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Accounting Scandals: Beyond Corporate Governance

Ifedapo F. Awolowo, Nigel Garrow, Murray Clark, Dora Chan
Sheffield Hallam University, Sheffield, UK

Accounting scandals are becoming perpetual in nature. They range from the ancient Mesopotamia, to the South Sea Bubble of 1720, to the famous Enron of 2001, down to Parmalat, Tesco, and Toshiba of today. The series of accounting scandals that have occurred in the last two decades calls for a greater concern by the accounting profession. The accounting scandals that have occurred in this 21st century alone have shown that there is a need to look beyond corporate governance in the fight against financial deception. In this paper, we argue that even in the face of the Sarbanes-Oxley Act (SOA) of 2002 and other regulations around the world that are targeted towards effective corporate governance, accounting scandals have never ceased to occur. Most of the legislations that have been passed in recent times were targeted at corporate governance, forgetting the crucial role that audit plays within the agency relationship. And whenever there is any revelation of fraudulent financial reporting, investors do not ask who are the directors, but the first question they ask is who are the auditors? Hence, there is a need to improve audit quality by approaching it from a forensic accounting perspective in order to reduce the incidence of financial statement frauds in this era of information revolution, thus restoring investors' confidence back in the financial reporting process and corporate governance. In this paper, we propose a forensic accounting paradigm as a viable option for reducing accounting scandals, since this will compliment corporate governance systems.

Keywords: accounting scandals, corporate failures, audit, forensic accounting, agency theory, fraud triangle

Purpose

The aim of this paper is to position forensic accounting as a viable option for reducing accounting scandals in this age of an information revolution and globalization, thereby complementing corporate governance mechanisms by enhancing audit quality. We utilize agency theory and the fraud triangle theory as our point of departure in building our argument for forensic accounting.

Introduction

Accounting scandals are becoming perpetual in nature. They range from the ancient Mesopotamia, to the South Sea Bubble of 1720 (Jones, 2011), to the famous Enron of 2001, down to Parmalat, Tesco, and Toshiba of today. For example, in the past two decades headline grabbing cases of fraudulent financial reporting at

Ifedapo Francis Awolowo, associate lecturer/doctoral researcher, Department of Finance, Accounting and Business System, Sheffield Business School, Sheffield Hallam University. Sheffield, UK.

Nigel Garrow, head of Department for Finance, Accounting and Business System, Sheffield Business School, Sheffield Hallam University. Sheffield, UK.

Murray Clark, principal lecturer, Department of Management, Sheffield Business School, Sheffield Hallam University. Sheffield, UK.

Dora Chan, principal lecturer, Department of Finance, Accounting and Business System, Sheffield Business School, Sheffield Hallam University. Sheffield, UK.

public companies has rocked capital markets (Kravitz, 2012).

In 2001, news of the Enron accounting scandal broke; in 2002, WorldCom, Adelphia, and Tyco were all involved in “cooking their books”. In 2003, news of the Parmalat accounting scandal broke in Europe; 2011 saw the revelation of the biggest accounting scandal (Olympus) in Japanese history revealed; in 2014, Tesco was caught overstating its profit by £263 million; and in 2015, Toshiba’s financial statement fraud came to light (Awolowo, 2016). These scandals had a negative impact on capital markets and have contributed to the erosion of trust of the investing public (Hogan, Razaee, Riley, & Velury, 2008).

Accounting scandals are costly. The Association of Certified Fraud Examiners (ACFE, 2016) reported to the nation on occupational fraud and abuse estimated that the cost of corporate fraud globally to be \$3.7 trillion, with financial statement fraud being the least type of occupational fraud occurring in less than 10% of the cases examined by the ACFE report, but with a median loss of \$975,000 (ACFE, 2016). Accounting scandals are now one of the biggest challenges in today’s modern business world (Lawyers Connect, 2016).

In all of the accounting scandals that have occurred in the past two decades, the financial statements of these companies were all audited and given unqualified audit reports, and yet these massive frauds were not spotted. Interestingly, whenever there is any revelation of fraudulent financial reporting, the investing public and the business community do not ask who is the CEO or CFO, or better still, they do not ask what the composition of the board looks like, the first question the investing public, business community, regulators, and the media are always quick to ask is who are the auditors.

Bhasin (2013) observed that the corporate accounting scandals that have occurred over the past two decades not only came as a shock due to the enormity of the failures, but also that the discovery of these scandals questioned the integrity and capability of the auditing profession. The waves of the 21st century financial scandals have therefore raised the awareness of fraud and the responsibilities of auditors in detecting those frauds (Hogan et al., 2008).

One Japanese professor of accounting, Shinji Hatta made the following remark after the revelation of Olympus accounting scandal which started back in the 90s “Maybe KPMG AZSA accountants thought it was not important. But it was important, and overlooking this in my opinion is a grave issue in terms of auditing”.

Whenever a financial statement fraud comes to light, it becomes an accounting scandal. Financial statement fraud is the deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users (ACFE, 2016). Equally of concern is the “sugar coating” of business performance in the narratives in company annual reports, an issue for corporate governance practice. Accounting scandals are a function of financial statement frauds.

Corporate governance according to the Institute of Chartered Accountants in England and Wales (ICAEW) is the system by which companies are directed and controlled. While the boards of directors are responsible for the governance of their companies, the shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.

In the aftermath of the series of accounting scandals that have made headlines in the past two decades, there have been several attempts by regulators around the globe to bring about effective corporate governance mechanisms. In the United States, for example, congress passed the Sarbanes-Oxley Act (SOA) in 2002 shortly after the collapse of Enron, elsewhere in South Africa was the Kings Report, and in the United Kingdom was the UK Code of Corporate Governance 2012, which was revised in 2014; in 2018, a consultation process is

currently underway by the Financial Reporting Council into the UK Code of Corporate Governance.

The various corporate governance codes that have been passed around the world may be seen as attempts to reduce accounting scandals globally. The SOA of 2002 and other regulators around the world are seeking to increase auditors' responsibilities in relation to fraud prevention and detection in the financial statement, and seeking to ensure the separation of the position of the Chief Executive officer (CEO) of companies from that of the Chief Financial Officer (CFO) in most countries (McConnell & Bank, 2003).

The fact remains that much has not been achieved since the passage of the SOA and other regulations. The series of accounting scandals and corporate failures that have occurred since the introduction of the various regulations on corporate governance indicates that the issue of financial statement fraud is far from being solved (Hogan et al., 2008), and neither is it that increasing auditors' responsibilities without commensurate training in forensic accounting will help solve the problem (Awolowo, 2016). Hence, there is a need to look beyond the corporate governance mechanism in the crusade against financial deception.

Take, for instance in the United Kingdom, the case of Palmer and Harvey, which went into administration without any warning signals in November 2017 and that of Carillion, which in January 2018, went into liquidation without any warning signs, damaging investment of nearly 2 billion pounds. While by no means are we suggesting that fraud has taken place, the activities of these companies raise some serious corporate governance issues. Of concern to us is the role of these companies' auditor (KPMG) in failing to highlight some red flags that indicated that the going concern of these companies was under serious threat.

Our argument is that if all external audits are approached from the forensic accounting standpoint, many of the accounting scandals and corporate collapses that we have witnessed in the past two decades could possibly have been avoided. This is because forensic accounting involves the application of investigative and analytical skills for resolving financial issues in a manner that meets standards required by the court of law (Hopwood, Leiner, & Young, 2012), which we argue currently lacking in the current auditing environment.

We utilize agency theory and fraud triangle theory as our point of departure in providing an argument for a more robust way for enhancing audit quality and complementing corporate governance mechanisms.

Theoretical Framework and Argument

By the use of agency theory advanced by Jensen and Meckling (1976), and the fraud triangle theory proposed by Cressey (1950; 1953), we believe providing a good rationale and foundation for the role forensic accounting can play in complementing the corporate governance mechanism. Thereby enhancing audit quality and restoring investors' confidence back into the combined financial reporting process and corporate governance process. Bearing in mind that whenever accounting scandals come to light, the first person, the business community, point an accusing finger at is the auditor of that company's financial statement.

In fact, auditors are usually the first set of individuals to lose their job after any revelation of fraudulent reporting. Such was the case of Tesco, who ended their 32 years audit relationship with PricewaterhouseCoopers (PwC) after the revelation of their accounting scandal in 2014 and appointed Deloitte as a replacement (The Guardian, 2015). Elsewhere in Japan, Olympus had to change their auditor from KPMG AZSA LLC to Ernst & Young Shin Nihon LLC immediately after Michael Woodford exposed the biggest corporate scandal in Japanese history (Aubin & Uranaka, 2011).

Agency Theory

Due to the separation of ownership from control of corporations, the financial statement serves as the primary mechanism for shareholders to monitor the performance of directors (Chariri, 2008). An audit serves a vital economic purpose and plays a crucial role in reinforcing trust and confidence in the agency relationship that exists between the principal and the agent (shareholders and directors respectively) (ICAEW, 2005).

Within the agency relationship, it is assumed, in part, that because of information asymmetry, the principal does not trust the agent (Jensen & Meckling, 1976). The implication of this is that no matter how effective the corporate governance mechanism is the principal still has a major problem of trust in the agent. Agency theory is premised on the economic perspective which assumes that the relationship between the principal and the agent is characterised by a conflict of interest (W. S. Albrecht, C. C. Albrecht, & C. O. Albrecht, 2004; ICAEW, 2005; Chariri, 2008).

The line of reasoning of agency theory follows from the economic models that argue people are only motivated by self-interest and self-preservation (Albrecht et al., 2004). In other words, the underlying agency theory is a set of behavioural assumption about the agent. The assumption holds that all agents are unconstrained self-interest maximizers who do not act in the best interest of their principal (Albrecht et al., 2004).

Consequently, managers are perceived as individuals who solely act in their own interests, which may conflict with the organisation's best interest. Such conflict usually occurs between agent and principal (directors and shareholders). This is the reason why we argue that there is a need to look beyond corporate governance in reducing accounting scandals.

This conflict of interest usually occurs because of information asymmetry (De Lange & Arnold, 2004). Information within an organisation is critical to decision-making, and management working at the "coal face operations" of the company are privy to essential information that can be manipulated to maximise their own interest at the expense of the principal (ICAEW, 2005).

Take for example, the board of Palmer and Harvey were probably aware that the going concern of the company was under threat and yet they kept this information from the principal. In fact, in the last annual report filed to company house by the company, before going into administration, the chairman's statement painted a picture that suggested all was well with the company. This later turned out to be untrue and KPMG gave an unqualified audit report.

No matter how sophisticated our corporate governance mechanisms are, management will always have information advantage over the shareholders. Management can always override existing internal controls within an organization. Such was the case of the Olympus accounting scandals that were brought to light by Woodford (2012).

Hence, managements (agents) have a competitive advantage, through information within the company, over that of the owners (principal). This results in the inability of the principal to control the desired action of the agent (De Lange & Arnold, 2004).

This conflict of interest is called "agency problem" (Albrecht et al., 2004). Because of information asymmetries and self-interest, principals lack reasons to trust their agent and will seek to resolve these concerns by putting in place mechanisms to align the interest of agents with those of the principal, and hence, try to reduce the scope for information asymmetries and opportunistic behavior (Albrecht et al., 2004; ICAEW, 2005).

There are various mechanisms that can be utilized to align the interest of the agent to that of the principal. Share options and good remuneration packages, for example, are some of the mechanisms that can be used. The

best mechanism however, that can be used to align the interests of agents with that of principals and to allow the principal to measure and control the behaviour of their agent and reinforce trust, is external audit. External audit serves a fundamental mechanism in promoting confidence and reinforcing trust between the principal and the agent (ICAEW, 2005).

Our observation is that other mechanisms, such as share options, good remuneration, and pension packages have proven not to be effective mechanisms for aligning the interest of the board with that of shareholders. Even in the presence of these mechanisms, the boards still committed financial statement fraud. We saw this happen in the case of Enron, the seventh largest corporation in American history. This was equally the case with the Olympus scandal, which is regarded as the worst accounting scandal in Japanese corporate history (Aubin & Uranaka, 2011).

What this suggests is that, going forward, the only mechanism that appears to be able to reduce accounting scandals is an effective external audit. The presently constituted external audit, however, cannot guarantee the detection of fraud in the financial statement and this is the main reason we are proposing the key issue of “forensic accounting analysis” of financial statements.

Forensic accounting incorporates an understanding of human behaviour and the knowledge of legal system into accounting for numbers. While auditors look at numbers, forensic accountants look behind numbers and try to analyse the underlying reasoning behind a transaction.

According to agency theory, the very purpose of external audit is to serve as an instrument for ensuring that financial reports financials have been subjected to an independent scrutiny by a competent external auditor (Wolk & Tearney, 1997). What the independent external audit represents, in this regard is a bastion of safeguards implemented by the principal in the agency relationship to monitor the agent (De Lange & Arnold, 2004).

Within the agency relationship, external audit serves a dual role (see Figure 1). We call this the agency triangle. External audit is that unique link between the principal and the agent. It serves an investigative role to the agent and an attestation role to the principal.

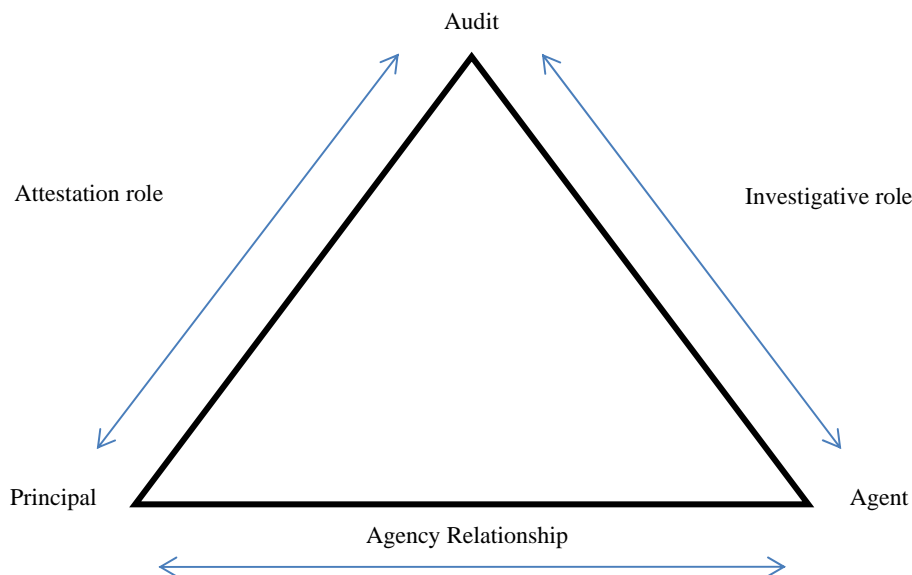


Figure 1. The agency triangle.

The investigative role involves checking the accounts prepared by agents for errors and frauds and in making sure that the account reflects a true and fair view of the entity’s affairs, thus safeguarding the

investment of the principal. While, the attestation role entails giving assurance to the principals (shareholders) that the enterprise is a going concern and will yield a good return on investment. Furthermore, the attestation role provided by external audit (as depicted in Figure 1) gives an assurance to the principal that their investment is safe and that the results of the entity's affairs are correct and accurate.

It is argued here that the investigative and attestation roles that audit is meant to play within an agency relationship are lacking in the current auditing environment. This poses a threat to the corporate governance process. The principal needs assurance that the business is a going concern, and this can only be achieved when financial statements are free of errors and fraud. What the current auditing framework gives at best is a reasonable assurance. Whereas, investors want an absolute assurance that financial statements are free from errors and frauds.

This is because investors rely on audited financial statements in order to make investment decisions. The investigative role audit plays is, at best, too weak to combat fraud in this age of information revolution. Hence, the need for a paradigm shift to forensic accounting which it is proposed will be able to fulfil these two requirements (assurance and investigation) that is lacking in the current auditing framework.

Why do Agents Commit Financial Statement Fraud?

Theoretically, everyone has the tendency to commit fraud (Center for Audit Quality [CAQ], 2010). Past research has shown that fraud perpetrators usually cannot be distinguished from other people by demographic or psychological characteristics. In fact, some individuals who engage in financial statement fraud have previous reputations for high integrity (CAQ, 2010).

Furthermore, the "80/10/10" saying suggests that just 10% of the population will be honest; they will not steal, lie, or cheat under any circumstances. Another 10% of the population is assumed to be dishonest and will participate in criminal activities whenever they can. The remaining 80% of the population, given sufficient pressures and the right opportunity, may behave unethically (APA, 2011).

Historically, most major financial statement frauds have involved senior management. They are in the best positions and possess the necessary capabilities to perpetrate fraud by overriding controls and acting in collusion with other employees (CAQ, 2010). Such were the cases of Enron, WorldCom, Olympus, and Toshiba. Their senior management teams were all involved in the massive frauds perpetrated by these companies.

Fraud Triangle Theory

Cressey (1953) published his hypothesis about why people violate trust. He hypothesised that for any criminal violation of trust to occur three elements which he called pressure, opportunity, and rationalization must be present. Whatever form a dishonest act takes, be it fraud against a company, for example, employee fraud or fraud on behalf of a company-management fraud, these three elements are always present (W. S. Albrecht, C. O. Albrecht, & C. C. Albrecht, 2011).

Cressey's (1953) aim was to gain an understanding of why people entrusted with authority and responsibility violate those trusts. Questions such as why do trusted people violate trust led Cressey to interview 250 convicted criminals over a period of five months. Their behaviours were classified based on two criteria: people who accepted responsibilities of trust in good faith and the circumstances that led them to violate such trust (Albrecht, 2014; Abdullahi & Mansor, 2015).

Cressey (1953), in his work titled *Other People's Money: The Social Psychology of Embezzlement*, postulated that

“trusted persons become trust violators, when they conceive of themselves as having i) financial problem that is non-sharable; ii) have the knowledge or awareness that this problem can be secretly resolved by a violation of the position of financial trust and; iii), are able to apply, to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as a trusted person with their conceptions of themselves as users of the entrusted funds or property” (Cressey, 1953, p. 742).

The fraud triangle states that when there is perceived pressure, some perceived opportunity, and some way to rationalize the fraud as not being inconsistent with one’s values, fraud will be committed by an individual (Albrecht, 2014).



Figure 2. The fraud triangle (Source: Albrecht, (2014)).

This is true with respect to financial statement frauds. When management (agent) feels the pressure of meeting analyst forecasts, can sense some laxity in the accounting system and standard, and can rationalize such behaviour as a way of helping the company stay competitive in the capital market, they often end up getting involved in creative accounting, which eventually leads to committing financial statement fraud.

Research has constantly established that the two elements of the fraud triangle (pressure and rationalization) are not directly observable (Albrecht, 2014); they are equally the two elements in our opinion that cannot be controlled by the accounting profession.

According to Cressey (1953) even in the presence of high pressure and high rationalization, if there is no opportunity, fraud will not occur. The question now is how can the accounting profession reduce the opportunity to commit financial statement fraud by continuing to rely on the current auditing reporting model.

Going forward, we are proposing the introduction of forensic accounting skills and techniques into present day external audit. Emphasizing the relevance of forensic accounting in fraud prevention and detection, Joshi (2006) stated that “auditors should be watchdog and not be the bloodhound”. This quote alone is enough in making the forensic accounting definition simpler and helps differentiate a forensic accountant from other accountants and auditors. The forensic accountant is a bloodhound of bookkeeping (Crumbley, 2009).

These bloodhounds sniff out fraud and criminal transactions in banks, corporate entities or from any other organization’s financial records. They hound for conclusive evidence. External auditors are known to find out the deliberate misstatement, but the forensic accountant finds out misstatements deliberately. External auditors look at the numbers but forensic accountants look beyond the numbers (Joshi, 2006).

This is because in many cases, external auditors normally assume that management are honest. This is in

sharp contrast to a forensic accountant's thinking. Forensic accountants normally assume people will tell lies because of their understanding and knowledge of human behaviour and, therefore, carry out their checks to find out the truth. Auditors are guided by sampling and materiality concept, but forensic accountants look at every transaction and they do not work to any materiality level. A penny is important to a forensic accountant so long what underpins that penny is fraud.

With this kind of approach to external audit, financial statement fraud might decrease. And the investigative role that audit is meant to serve within the agency relationship will be more enhanced through a forensic audit of financial statement. Likewise, the attestation function of audit to the principal will restore their confidence back to the financial reporting process and corporate governance.

Conclusion

While effective corporate governance mechanisms are important and necessary in reducing accounting scandals, they can no longer be used as stand-alone mechanisms. In order to reduce the incidence of fraudulent reporting, there is a need to look beyond corporate governance mechanisms. One way this can be done is through forensic accounting. As already established, the principal lacks reasons to trust the agent and will therefore look for ways to align his/her interest with that of the agent. A strong mechanism for this is the external audit. However, the external audit, as presently constituted, is not adequate to combat fraud. Our proposition is that a paradigm shift to forensic accounting will enhance audit quality and complement the corporate governance system, and by so doing investors' confidence will be restored in the financial reporting process and corporate governance.

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