

Herr Reto Silvani

Kurzfassung: Fraudulent Financial Reporting / Key Concepts / Common Methods and Risks

What is involved

This concludes the conceptual analysis; i.e. circumscribing situations leading up to, and key factors underlying financial statement fraud. It is evident that the most pervasive research relating to the subject emanates from the US, and the conceptual analysis presented is therefore admittedly US-oriented. It is also evident that the US uses the term financial statement fraud indiscriminately to refer to material misstatement of financial information as well as to fraudulent financial reporting without paying much attention to the fact that fraud in the legal sense may not always be involved. In section 1.2 the attempt is made to draw attention to a so-called "grey area" between fraud and aggressive accounting, citing the relevant professional literature and a known authority on the subject in the person of former SEC chairman Arthur Levitt. That section also highlights two important characteristics of FFR which have been corroborated by empirical research, namely the fact that misleading financial information almost always involves the enhancement of reported sales or earnings, and that FFR primarily involves improper revenue recognition. This concept, in turn, should not only be understood in terms of violating realisation rules and disregarding the completion of the earnings cycle, but also in terms of disregarding Substance Over Form when dealing with certain gains or unusual and infrequent events or transactions. Misleading financial statements often contain less than "arms length" transactions which are difficult to detect because they involve collusion of co-conspirators or related parties both within and outside the enterprise.

Who is involved

Studies of the motives for FFR cite internal and external incentives and pressures triggering reactions in individuals for reasons of fear, pride or ego. The phenomenon is described in the form of a so-called "fraud triangle", which depicts these incentives and pressures, the opportunities to carry out the fraud and the rationalisations to justify it. The perpetrators involved almost inevitably include the CEO or the CFO. These top executives are also the people best in a position to influence the auditors and, paradoxically, they are looked upon in the "pecking order" of corporate hierarchy as the very individuals responsible for producing so-called "fair presentation of financial position and results of operations". The size of the companies involved has surprisingly been found to be rather small and not commanding over a huge amount of assets or turnover. The research results are however limited to cases scrutinised by the SEC. Had the study been extended to cover publicly listed companies involved in expansion, mergers and acquisitions or excessive diversification, the results would probably have been quite different. Finally, section 1.3 comes to the conclusion that the victims involved are not only creditors and shareholders, but also professionals and insurers and, last but not least, the consumer at large end up as victims of FFR, if for nothing else than losing their job and thereby starting a vicious macroeconomic downward cycle.