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FINANCIAL STATEMENT FRAUD: INTENT - THE FINE LINE

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Introduction:

In 2001, Enron was forced to file bankruptcy due to fraudulent accounting practices (Enron). In 2003, the CEO of HealthSouth was charged with $1.4 billion in accounting fraud (SEC). In 2002, the SEC filed charges against former senior executives of Rite Aid for many fraudulent accounting practices including overstating net income by $1.6 billion (SEC).

Riding the waves created by the above-mentioned fraudulent activities, it is difficult for investors and the general public to trust companies and their financial statements. After much research on the underlying causes of fraud and ways to detect it, the key component of fraud is intent. Intent is the fine line between fraud and earnings management. Earnings management is the act of smoothing income to make a company more attractive to investors. Investors, as a general rule, do not desire to invest in companies with volatile earnings. Timing investments, sales, and expenditures are legitimate ways of smoothing earnings (Magrath and Weld 2002). The problem begins where the legitimacy ends. Fraud can be difficult to detect because, obviously, the people committing fraud are also committed to hiding it.

FASB Pronouncements:

All FASB pronouncements are relevant to fraudulent accounting due to the fact that fraud occurs when the procedures described by the pronouncements are not adhered to. In 2002, President Bush signed a new law that was designed to reform business practices in an attempt to make it more difficult to report fraudulently. The law is the Sarbanes-Oxley Act of 2002.

Implications:

According to Magrath and Weld (2002), in 1998, Chairman of the SEC, Arthur Levitt expressed his concern on the issue of earnings management, and threatened any company suspected of the act. He failed to draw a distinction between abusive earnings management
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and normal earnings management. He did, however, list techniques that suggested he was talking exclusively about fraudulent earnings management, such as cookie jar reserves, creative acquisition accounting, big bath restructuring charges, immaterial incorrect applications of accounting principles, and premature recognition of revenues. Since these sorts of techniques are hard for investors and other outsiders to detect, Magrath and Weld (2002) offer some early warning signs that companies may be exercising fraudulent accounting practices.

The first warning sign is the failure for cash flows to correlate with earnings. Cash flows should correspond with earnings. If they do not match, there is a possibility that revenues are being artificially increased by early recognition or false sales. Receivables should also correlate with revenues. The failure to be correlated could be a sign that the company is recording false sales or receivables. The allowance for doubtful accounts not matching the receivables account is a sign that they may be purposefully understating or recording false sales. Reserve accounts should be correlated with particular balance sheet items, such as warranties, future commissions, and allowance for doubtful accounts. These not matching their counterparts could indicate earnings manipulations. Acquisition reserves should be closely scrutinized for their legitimacy by investors. There is the possibility, if a company has large reserves for acquisition of new assets or restructuring, they are overstated. The last of the warning signs that Magrath and Weld (2002) offer is too much consistency. Companies that consistently meet analysts' expectations are possibly exercising fraudulent accounting. The incentive to practice fraudulent accounting is the company's desire to meet these expectations to protect their value and reputation in the market.

Geresh (2003) expresses the relationship between organizational cultures and accounting procedures through research of 160 companies, half of which had been convicted of issuing fraudulent financial reports and the other half of which had not been found guilty of such practices. Geresh (2003) compared the organizational culture of the fraudulent companies to those companies not guilty of fraudulent accounting. The first cultural behavior in question was related-party transactions. The other behavioral questions include the history of the company relative to fraudulent behavior, the influence of founders on the board of directors, and the influence of CPA's on the board of directors.

The findings of Geresh (2003) indicate there is a correlation between these behaviors and fraudulent activities within companies. Firms with more founders and less CPA's on the board of directors are
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more likely to behave fraudulently than companies without these characteristics. Firms that are involved in related-party transactions are also more likely to use fraudulent accounting procedures. Also, there appears to be a trend in the history of the fraudulent companies. Companies that have not committed fraud before are less likely to commit fraud than those who have done it in the past. This is also consistent with the ideas of Magrath and Weld (2002), who believe in the domino effect. Once a company prematurely recognizes revenue, they must continue to do so in order to keep up with analysts’ expectations.

Hotaling and Lippitt (2003) feel part of the blame for the rise in fraudulent accounting is due to FASB itself. They believe that in order to comply with FASB pronouncements, accountants are not allowed to exercise much judgment and, therefore, are not able to adhere to the basic structure that supports the pronouncements and our reporting rules. They make their case based on the fact that all FASB pronouncements are not all-inclusive and some are extremely complex. Not all types of transactions are covered by the pronouncements and, therefore, some transactions have to be defined by the rules in order to be accounted for in a specific manner. The rules that Hotaling and Lippitt (2003) mention are as follows: accounting for leases, research and development (R&D) expenditures, stock options, and special purpose entities (SPEs).

The guidelines used for determining whether a lease is capital or operating provides some scope to structure the lease so that, regardless of the actual economic reality of the transaction, it meets the company’s needs. For example, a company can lease an asset for 74.9% of the estimated useful life of the asset and still classify it as an operating lease even though for the majority of the life of the asset it will be in the lessee’s control. R&D expenditures are to be expensed immediately according to GAAP because FASB feels that it is difficult to measure future economic benefits from these sorts of expenditures. Hotaling and Lippitt (2003) feel that this is inappropriate because many of these expenditures produce assets that clearly increase the value of the company’s stock. While FASB feels that the fair value method of accounting for stock options is more reflective of actual economic costs, they allow companies to use the intrinsic method as long as the fair value method is disclosed in footnotes. Hotaling and Lippitt (2003) feel that this is due to FASB conceding to pressure from industries and politics. Accounting for SPEs is another area of concern. A lessee can avoid consolidating special purpose entity’s statements if one of the following guidelines fails to be met: the SPE was created specifically to solely benefit the lessee, the lessee guarantees
the SPE’s debt, and the lessee owns at least 98% of the equity in the SPE. For example, if a lessee creates a SPE specifically for its own benefit and guarantees its debt, the debt does not have to show up anywhere but in the notes if at least three percent of the SPE is owned by someone else.

Hotaling and Lippitt (2003) feel it is time for FASB to do something about some of these pronouncements. They are opposed to FASB being dictated by politics, especially when the end results are not in conjunction with the real economic picture. They also express their concern that accountants and auditors are not allowed the freedom to use educated judgment in order to express the economic reality of a company in their financial statements.

Phillips, et al. (2003) explored the possibility of using deferred tax expense as a tool for detecting earnings management. The idea they share is that, because of the differences in tax laws and GAAP, managers can report less income for tax purposes by creating temporary book-tax differences. For example: managers can play with depreciation expense to have their financial statements show the net income they desire, but not pay taxes on the increased income because for tax purposes they can only use certain depreciation measures and GAAP is fairly flexible regarding the type of depreciation and the length of the useful lives of depreciable assets. Their research is based on the prior research of Mills and Newberry (2001), which provided evidence that firms with more incentives for earnings management have larger book-tax differences than firms with fewer incentives.

Phillips, et al. (2003) tested three hypotheses: (1) the effectiveness of using deferred tax expense to detect earnings management to avoid a decline in earnings; (2) using deferred tax expense to detect earnings management to avoid a loss; (3) and using deferred tax expense to detect earnings management to avoid failing to match analysts’ forecasts. Their samples consisted of only United States corporations because foreign companies have different accounting issues. They excluded financial institutions and utilities because they would have different incentives for managing earnings. They also excluded partnerships and other flow through entities because they do not account for income tax expense. They could only include information starting after SFAS No 109 became effective, since it caused many changes in GAAP for income tax reporting purposes. Their statistical research was based on formulas derived from the previous research of Bugstahler and Dichev (1997), Healy (1985), Dechow (1995, 2002).

Phillips, et al. (2003) found their results to support two out of three of their hypotheses. They found that deferred tax expense can be useful in detecting earnings management in regards to avoiding losses
and avoiding reporting a decline in earnings but not in avoiding failing to match analysts’ forecasts. They suggest that further research take the following into consideration: managerial guidance, components of deferred tax expense, and the usefulness of deferred tax expense in other settings.

Beneish and Vargus (2002) explored insider trading as a basis for determining earnings quality and the impact of accruals on earnings management. They suggest that, based on the fact that managers have relevant private information about economic factors that affect earnings quality, they can and will trade based on this information. They also suggest that auditors and investors fail to realize the potential for earnings management through accruals. They show that companies with income-increasing accruals and unusual insider selling have abnormal accruals that suggest earnings management and a larger tendency to report larger profits due to income-increasing accruals. They propose that investors should be made aware of insider trading. Their research is based on the belief that stock prices create expectations of earnings quality.

The beliefs of Beneish and Vargus (2002) led them to several hypotheses. Their hypotheses propose that the relevance of income-increasing accruals and income-decreasing accruals can be suggested by insider buying and selling, and that the expectations caused by market prices fail to reflect the relevance of insider trading. Their sample began with all of the companies listed on the Compustat Industrial, Research, and Full Coverage 1998 tapes for the years 1985 through 1997. They excluded financial service companies, companies without December year ends, companies with discontinued operations that were equal to more than five percent of total assets, and those without enough information to compute accruals. They ended up with a sample consisting of 3,906 firms from 1985 through 1996. They retrieved their insider trading information from the National Archives Center for Electronic Records and from Thomas Financial. Their statistical research formulas were based on prior research on insider trading by Baesel and Stein (1979), Nunn et al. (1983), Seyhun (1986), and Lin and Howe (1990).

The research of Beneish and Vargus (2002) shows that insider trading is a relevant factor in determining earnings quality and the importance of accruals. They provide evidence that investors tend to have faith in the quality of income-increasing accruals and that the relevance of income-increasing accruals is linked to insider selling and buying. Income-increasing accruals, along with insider buying, is a sign of higher quality accruals. Income-increasing accruals, along with insider selling, is a sign of lower quality accruals. They suggest
that future research take the following into consideration: isolation of the motives of insider trading, the separate components of accruals, and basis of investors' optimism related to companies.

Conclusion:

In a capitalistic society, it is imperative that investors be able to trust the worthiness of financial statements, accountants, and auditors. Fraud detection is key to the survival of our society. It is almost impossible to determine the intent of key decision makers of corporations, but it is easy to be leery of any inconsistencies in their statements and accounting practices.

There are many ways of committing fraud: premature revenue recognition, insider trading, inflating reserve accounts, playing with accruals, exploiting the differences between financial accounting and tax accounting, just to name a few. The best way to detect fraud is to be aware that it exists in many different forms. Fraud is a major problem, not just for the companies who practice it or the accountants and auditors linked with fraudulent companies, but also for the accounting profession. Reputation is key to the future of any profession. Detecting fraud is important in protecting the reputation of the accounting profession.
References


