of whether a price is charged.

The most common related party relationship is where one entity is a subsidiary or an associate of another entity.

Effect of Financial statements fraud on company and Management

Financial statements fraud affects the company and management in several ways. They include the following:

1. In the majority of cases, the Securities and Exchange Commission (SEC) enforcement action for financial statements fraud is associated with bankruptcy/liquidation or a change in ownership.
2. In many cases companies are delisted from the Stock Exchange. Delisting tend to be associated with large declines in companies' market values.

3. Managers accused of financial statement fraud are often named in class action civil suits under the Criminal Code Act Cap C38 LFN 2004, or the EFCC Act 2004.

4. Accused managers are often fined or their employment with the company is terminated.

5. Jail sentence occur relatively infrequently, but this is changing as a result of the EFCC Act (Nigeria) and Sarbanes-Oxley Act (USA).

6. The various Acts empowers SEC and other related regulators to permanently bar offenders from serving as corporate officers or directors.

Summary and Conclusion

This paper reviews a number of features of financial crises with special focus on financial statements fraud (FSP) as the root cause of capital market financial crises. Financial statement fraud is harmful not only to individual investors but also to capital markets and society as a whole. The Stock Exchange can be viewed as a mechanism that assigns gains and losses to individual shareholders on a risk-reward basis. Capital market participants take risks when buying or selling shares, and the market rewards investors who make good decision (gainers) by transferring wealth to them from those who make bad decisions (losers). Financial statement fraud artificially interferes with the capital market's determination of who is a gainer and who is a loser. For example, SEC rules require public companies to file annual and quarterly financial statements with the capital market. The information contained in those financial statements influence the behaviour of the stock market significantly. Artificially interfering with the market's rewarding of gainers and losers hurts the economy and the capital markets because rewards are in effect a signal to produce more product and services (Hopwood *et al*., 2012). The effect of financial statement fraud therefore is to reduce the supply of valuable services and products that are available to society at large.

Recommendations

Based on the literature review, summary and conclusion, the paper recommends as follows:

1) Independent auditors should determine whether accounting principles are properly selected and applied and whether disclosures are adequate.

2) Corporate executives, auditors and directors should realise that they are agents to the company's principal (the shareholders) and as such should not fix remuneration that will erode the earnings per share of the company or the shareholders' interest. Persistent decline in earnings per share affect the capital market negatively.

3) Audit committee should work closely with the internal auditors, external auditors and management to ensure the integrity of external audit processes. It should carefully investigate any problem pointed out by external auditors.

4) Corporate directors' remunerations must not be tied to a certain percentage of gross profits or gross earnings as such can tempt them to manipulate a component of the company's income statement to their own advantage.

5) Policy makers need to determine when (and to what extent) increases in asset prices and credit represent substantial deviations from those that can be explained by market fundamentals.

If the behaviour of credit and financial markets suggests signs of risks, they need to determine what would be the optimal policy responses to minimize risks and mitigate the adverse effects when risks materialize.

6) Public exposure or loss of reputation from investigating and not investigating should also be considered by fraud investigators, because an exposure of fraud in a particular bank for instance, can result to **bank runs,** (i.e, a situation where a large number of customers withdraw their deposits because they believe the bank is , or might become insolvent or liquidated).

7) Government should not tolerate gross inequalities of wealth status and power. Executives being in public, banking, or private sector should think how their decisions affect other people. They should let conscience be their guide.

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