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Roots of Responsibilities to Financial Statement Fraud Control

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Abstract

Financial statement fraud cases also occur when weak internal controls exist. Besides these reasons, the research differentiates between the two major types of financial statement fraud. This research discusses the responsibilities of financial statement fraud control by looking at agency theory, stakeholder theory, public interest theory; capital needs theory and communication theory. This discussion is in tandem with the principal investigation of internal control strategies in relation to financial statement fraud control. The output of this paper provides a comprehensive understanding of responsibilities for financial statement fraud control in the context of the above theories and finally contributes recommendations for improvement in financial statement fraud control in public interest entities.

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Keywords:

1. Introduction

The collapse of a number of large companies such as Enron Corporation (Moncarz et al., 2006), WorldCom (Thornburgh, 2006), Global Crossing (Gomez, 2008) and Adelphia (Barlaup et al., 2009) at the turn of the 21st Century, after the publication of financial accounts which were found to be misleading, affected the confidence of investors and led to legislative responses typified by the Sarbanes-Oxley Act 2002 in the United States.. These accounting scandals raised general questions concerning the reliability of financial information in the US capital

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market, the extent of market misconduct in the US and the responsibility of auditors in relation to financial statement fraud detection (Razaee, 2002). More recent, further doubt was thrown on the reliability of accounting practice in the relatively simple grocery business of retailing, when the major UK retailer Tesco revealed that interim profits had been overstated by £250 million – over a quarter of the true figure (Felsted, Oakley and Agnew, 2013).

The subsequent attention to financial statement reflected an increasing number of global financial statement fraud cases (PricewaterhouseCoopers, 2005). Research done by Skousen et al. (2008) explored examined the effects of pressure and opportunity on the incidence of financial statement fraud. Financial statement fraud cases occur where there are weak internal controls. Besides these reasons, the research differentiates between the two major types of financial statement fraud. The first type of financial statement fraud committed by top management involves misleading the company investors, which results in large losses to investors and diminishes the company's reputation and that of accounting professionals associated with it. Generally, the second type of financial statement fraud might be committed by top or middle management concerned with fulfilling the company's expectations, particularly to earn bonuses and compensation.

This paper discusses the responsibilities for financial statement fraud control by looking at agency theory, stakeholder theory, public interest theory; capital needs theory and communication theory. This discussion is in tandem with the principal investigation of internal control strategies in relation to financial statement fraud control. The output of this paper provides a comprehensive understanding of responsibilities for financial statement fraud control in the context of the above theories. Finally, this paper also contributes recommendations for improvement in financial statement fraud control in public interest entities.

2. Financial Statement Fraud

Financial statement fraud constitutes a variety of offenses in different jurisdictions. For example, in the UK it constitutes false accounting under the Theft Act 1968, s.17, fraud by false representation under the Fraud Act 2006, s.2 and potentially market abuse under the Financial Services and Markets Act 2000, s.118.The National Commission on Fraudulent Financial Reporting (1987) defines financial statement fraud as reckless conduct by act or omission that results in materially misleading financial statements. Grazioli et al. (2006) define financial statement fraud as an intentional process of deception by the company management and KPMG (2005) explains that financial statement fraud occurs when financial records have been falsified or manipulated or altered. However, this goes beyond the requirements for intent in common law, where recklessness is sufficient to constitute the necessary *mens rea* for most criminal acts. The Fraud Act 2006, s.2(3) requires only that the person making the false representation "knows that it is, or might be, false or misleading," while the Financial Services and Markets Act 2000, s.188(7) establishes an even lower threshold, only requiring that a person disseminating misleading information to the market "knew or could reasonably be expected to have known that the information was false or misleading.

Financial statement fraud may occur through the fabrication of numbers in the accounts or by the misapplication and wilful misinterpretation of accounting standards (Rezaee, 2002; Spathis, 2002). A number of financial statement fraud issues have been discussed in the literature. The Federal Bureau of Investigation (FBI) (FBI, 2010) and Telberg (2004) identify improper revenue recognition and profit inflation as the most common forms of financial statement fraud, with Fifth (2005) identifying the use of fictitious customers balanced by fictitious suppliers as a common method of recording fictitious revenue. There have been proven cases where managers of listed companies have committed financial statement fraud to increase share prices and attract company investors by inflating the company's profit (Kellogg & Kellogg, 1991). Other common types of financial statement fraud are delaying financial disclosure and including false information in the company's prospectus (Rezaee 2002; Cheng et al., 2006). Such fraud not only breaches the Listing Requirements but also misleads the existing and potential investors in the company. In relation to this, the motives for financial statement fraud are mainly (1) to increase the share price (2) to attract the investors and (3) to "window dress" the company's financial performance to meet the Listing Requirements (Beasley et al., 1999).

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