

## The Anatomy and Synthesis of Financial Fraud

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### Abstract

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This paper explores the synthesis and anatomy of financial fraud and factors that led to the fraudulent financial reporting. It examines the role accounting rules and standards, regulators, auditors and regulatory capture played in misleading published financial reports. This paper finds that the broad nature of accounting rules manifests the deliberate actions of some corporate executives to engage in earnings manipulation, income smoothing, improper revenue recognition or realization and earnings management to meet predetermined earnings projections. The SEC deems these practices as abusive, materials and intentional misrepresentation of financial information. This paper postulates that the actions of the corporate executives to take adverse advantage of the broad nature of accounting rules grossly violates GAAP requirement and precludes transparency in the published financial reports. This paper finds that the practices of some auditors violate The Standards for the Professional Practice of Auditing which requires auditors to alert all concerned the possibility of intentional fraudulent accounting information and the auditors should have sufficient knowledge to recognize the indicators for potential fraud.

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### Introduction

This paper discusses the synthesis and anatomy of financial fraud and the contributing factors to the Financial fraud. In the past several years the roles the accountants, auditors, managements, accounting stand boards and regulators plays have come to question in the wake of demise of companies like Enron, WorldCom, Global Walk, Health South fiasco just to name a few. Academicians, Accountants, Financial Economist and the Legislators have recognized that for years firms use the latitude in accounting rules to manage their earnings.

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The former SEC Chairman, Arthur Levitt Jr., states that the current approach and practice to use of judgment and fair value management of financial instruments in preparing financial statements has had a destabilizing effect on some companies and financial markets. Corporate scandals including numerous earnings restatements that occurred in the 2000's are evident in the use of judgment and fair value in preparation of financial statements. The management objective to beat earnings forecasts and attain a double-digit return to boost stock prices have saddled us with loss of confidence and mistrust of financial reporting and loss of confidence in the financial market. The insufficient and misleading financial statements information provided to investors and the financial market has led to inflated stock prices and subsequently contributed to financial market instability and recession. This has had a profound and a devastated impact on the US economy and world financial markets. It has also led to current level of high of unemployment excess inventories and plant closures. Jennings (2004) states that the impact of financial statements manipulations on the market is evident when one observes the stock price movement of the three major indices from January 1, 2001 to January 1 2007.

He argues that a sharp decline in indices in the months of April through November 2002 reflect the deterioration of market prices related to numerous adverse report of corporate earnings management and earnings restatements schemes. The stock market did not recover to the pre-April 2002 for approximately two years (Jennings 2004). The slow recovery was due to the loss of confidence in the investing public in annual financial statements published by the firms and audited by the certified Public Accountants. The accounting principles Generally Accepted Accounting Principles (GAAP) are a set of dynamic accounting guidelines that firms and accountants should adhere to when preparing and measuring financial information published in the financial statements. GAAP requires that Accountants prepare financial statements of publicly held firms or publicly traded to conform to GAAP standards and guidelines. The Securities Act set forth accounting and disclosure requirements for publicly held firms. The publicly held companies are required by the Securities Exchange Act to undergo an external audit by an independent accountant once each year. The Securities

Exchange Acts of 1933 and 1934 were designed to restore investor confidence in the financial market after the market crash of 1929 (Gitman and Zutter 2010). In spite of Securities Acts of 1933, 1934 and Investors Protection Act of 2002, good number companies are still engaged in earnings manipulation, structured financing,

earnings restatements which are prelude for recipe to dishonest financial statements presentation. The continue practice of earnings management or restatement and evading annual audit by independent auditors are grounds for the auditors to express their professional and independent opinion to the investing public and to the management. The auditors' opinions are crucial and reflect the auditors' assessments of the financial statement fairness which is determined by the extent to which they are prepared in compliance with GAAP.

In light of the widely publicized cases of fraudulent accounting practices involving such major corporations as Enron and World-Com, Health South along with one of the world's largest and respected accounting firms Arthur Andersen in 2000's some companies faced increased scrutiny. Enron manipulated and inflated its financial information that gave the appearance that company had revenue windfall much higher than they actually were. After the declaration of bankruptcy Enron in 2001, the accounting firm that audited and signed off on Enron's financial statements Arthur Andersen came under attack because its auditors had signed off on Enron's financial information despite numerous misleading financial information. Andersen was found guilty of obstruction of justice by a jury in Houston, Texas, in June 2002. In a speech by SEC staff in the office of Chief Accountant Robert K. Herdman expressed concerns that investors do not have sufficient confidence in the current auditing and financial reporting processes. He states that the investing public and the Commission must be able to rely on the competence, ethics, and independence of accountants who certify the financial statements of public companies. Over the past few years, the dramatic and sometimes sudden reversals of public companies' financial condition, among other things, have highlighted longstanding deficiencies in the regulatory systems used to oversee the quality of audits of financial statements that are filed with the Commission and relied on by investors (Robert K Herdman 2002).

On September 16, 2008 failures of large financial institutions in the United States were attributed to primarily exposures of securities of packaged subprime loans and credit default swaps issued to insure these loans. The issuers of these securitized loans quickly or rapidly devolved into a global financial crisis resulting in a number of bank failures in Europe and a sharp reductions in value of stocks and commodities worldwide. The impact of accounting fraud is evident on financial market when one observe stock price movements or fluctuations of the three major indices from January first 2001 to January 1, 2007.

Beginning October 6<sup>th</sup> 2002 and lasting all week the Dow Jones Industrial Average closed lower for all 5 sessions and volume levels were also record low breaking. Robert L. Putman, Richard B. Griffin and Ronald W. Kilgore (2009) note that Dow Jones Industrial Average fell over 1,874 points or 18% in its worst weekly decline ever on both points and percentage basis. The S&P 500 fell more than 20%. The prolong drop in stock prices began on April 2002, and bottomed out in late 2002. The indices indicate that these few months (April-November, 2002) reflect the deterioration of the market prices related to numerous adverse media reports of corporate earnings management scheme (Robert L. Putman, Richard B. Griffin and Ronald W. Kilgore et al 2009).

In 2010, it was discovered that Lehman executives employed balance sheet manipulation by implementing an esoteric financial procedure called Repo 105 and 108 which masked the bank's true financial conditions from the regulators and investors. Repo '05' and '108' transactions temporarily removed the structured securities inventory from the Lehman's balance sheet to create a materially misleading financial picture of the firm. Lehman accounted the Repo 105 transaction as sales instead as financing transactions based upon the over-collateralizing in Repo 105 transaction. By reclassifying the Repo 105 as sales, the Lehman executives were able to remove the Repo 105 inventory from its balance sheet. Lehman executives regularly increased its use of Repo105 transactions prior to the reporting period to reduce its reported net leverage and balance sheet.

### **Accounting Standard and Financial Statements.**

Financial accounting is the process that culminates in the preparation of financial report of a firm or business as a whole for use by both internal and external users. A financial statement then becomes the principal through which financial information is communicated to those outside the firm. Financial accounting plays a vital role in a market driven economy and competition because it assist in providing information that leads to capital and assets allocation. The better the information provided in the financial statements and the markets, the more effective the process of capital allocation and then the healthier the economy.

The objectives of financial statements are to provide information that are useful for decision making process that are helpful to present, potential investors, creditors, and other stakeholders in making prudent and rational decisions.

It also assist the users of financial information to predict the risk, timing of cash flows, economic resources, changes to economic resources , changes inresources and claim to those resources. Financial statements provide the users with the much needed information that is used in valuation of firms, and in corporate finance. The principles that govern the preparation of financial statements and help determine the rules are the GAAP. Accounting practices are guided by four broad principles 1. Revenue recognition or realization principle, 2. Matching principle, 3. Historical cost principles, and 4. Full disclosure principles.

GAAP require that income statement be prepared and classified into four sections: Income from continuing operation, Income from discontinued operation, extraordinary gains and losses and Adjustments for changes in accounting principles. Firms' financial statements are presented in four basic financial statements 1) Statement of Financial Position (Balance Sheet) 2) Statement of Operations (Income Statement) 3) Statement of Cash Flows, and 4) Statement of Owner's Equity. These statements put together give an accounting picture of a firm's operation and financial position. Financial statements provide useful information as to acquisition assets, uses of funding, earnings and dividends over a period of time. The elements of financial statements provide useful information to the users of financial statements when they possess qualitative characteristics, subject to the constraints of materiality, cost effectiveness and conservatism. Pitman (2001) states that manager's abuse the discretion afforded them by the Generally Accepted Accounting Principles (GAAP) and intentionally distorts information contained in financial statements. The current corporate accounting and auditing standards threatens investors' confidence in the quality and integrity of financial reports. Grover Beth M.(1992) states that some large corporations are taking advantage of rules to bolster their economic outlook. They argue that companies are taking big write-offs so that later they can add that reserve to their operating income if the initial write-off was too large. Church, McMillan, and Schneider (2001) state that managers typically have income-increasing motives. They argue that managers may be compelled to maintained earnings growth or outperform expectations because such behavior enables them to placate current shareholders and attract potential investors creditors.

The fraudulent financial statements, earnings manipulations, understated liabilities, and overstated assets reported were the prelude for deception and eventually led to the demise of Enron, WorldCom, Tyco, Lehman Brothers, HealthSouth, Global Crossing, Adelphia, and the host of other businesses.

Lev (2003) argues that earnings are a major variable to into firms' security valuations which in turn affect security prices, and management's compensation and wealth. Earnings are used in evaluating viability of a firm, performance and quality of management. King (1992) states that GAAP set of standards adopted by Accountants concerned with the preparations of financial statements. He argues that based on the contents of the Generally Accepted Accounting Principles, however, misleading financial statements may be reported in a manner in which that knowledgeable credit managers may not to be able to detect. Thus it is to the credit managers' benefit not to rely solely on the misleading GAAP financial statements (King 1992).

### **Accounting Setting Standard**

Quinn (2003) states that until the early 1970's US accounting setting standards evolved around a relatively straight forward set of principles designed to guide accountants and auditors involved in overseeing the number crunching processes at the publically held companies. He says that the principles were developed under the auspices Accounting Principles Board (APB), launched by the American Institute of Certified Public Accountants (AICPA) in 1959 to ensure that audits adhere to ethics and auditing standards. Quinn (2003) argues that in the late 1960's, a series of accountingscandals erupted, and overly aggressive CEO's took advantage of the broad nature of the Accounting Principles Board pronouncements and their underlying principles were to achieve the financial results they wanted. In the circumstance, therefore, there were congressional hearings on the broad nature of the principle base accounting system that manifested the blatant fraudulent financial reporting and as a result Accounting Principles Board was replaced with Financial Accounting Standard Board in 1973. These financial reporting improprieties have led to the erosion of confidence in investors, employees and the general public. The growing concern is that management takes advantage of flexible nature (loophole) in accounting rules provided by the generally accepted accounting principles (GAAP), to distort and misrepresent information contained in the financial statements without stepping outside the loose confines of generally accepted accounting principles.

The provisions in Generally Accepted Accounting Principles allow corporate executives use judgment to determine the amount to be reported in the financial statements that are made available to the external users of the financial information. The use of judgment in reporting financial information opened a Pandora box. Larry and Raymond (1994) indicate that there is a conflict between Financial Accounting Standard Board (FASB) and the Governmental Accounting Standard Board ( GASB) when promulgating new standards for transactions that affect both areas.

The conflict being that the two bodies tend to provide different answers to the same questions. Walter (1991) believes that accounting standards should be less complex so that they can be implemented and understood by everyone. The author states that some of the FASB's recent and no-so-recent standards are too complicated and so future standards should be based more on simple bright-line rules. He argues that keeping accounting standards simple will help not only users and preparers but also the FASB as it promotes its ideas to international community. Davis (1989) points out that user of accounting information have a difficult time as it is with accounting terminology, but when the user changes the meaning of the same term from day-to-day, the interpretation of the information becomes impossible. He stresses that the importance of interpretation is critical for internal and external users. Dailey and Poteau (1994) suggest that Financial Accounting Foundation (FAF) provide more leadership in resolving these dilemmas. They argue that the management, the accountants and the auditors have come to believe that it is easier to circumvent the accounting rules to look good and boost earnings per share. The authors stress that this loophole abuse corporations and banks be it defunct or existing ones should call for investigations into how other firms or corporations are presently taking advantage of artificial schemes to manipulate and misrepresent their financial statements. Dean (1993) suggests that corporate interest influence many of the FASB's standards along with funding and membership. One way to make FASB update accounting regulations is to make Securities and Exchange Commission responsible for appointments of Board membership (Dean 1993).

In 2002 the Investment Protection Act of 2002 popularly known as Sarbanes-Oxley Act was signed into law. The legislation is designed to curb the deliberate actions by management to misrepresent their financial statements and to bring back, heal, and restore confidence and trust for the American financial market. Levitt (2002) states that Investors Protection Act by itself is not a sufficient mandate for insuring accuracy for future accounting malpractices and other legal misrepresentation of accounting data and figures many companies have thus far employed. He stresses that compliance to Sarbanes-Oxley Act requires documentations and verifications on internal controls and increased emphasis in internal control effectiveness. The desired results include more transparency, accountability, and truthfulness in reporting transactions. Herdman (2002) expresses his pleasure to the commissioners to recommend a rule proposal that will provide a framework for a Public Accountability Board (PAB) to oversee the auditors of public companies.

The proposal addresses concerns that investors do not have sufficient confidence in the current auditing and financial reporting processes. He stresses that the investing public and commission and the Commission must be able to rely on the competence, ethics, and independence of accountants who certify the financial statements of public companies.

### **Earnings Management and Manipulation**

Earnings management is a management practice of using the flexibility in accounting rules to improve firms' earnings. Stanley and Waldron (2007) argue that corporate managers take a deliberate action to manage earnings within the provisions of GAAP meet or exceed analysts' projections and market expectations. They argue that GAAP is rule based that allow the use judgment, but the wide latitude flexibility that exist in its application, and many subjective judgments and assumptions must be made in determining accrual-based earnings. Brown (1999) notes that it is the latitude, flexibility, use of judgment, and subjectivity within the provisions in GAAP that allow earnings management to thrive. Pitman (2001) defined earnings management as the use of judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting judgment.

SEC Chairman, Arthur Levitt Jr., states that earnings management is generally pursued with five accounting practices such as the big bath, restructuring charges, creative acquisition accounting, and cookie jar reserves immaterial misapplications of accounting principles, and the premature recognition of revenue. Desai (2005) states that the corporate profits are the measurement that is central to capital allocation within the economy and to a variety of economic policy decisions.

He argues that investors infer a company's prospects and value from reported earnings, adjusting portfolio decisions in response to changed estimates and aggregate corporate profits are often employed to forecast overall stock market.

Earnings manipulation occur when management use judgment in financial reporting and structuring transactions to alter financial report to make earnings appear higher than they actually are.



The underlying economic performances of the company are masked to mislead or influence contractual outcomes that depend on published financial statements. Schipper (1989), Lev (2003) classified earnings manipulations into three overlapping categories: personal gain, continuation of investors/suppliers support, and satisfying contractual agreements. He argues that in some cases managers manipulate earnings for personal gain because a large portion of executive compensation (stocks and stock options) is typically linked directly or indirectly to earnings.

Healy (1985) documented an upward trend in earnings manipulation when pre-manipulated earnings fell within the bonus bounds of the company, and a downward trend of earnings manipulations when pre-manipulated earnings fell outside the bonus bounds, presumably to shift the "saved" earnings to future periods when they would have an impact on the bonus. Lev (2003) report that in 1990's accounting scheme helped to inflate Xerox's stock price so that the executives could cash in \$5 million in performance based compensation and more than \$30 million from stock sales. He argues that Xerox stock rose to more than \$60 per share in mid 1999, the period which SEC says that the Xerox's executive were manipulating earnings before the stock price fell to less than \$4 per share in 2000.

Jordan, Clark and Waldron (2007) state that one of the reasons why firms manage or manipulate earnings is to meet market expectations or forecasts by analysts. They argue that the companies that meet or exceed earnings expectations enjoy the benefit of higher stock prices and earnings per share relative to companies that do not meet earnings expectations. Glaum, Lichtblau, and Lindeman (2004) also indicate that that management manipulates earnings to increase their own wealth through bonus schemes tie to earnings. Brown and Higgins (2001) earnings management occurs as management seeks to enhance share-price performance because of the resultant benefit accruing to them from their stock-based compensation packages. Church et al (2001) note that earnings-based bonus plans and restrictive debt covenants can create economic incentives for managers to manipulate earnings. They argue that the objective of such behavior is to maximize the present value of bonus income and maintain compliance with debt covenants. Such behavior may involve the use of discretionary accruals and accounting changes, it may also be affected through deliberate, non-GAAP manipulations of financial data (Church, et al., 2001)

Schipper (1989) states that financial statement manipulation can be divided into two separate but often blurred categories: earnings manipulation and earnings management.

He argues that the distinguishing characteristic between manipulation and management is somewhat subjective but it is generally seen as a technique(s) used in preparing financial information that is either misleading or inaccurate. The difference according to Schipper in 1989 can rest in whether the technique used might fall within or outside the requirements and recommendations provided Generally Accepted Accounting Principles. Goel and Thakor (2003) earnings smoothing is a special case of earnings management involving inter-temporal smoothing of reported earnings relative to economic earnings; it attempts to make earnings less variable over time. They distinguish two types of earnings smoothing (artificial and real smoothing) and argue that real smoothing involves the changing the timing of cash flows from investments and providing promotional discount and provide financing to risky customers to boost sales. On the other hand artificial smoothing involves the use of flexibility afforded by the general accepted accounting principal to attain desired sales level. Jackson and Pitman (2001) argue that earnings management represents purposeful intervention in the financial reporting process with the intent of obtaining personal gains. Arthur Levitt, chairman of SEC, states that "the practice of management of earnings should be abolished for the sake of our markets; for the sake our global economy which depends so much on the reliability of America's financial system; for the sake of investors; and for the sake of a larger commitment not only to each other, but to ourselves".

A version of earnings management that has become far more common in recent years is the reporting of 'pro forma earnings' measures. Pro forma earnings are based on forecasted financial data to ascertain the sales, expenses, and income to sustain the operation of the company. These measures are called or referred to as operating earnings; a term with no generally accepted definition. The pro forma earnings statements are calculated ignoring certain expenses such as restructuring charges or costs, stock-options expenses or write-down of assets from continuing operations. Ross (2005) points out that the corporate executives are allowed to use judgment to determine amounts reported accounts that greatly affect resulting financial information. The 70-year old development GAAP has produced a set of principles, not hard-and-fast rule, that allow judgment to be exercised when measuring the effects of company events.

Management believes that by ignoring these expenses, a clearer picture of the underlying profitability of the firm will emerge. Stanley et al (2007) state that earnings management can be accomplished because the determination of accrual earnings under GAAP is subject to numerous estimates and judgments in accounting policy choice. Statement of Financial Accounting Standards No 143 (SFAS No 143). There is so much leeway for choosing what to exclude or include that it becomes hard for investors and analysts to interpret the numbers across firms. The lack of clearly defined standards gives management leeway to manipulate earnings. GAAP allows firms considerable discretion to manipulate earnings. David and Geoff (1991) notes that, it is precisely this subjectivity in applying GAAP that allows earnings management to flourish in firms. In the late 1990's Kellogg took advantage of the flexibility in accounting rules and capitalized its restructuring charges over three years which are supposed to be treated as ordinary expense or period costs.

Jackson and Pittman (2001) argue that there is a growing concern in the investment community that certain practices of earnings management are eroding public confidence in external financial reporting and impeding efficient flow of capital in financial market. In September 28, 1998 in a Number Game Speech, the former SEC Chairman, Arthur Levitt Jr., expressed his concern that failure of corporate managers to provide meaningful and representative financial information on their financial statement erodes not only the trust between stockholders and the company, but also threatens the U. S. economy with subsequent price fluctuations. He states that too many corporate managers, auditors and analyst are participants in a game of nods and winks. Later in his speech he emphasizes concern for the American Economy, and argues that the current culture among the corporate managers, auditors, and analysts and their credibility has been called into question.

He call on independent auditors to lead the crusade to prevent deceptive accounting practices because of their in-dept knowledge of accounting and reporting matters but also have access to audit committee and the board of directors responsible for scrutinizing a company's decision makers. He expressed his fear of witnessing erosion in the quality of earnings, and therefore, the quality of financial reporting, and uniformly agreed accounting misrepresentations, which ensues among them, undermines the integrity and the number one position of the American financial market in the world.

Arthur Levitt believes that the earnings management game negatively influence the accuracy of company's financial statements will eventually, if not addressed soon would yield to the erosion of faith in market driven economy (capitalism) as a viable solution to the efficient allocation of resources in our societies.

Leonard, Peter, and Lorraine (2004) state that a forensic audit conducted by PricewaterhouseCoopers concluded that HealthSouth Corporation's cumulative earnings were overstated by anywhere from \$3.8 billion to \$4.6 billion, according to the report issued January 2004. HealthSouth acknowledged that the forensic audit discovered at least another \$1.3 billion in fraudulent financial report in addition to the previously estimated \$2.5 billion. Securities and Exchange Commission (SEC) charged HealthSouth and its Chief Executive Officers with accounting fraud. The SEC's complaint alleged that Health South had systematically overstated its earnings by at least \$1.4 billion since 1999 and U.S. Justice Department used the information gathered from HealthSouth executives to uncover another \$1.1 billion of overstated earnings (Leonard, Peter, and Lorraine 2004). Following the demise of Enron and other corporations, the US accounting profession is rushing to restore confidence to the investing public. In late October 2002, FASB issued a proposal for public comments on a principles-based approach to accounting setting, which might improve the quality and transparency of financial reporting. The FASB Chairman Robert Herz says FASB is committed to improving U.S. financial accounting standards. Chairman Robert Herz states that "Many believe that moving to a broader or more principles based accounting standards as those used in other parts of the world would facilitate better reporting in the United States" Quinn (2003). argues that Principles-based approach to accounting could reduce the comparability of financial information and leave too much room for the use judgment by corporate managers and auditors

### **Revenue Recognition**

The realization principle requires that two criteria be satisfied before revenue is recognized. 1) The earning process is judged to be complete or virtually complete. 2). There is reasonable certainty as to the collectivity of the asset. Stated alternatively revenue can be recognized only after the earning process is virtually complete and collection from the customer is reasonably assured. Revenue recognition guidelines by nature could be controversial and strictly adhering to the criterion would violate the overriding objectives of revenue recognition principles in the period revenue generating activities of the company are performed.

Green (2003) notes that understanding when revenues are recognized is the first step to comprehending the quality of the revenue stream. He argues that revenues of the highest quality are those that are recognized after the customer has received, accepted, and paid for the product or services without any further performance requirements or contingency. The former SEC chairman, Arthur Levitt identified revenue recognition guidelines as a popular way for companies to manage earnings primarily prematurely. He argues that premature revenue recognition reduces the quality of reporting earnings, particularly, if those revenues never materialized. Davis (1989) remarks how Memorex struck a deal in early 1970's with Independent Leasing Corporation for the sale of some computer equipment; Memorex quickly reported the sale in its nine month earnings statements of September 30. On December the president of Memorex wrote the stockholders asking them to revise their earnings per share downwards from \$1.64 to \$0.97 because financing for the deal had fallen through and Memorex reported earnings of \$3 million in revenue from sales that did not materialized. In the 1980's large oil companies such as Texaco and Occidental used the full-costing method to boost earnings by capitalizing the current costs (period costs) that should have been expensed. Qwest communications incorrectly accounted for more than \$1.1 billion in transaction between 1999 and 2001 (Green 2003).

Corporate executives tend to believe that by manipulating earnings and presenting fraudulent financial report to meet predetermined level of earnings would increase firm value, earnings per share, market price per share and favorable bond rating. This may have short-term positive effect on the company but on the long-run it will have an exact opposite effect on firm value etc. Sarbanes -Oxley Act examines the role of board of directors in constraining earnings management (Klein 2002). Sarbanes -Oxley Act enacted provisions that deal with the rules governing corporate governance in general and the board of directors in particular that should likely constraint earnings manipulation. Sarbanes-Oxley Act reiterates the importance of ensuring that financial statements are free of material misstatements due to error or fraud.

The Sarbanes -Oxley Act is the most sweeping regulatory reform since the creation of SEC in 1943. The Act mandates the SEC to regularly and systematically review the disclosures of companies that have securities on a national securities exchange, and particularly those firms that have issued material restatements of financial results or those that that have experience significant volatility in their stock price as compared to other listed companies.

The Act also mandates that each periodic SEC financial statement report should be accompanied by a written statement by issuer's Chief Executive Officer and Chief Financial Officer certifying that the report fully complies with the 1934 Act and that information contained in the periodic report "fairly presents, in all material respects, the financial condition, and results of the issuer".

Fama and Jensen (1983) argue that separating the positions of Chief Executive Officer and the Chairman of the board would improve board monitoring and organizational performance by providing an independent check on the chief executive officer position. They postulate that firms that have the same person holding these the dual positions are likely to have effective monitoring which reduces the likelihood of constraining earnings manipulation. Visvanathan (2008) reports that much attention has been focused upon the role of the board of directors and audit committees, in overseeing the activities of corporate executives in particular instances of earnings manipulations. Management can significantly alter the earnings to deceive the investors and Wall Street that earnings or certain financial goals have been met. Visvanathan (2008) says that much of the attentions are focused on accrual type earning management such as aggressive revenue recognition, misstatement of inventories and accounts receivable. Spiceland, Sepe, Nelson and Tomassini (2009) state that receivables should be recorded at the present value of accounts receivable of future cash receipts using realistic discount rate or interest rate.

However, because the difference between present and future of accounts receivable often is immaterial, therefore APB 21 specifically excludes accounts receivable from the general rule that receivable be recorded at present value (Spiceland, et al 2009). They argue that accounts receivable are initially valued at the exchange price agreed upon by the buyer and seller. Ross (2005) states that in many cases of fraud, companies try to manage their appearance by inappropriately reporting fictitious revenue and by failing to report expenses as they occur. The author argues that without egregious transgressions, companies can take full advantage of two types of legitimate latitude, operational freedom and reporting freedom accorded them by the generally accepted accounting principles.

The infamous Enron, a natural gas trading company, used varieties of accounting techniques such the mark to market, structured financing vehicles and special purpose entity to inflate earnings.

Enron employed mark to-market accounting technique to recognize revenue by assigning value to an asset based on its present value or current market value of future cash inflows. Enron would recognize revenue using the present value of future cash flows of long term contracts the company signed and matched the expense and using the present value of future cost. Enron reported unrealized gains and losses in the market later on as part of earnings as they occur. Structured financing was utilized by Enron to hedge against credit risk, interest risk and liquidity risk exposures. Enron failed to report varieties of the structured financial vehicles in its financial statements which were designed to permit Enron to recognize the financial benefits of the structured finance immediately even though the federal income tax benefits would not occur until significantly over into the future. Structured finance is a form of securities securitization in which corporations and financial institutions package assets, loans, and mortgages into a standardized securities backed by those assets, loans or mortgages which can be traded like any other securities. The corporation and financial institutions act as servicing agents for the securitized assets.

## **Regulatory Capture**

Amidst the financial crisis of recent history has rekindle public interest in regulating the market. Laffont and Tirole (1991) there are two theories that has been proposed to this effect. They argue that one of the theories emphasizes "public interests", where government role to correct market imperfections such as monopoly pricing and environmental externalities. The second theory the "capture" or "interest group", this theory emphasizes the role of interest groups in the formation of public policy. Interest groups and powerful institutions that don't like being regulated try to capture government decision making because they believe that regulations sometimes cuts into their profits and interferes with their business. These special interest group therefore use the political process to sabotage, redirect, defund, undo, and hijack the regulation that is meant to control their act.

Regulatory capture refers to a situation in which a government regulatory agency come up with Legislation or an act in the public interest but, instead act in the favor of the industries, professions, Businesses or special interest that dominate in the industry or sector it is charged with regulating. Regulatory capture is an explicit manifestation of government failure in that it not encourages, but Actively promotes the activities of large firms that produce negative externalities.

Etzioni (2009) Critics of regulatory capture have shown that regulations are routinely and predictably 'capture' either by those that the regulators are supposed to regulate or other interest groups or by the bureaucrats or legislatures who write and control legislation (Etzioni 2009). Regulatory capture serves to promote the interest of the group that is meant to control instead of the public interest. One way regulatory capture occurs is when lobbyists representing industries or other special interest play key role in drafting the legislation that is designed to control their act. The Securities and Exchange Commission joined 12 Wall Street firms in 18 seeking to amend a key portion of a landmark 2003 deal that put strict curbs on stock analysts, a move that could heighten the ongoing debate about a broad overhaul of the financial-regulatory system. (Ritholtz 2010). On March 15<sup>th</sup> 2003, the U.S. District Judge William H. Pauley III in New York rejected a proposed change to the legal settlement put in place to end abuses on Wall Street. The proposal would have allowed employees in investment-banking and research departments at Wall Street firms to "communicate with each other...outside of the presence" of lawyers or compliance-department officials responsible for policing employee conduct—an activity strictly prohibited by the settlement.

In many instances, regulatory capture takes effect after the legislation has been adopted. Special interest group often have been successful to intervene in weakening or diluting regulation that are meant to control their conduct. In 2002 the congress passes the Investors Protection Act of 2002 popularly known as Sarbanes-Oxley Act of 2002 to restore confidence to the investing public and financial market following financial and economic disaster manifested by the collapse of Enron, Tyco, and WorldCom etc. The act establishes a stricter, firmer and new accounting rule. One part of the Sarbanes -Oxley Act that requires companies to regularly audit their own internal, and anti-fraud and bookkeeping safe-guard, and set up the Public Company Accounting

Oversight Board to audit theses auditors was fiercely lobbied by Business to get this provision overturned. In 2006, after the Enron –inspired public outcry against corporate greed subsided; the SEC yielded to the Special interest group and dramatically curtailed and modifies or weakened the regulation provision. The original piece of the legislation was 180 pages after the intervention by lobbyist the regulation now has only 65 pages.



The new rule only require auditors to investigate issues that had a reasonable possibility of fraud instead of the old version requiring auditors to investigate any accounting issues that had a more remote chance of turning out to be errors or fraud.

Companies have been providing earnings forecast to investors, brokerage firms and analyst, and in turn, the analysts then forecast their own earnings expectation based on the information made available to them by the companies. The investors, creditors and other users of financial information need as much information as possible to accurately evaluate the companies' performance. Green (2003) states that firms with greater transparency have higher valuations and higher disclosure. He argues that greater disclosure often brings the possibility of legal actions if the investors have the reason to believe that the financial disclosure is fraudulent.

Financial statements improprieties and lack of transparency are not only perpetrated by top management alone. Internal auditors, Chief Financial Officers, Independent auditors play vital roles in earnings management schemes.

Top management, internal accountants, Chief Financial Officers, and Independent auditors along with Wall Street officials had lobbied for the passage of The Private Securities Litigation Reform Acts of 1995. This act made it more difficult for investors to sue corporate executives, auditors, and financial analyst for security fraud.

## **Auditing**

In February 1997 the Accounting Standard Board (ASB) released new auditing standards known as the Statement on Auditing Standards No. 82. This new standard discusses the responsibilities of the auditor on determining and reporting material misstatement of financial statements resulting from fraud. The standard defines what constitutes frauds and its traits, calls for a specific fraud risk assessment in each audit engagement, offers guidance when fraud risk factors are detected, and describes documentation requirements (McConnell and Banks 1997) The SAS No 82 is designed to clarify and to expand SAS No 53 The Auditor's Responsibility to Detect and Report Errors and Irregularities that was issued by ASB in 1988.

SAS No 53 was issued in 1988 with the intent of narrowing the gap between the independent auditor's actual responsibilities in detecting statement misstatements and financial statement user perceptions concerning those responsibilities (McConnell and Banks).

Green (2003) states that the Sarbanes-Oxley Act of 2002 was intended to protect the interests of those who invest in publicly-traded companies by improving the reliability and accuracy of corporate financial reports and disclosures. The key aspects of the Sarbanes-Oxley Act include the following: 1) The Act establishes the Public Company Accounting Oversight Board (PCAOB) to provide additional oversight to the audit profession. 2) The Act places the power to hire, compensate, and terminate public accounting firms in the hands of the audit committee. 3) The Act also requires a company's auditor to issue an opinion on the effectiveness of the company's internal control over financial reporting to accompany management's assessment, and both are included in the company's annual report. The overall objective of PCAOB is to ensure a separation of audit function from the control of the corporate officers.

In 2003 the International Federation of Accountants (IFAC) issued a proposed international standard on auditing (ISA) to provide guidance on auditor's responsibilities with respect to fraud. The 40-page document outlines the accountability of those involved in financial reporting process and also acknowledges that the primary responsibility for the prevention and detection of fraud that lies within an organization's management and those charged with corporate governance. The guidelines require auditors to assess the risk of material misstatements resulting from fraud and misstatements due to misappropriation of assets, improper revenue recognition, management override of control and misstatements resulting from fraudulent financial reporting.

Audit includes the understanding the particular business environment in which the client operates on, conducting auditing process and tests, appraising the audit results, and communicating the results to the parties involved. Auditing helps organizations to accomplish their objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Shastri and Gist (2003) state that audit failures could be significantly reduced, if audits were planned and executed with due care.

They argue that implicit in the application of the due care is maintaining an attitude of professional skepticism at a heightened level (AU23007 and SAs 99) and exercising professional judgment when conducting GAAS (Generally Accepted Auditing Standards) audit. Auditors can minimize the probability of missing material information by relying on GAAS.21Sbastri (2003) stresses that the concept of materiality, in conjunction with audit risk and its components ( AU 312) forms the backbone of the audit process, and applying it properly has often been elusive, and professional standards do not provide specific guidelines to operationalizing these concepts. Professional standards states that "the auditor's consideration of materiality is a matter of professional judgment and it is influenced by his or her perception of the needs of a reasonable person who rely on the financial statements" (AU 312A.10)

The materiality standard should thus play a crucial role in screening out trivial financial misstatement from substantial financial misstatement, making the potential liability companies face for inaccuracies in their financial statements manageable. But there is little or no consensus as to constitute reasonable to an investor to consider important with respect to financial information. The current approach which has been described as qualitative, considers a wide range of factors has been criticized as nebulous. On February 8, 2008 the Security and Exchange Commission (SEC) Commissioner pointed out the need to clear up the issue of materiality with the full input of investor, legal, accounting, academic, and business communities. For a time materiality with respect to financial misstatements was arguably defined by a rule of quantitative standard. If a financial misstatement had an input on net income below a certain threshold often five percent, it was assumed to be immaterial. The problem with the quantitative standard is that it allowed for significant amount of earnings manipulation by companies

## **Conclusion**

The financial market, investors, market participants, creditors, and the investing public are yawning for transparency in financial reporting. A transparent financial reporting means that the financial information provided to users are free of defects, are of high quality, very clear, and easily understood by all users. In the past few years we have seen unprecedented change in the financial reporting environment in the United States, the SEC's goal in this area remains unchanged to make publicly held companies provide information that allows capital market participants to understand the company's operations, cash flow, and financial position and to make prudent investment decisions.

In 2006 the SEC released a report that directly looked at the transparency of financial information. SEC states that the Off-Balance Sheet Report notes that achieving transparency in financial reporting depends on the efforts of many parties.

Financial reporting is also heavily reliant on the standards that govern the preparation of financial statements. These standards create the "language" of financial statements that are blurry, flexible and inconsistent. The flexibility and blurry financial information are a prelude to inaccuracies in financial information made available to investors and other stake holders that eventually led to not been able to assess the operational risk, financial risk, and overall performance of the firm. Transparent financial information would translates to a higher firm value, lower cost of capital and lower risk to the stake holders. Transparency in financial reporting will promote sound decision making, productivity, and organizational performance and attract influx of additional capital to firms and capital market. It will restore investors' confidence and change disclosure policies adopted by firms and the financial market. Transparency in financial disclosure will contribute to the fairness and efficiency of financial market and much too effective corporate governance and oversight. It will give substance to shareholders and potential investors by providing information that are vital to investment decisions.

Years after the wave of financial misrepresentations by some companies that sent U.S. financial market into one of the worst collapse since 1980, the devastating flood of financial statements misrepresentations shows no sign of abating. These problems are getting worse; securities are over-valued and destabilizes financial markets, and leaving investors in financial limbo. The onus to curb financial tsunami fraud that devastated some companies that sent shocking waves across U.S. economy and financial market fall within the auspices financial accounting standard setting bodies, Securities and Exchange Commission, Regulators, and the Law Makers. These are the group of bodies who can bring sanity to the financial market and restore confidence in the investing public and they are to be held responsible for the financial mayhem that has befallen some U.S corporations and challenges the market driven economy.

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