Chapter 8

Fraud Risk Management for Listed Companies’ Financial Reporting

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ABSTRACT

Using accurate and reliable financial information is the primary condition for successful investments on a stock exchange. Nevertheless, some major corporate scandals broke out at the 21st century horizon and concluded with a major capital market crisis in confidence. Recent events have proved that Romanian capital market is no exception. All these unfortunate scandals had in common some ingredients, among which are a poor corporate governance, a lack of accountability, and misrepresentation of financial information. This chapter relates to the need of integrity in financial reporting process, as the basis for adequate, reliable, and comprehensive information used in decision making by investors in general, institutional investors in particular. The main focus is to review the characteristics of financial information in order to identify some patterns and depict an overview for sensitive areas that may be vulnerable to fraudulent behavior, such as fair value measurements, related party transactions, revenue recognition, provisions, or asset impairment (inventories and receivables).

INTRODUCTION

Effective capital markets require that accurate and reliable financial information is provided for stakeholders who have invested in the financial perspectives of a listed entity (Kizil & Burhan, 2018). Some resounding corporate accounting scandals that occurred at the beginning of 21st century raised awareness upon the negative effects of fraudulent financial reporting and determined organizations to act more proactive...
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in fighting fraud (Nelson, Elliot & Tarpley, 2002). Soltani (2007) considered that notwithstanding the measures undertaken by market regulatory forces in the aftermath of such scandals, the audit profession is still under pressure to respond to criticism generated by corporate scandals. Enron, HealthSouth, Kmart, Parmalat, Tyco, WorldCom, Waste Management, Sunbeam, Adelphia Communications or Xerox represent just a few examples of companies that were subject to manipulation of financial information, with undesirable effects upon the investors’ community, at the beginning of 21st century. Apart from other corporate failures, Enron, WorldCom, and Tyco highly-publicized scandals provoked over $500 billion in market value declines (Lord & Benoit Report, 2008).

As a result of the major accounting frauds unrevealed within these corporations, investor confidence has been seriously shaken, which has led to the collapse of trading prices despite all management efforts to delay the dissemination of bad news to investors (Kothari, Shu & Wysocki, 2009). According to Louwers, Ramsay, Sinason and Strawser (2007), financial experts have estimated investors’ losses to $7 trillion, over a period of three years from peak prices recorded in September 2000. Other authors, such Beasley, Buckless, Glover and Prawitt (2009) described the devastating impact caused by Enron’s announcement in 2001 related to an overestimation of the earnings declared over the last four years by $586 million, as well as debt understatement due to past unreported liabilities for estimated dollar amount of $3 billion. The massive and understandable public outcry over Enron’s implosion during the fall of 2001 spawned a mad frenzy to determine how the nation’s seventh-largest public company, a company that had posted impressive and steadily rising profits over the previous few years, could crumple into insolvency in a matter of months. From the early days of this public drama, skeptics in the financial community charged that Enron’s earnings restatement demonstrated that the company’s exceptional financial performance during the late 1990s and 2000 had been a charade, a hoax orchestrated by the company’s management with the help of a squad of creative accountants (Knapp, 2006).

Another relevant case is related to WorldCom which, in June 2002, announced a restatement of its financial results caused by the capitalization over the most recent two reporting periods of $3.8 billion in expenses. In fact, at the time, the WorldCom scandal was perceived as “the largest accounting fraud in history, with an overstatement of revenue estimated at $11 billion, an overvalued balance sheet of over $75 billion, and shareholders’ losses estimated at $200 billion”, according to Securities Exchange Commission pronouncements (Ricchiute, 2006).

From examples previously described, one may conclude that fraudulent financial reporting may seriously deteriorate an organization’s reputation and financial strength. The companies’ market capitalization might drop instantly, causing billions of dollars losses for investors, as a result of financial statement fraud. Even if the balance sheet and income statement do not change substantially, a restatement is likely to damage investors’ confidence, and the stock price will deteriorate as a consequence. Also, the auditors may face litigation as a response to investors’ losses, which could mean billions of dollars for large public companies (ACFE, 2014).

According to Soltani (2007), the increasing number of public companies and the high valuations of equity securities have put tremendous pressure on management to achieve earnings or other performance targets. Missing those targets, particularly increasing earnings per share and dividend per share each year, can result in significant declines in a company’s market capitalization and, consequently, reduced pay for those managers whose income largely depend on achieving earnings or stock-price targets.

Even though the auditor profession has a strong position in fighting against fraudulent financial reporting, unfortunate corporate scandals did not avoid Romanian stock exchange, weakening the investors’ confidence. The Romanian case has also a negative connotation among the investor community, due to a
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