Impacts and Losses Caused By the Fraudulent and Manipulated Financial Information on Economic Decisions

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Abstract

Nowadays the effects of the fraudulent and manipulated financial information have been more controversial. We should take into consideration that the financial losses caused by fraudulent or manipulated financial information are remarkable. Preventing the fraud in the financial information has been an important issue by auditors all over the world. As the American economy is the dominant economy may cause and affect the capital market mostly all over the world. In the last decade we can see the financial losses caused by the fraudulent and manipulated financial information rather big. Today's world has been affected by frauds and manipulation of the financial information. An investment decision based on false financial information causes the investors to suffer losses as was experienced in Enron and WorldCom cases. Financial information has, certainly, an important positive or negative effect in economic decisions. Positive or negative effects of financial information on economic decisions depend on reliability of the financial information. This paper aims to show the impacts of fraudulent on the financial information, effects on economic decision and what we should do for preventing the fraudulent or manipulation on the financial information.

Keywords: *Financial information, fraudulent, manipulation, decision.*

JEL classification: M41, G14, G15

Introduction

Today's economy is rather fragile and sensitive. Especially any recession in developed countries lead the global economy to recession also like dominos as experienced in 2009. Investigations show that the effects of manipulated financial information are immense. Fraudulent financial information damages today's economy while leading users of financial information to make unhealthy decision on economy. Manipulators try to get maximum benefit with limited resources and this action cause to manipulate the financial information by senior managers. Louwers (2007) declares that the fraud consists of knowingly making material misrepresentation of fact, with the intent of inducing someone to believe the falsehood and act on it and suffer a loss or damage. The transparency, reliability and accurate information allow users of the financial information such as investors,

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creditors to make intelligent decisions. “Audited financial statements provide the foundation for securities markets. Audited financial statements allow investors to make decisions on whether to buy, hold, or sell a particular security” (SEC, 2002a). “Accurate information also improves the quality of markets by allowing markets to discover the true price at which specific securities trade” (SEC, 2002b).

The cost of losses on real economy caused by fraudulent or manipulated financial information cannot be calculated by economists. But according to some investigation we can have an idea on economic losses caused by the fraudulent and the manipulated financial information. The causes of manipulation financial information are remarkable. We can classify some of the causes manipulating the financial information.

- Weakness Structure of the Company’s Management.
- Managers` Interests and the Partnership Structure of the Companies.
- Inadequate Internal Control System.
- Accrual Accounting and the Flexibility of the Accounting Standards.

All the causes given above are very important and should be expressed separately in order to have an idea for manipulated financial information how the fraudulent is started in the financial information.

1. Financial Information and Its Importance

Financial information is a touchstone of the economy. Lack of the financial information causes to take no decision on economy. The purpose of the financial information is to give an idea to users of the financial information to make a rational decision on economy. Any false information may lead the users to invest in unprofitable area in the economy.

There are different definitions of financial information manipulation. Financial information manipulation in this context is misreporting, in other words intentional fraudulent financial reporting. Fraudulent financial reporting is the violation of accounting standards, the omission of existing amounts or the inclusion of fictitious amounts (Arens & Loebbecke, 2000). Financial information may have few errors in financial statements. If these errors are significant important so they should be corrected otherwise errors may be called fraud. In our study we will focus on fraudulent in the financial statements and manipulated financial information. Manipulated financial information sends false signals to users of the financial information and results to make irrational decision on economy especially for investments. In order to prevent the fraudulent in the financial statement some measures should be taken. Fraud detection is very costly and is impossible to detect all frauds.

Fundamentally the financial information is produced for business but besides it is also used in other parts of the life. The main purpose of the financial information is to be understood and interpreted by everyone. But accounting standards differ from country to country so it makes difficult to be understood internationally. In order to talk on financial information, the financial information should meet some conditions. These are as follows:

- Should be provided on the basis of particular time
- Should be relevant and for purpose
- Should be objective, accurate and complete

Financial information is mainly an accounting function, but not only the accounting department or accountants collect and preparing the information, but also all units contributes to production of financial data. Nevertheless, analyzing and reporting of data, transforming this data to financial information is the responsibility of the accounting system or accountants (Tak Isa, 2010).

IAS 1 describes financial statements as a structured representation of the financial position and financial performance of an entity. It states that the objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. A focus on assisting decision making by the users of financial statements is seeking (at least in part) a forward looking or predictive quality.

IAS 1 also acknowledges a second important role of financial statements. That is, that they also show the results of management's stewardship of the resources entrusted to it. To meet this objective, IAS 1 requires financial statements provide information about an entity's:

a. assets;
b. liabilities;
c. equity;
d. income and expenses, including gains and losses;
e. contributions by owners and distributions to owners in their capacity as owners (owners being defined as holders of instruments classified as equity);
f. Cash flows.

The standard observes that this information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

1.1. Techniques of manipulation financial information

The main purpose of financial information manipulation is to deceive the investors by publishing financial statements that do not present the financial position and the performance of a company fairly. Financial information manipulation prevents decision makers from making rational decisions. So, it is of utmost importance to detect financial information manipulation and prevent it before the financial statements are made public. Researchers have developed models to predict whether the financial information manipulation occurred or not (Hulisi Öğüt, Ramazan Aktaş, Ali Alp, M. Mete Doğanay, 2009).

Main techniques for manipulation financial information are earnings management, income smoothing and creative accounting practices but there also other techniques like aggressive accounting, big bath accounting, fraudulent financial reporting and accounting errors and irregularities. Applying some of the techniques determined in the accounting standards may be acceptable but if the manager of the company exceeds accounting standards so it is called fraud in the financial information or manipulated financial information.

According to Maydew (1997), because the companies that are by definition profitable pay lower taxes, they manipulate financial data by reducing the profit of the activities. According to Eilifsen, Knivsfla and Saettem'e (1999), if the taxable income is related to the accounting profit, in this case we speak about an automatic security mechanism as response to the financial information's manipulation.

In order to manipulate the financial information, earning management technique is used mostly than other types to evade any sanction and not exceed the accounting standards. Beneish (2001) gives three different definitions of earnings management that he compiled from several studies.

a. Managing earnings is the process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earnings.

b. Earnings management is a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain.

c. Earnings management occurs when managers use 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 numbers.

1.2. The incentives of the manipulation financial information

For any action there should be reasons and conditions should be compatible for. What kinds of reasons trigger managers to manipulate the financial information? According to surveys incentives of the manipulation financial information are follows: Influencing the shares' prices, compliance with debt covenants clauses, managers` salaries and bonuses, minimizing of certain costs from political or organizational reasons, decrease of the due taxes quantum, providing the better performance in the future for company`s financial pictures. The main benefit of the financial information is to reduce the financial cost of companies` projects. On the other hand one of the incentives of the manipulation financial information is to obtain resources with reduced financial cost. There is in literature no consensus on the incentives of the financial information manipulation.

When the Certified Fraud Examiners (CFEs) from the USA were asked to estimate the percentage loss of income to their employers or clients that were victims of occupational frauds the average suggested loss was approximately 7% of income. When this percentage is applied to the GDP of the USA it converts to almost $1 trillion" in losses. Of course, nobody can determine the actual losses because there most certainly are frauds being perpetrated as you read this article that have yet to be discovered. However, if the 7% loss rate was applied to the Romanian GDP (since this paper was presented in Romania) it would represent annual losses in excess 15 billion US dollars. This would assume that Romanian organizations would be no more or no less susceptible to these frauds than organizations within the USA. Even if the estimate of 7% was three times greater than the actual losses, there would be more than $325 billion dollars of losses in the USA and $5 billion of losses to a country the size of Romania. We do know that the median loss for the reported frauds in the ACFE study was $175,000 and Figure 1 shows that more than 25% of the frauds had losses in excess of $1 million (Alan T. Lord, 2010).

2. Financial Losses Statistics

SAS No.99 (paragraphs. 5-12) focuses on two sources of risk of material misstatements. Material misstatement can arise from: (1) fraudulent financial reporting and (2) misappropriation of assets which result in nonconformity of the financial statements' presentation with generally accepted accounting principles (GAAP). Fraud is always intentional, intentional by appearance, or intentional by inference from the act (Lucian Vasiu, Matthew Warren and David Mackay, 2003). According to Brenner (2001), someone commits fraud if the following four elements are proved beyond a reasonable doubt:

- Actus reus: The perpetrator communicates false statements to the victim;
- Mens rea: The perpetrator communicates what she knows are false statements with the purpose of defrauding the victim;
- Attendant circumstances: The perpetrator's statements are false; and
- Harm: The victim is defrauded out of property or something of value.

Any financial statement may have an error but they have to be corrected. If the error is done intentionally then it means an error is being converted to fraud. Companies` internal or external control systems must be durable. Otherwise errors cannot be detected so it leads the financial information to be incorrect.

There are three categories of occupational fraud which have been used to get benefit for interests. According to the ACFE (2010) occupational fraud categories are defined as follows: *Asset misappropriations* are those schemes in which the perpetrator steals or misuses an organization`s resources. *Corruption* schemes involve the employee`s use of his or her influence in business transactions in a way that violates his or her duty to the employer for the purpose of obtaining a benefit for him or herself or someone else. *Financial statement* fraud schemes are those involving the intentional misstatement or omission of material information in the organization`s financial reports. Common methods of fraudulent financial statement manipulation include recording fictitious revenues, concealing liabilities or expenses and artificially inflating reported assets.

The information in Figure 1 gives an overview of the median loss for the frauds. As seen in the Figure 1 Financial Statement Fraud caused more losses than other categories of frauds. But in Figure 2 we can get information that the mostly frequency category type is asset misappropriation but smallest amount loss. Financial statement fraud is committed by senior managers. So the damage on real economy is bigger than other categories. Detection of fraud is quite difficult so the loss number may not be flexible. Anyway as explained above loss rate is 7% of income. If this percentage is applied to GDP of the USA it converts to almost $1 trillion in losses. Alan T. Lord (2010) also argues that if this percentage is applied to GDP of the Romania it converts to almost 15 billion US dollars.

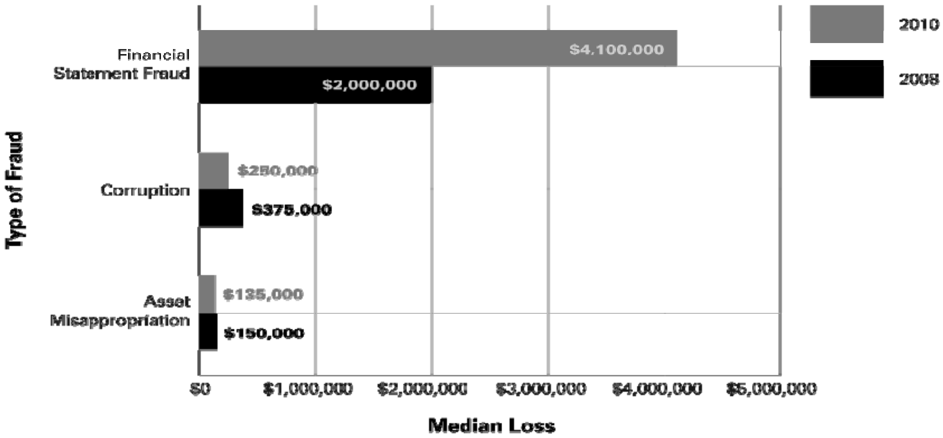

Figure 1: Distribution of Dollar Loss
(*Source*: ACFE, 2010)

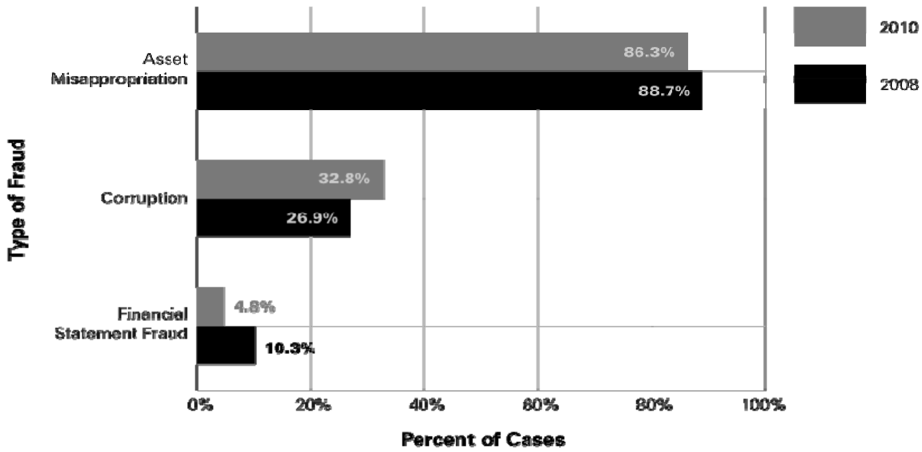

Figure 2: Frequency of Frauds by Category
(*Source:* ACFE, 2010)

3. Important of the Internal Controls For Preventing the Fraud

Actually the control term is a touchstone of detection of the frauds in the financial information. So if the internal control is done accurately for the financial statements expectations from financial information will be rather significantly especially for users of the financial information. Internal control process will contribute to decision taken by users of the financial information like investors, creditors to make rational decision on economy. Otherwise resources may be allocated in wrong area of the economy and this kind of irrational decision may lead users of the financial information to waste the recourses because of the incorrect financial information. In order to evade irrational decision by users of the financial information internal control plays very important role.

Besides, internal control protects any misappropriation asset, corruption or fraudulent financial information before the financial information disclosed to the public. The main purpose of the internal control is to make perpetrators to evade any irregular situation regarding financial information.

The literature on fraud consistently claims that an effective internal control system (ICS) is the primary means of preventing, detecting, and correcting fraud and errors. Yet, that which constitutes an *effective* ICS is largely conjecture established through *ex post* forensics (a form of induction) performed by practitioners (Roberta Ann Barra, 2010). Internal controls alone are insufficient to fully prevent occupational fraud. Though it is important for organizations to have strategic and effective anti-fraud controls in place, internal controls will not prevent all fraud from occurring, nor will they detect most fraud once it begins (ACFE, 2010).

Lack of the internal control no company can compete with competitors from all over the world. First of all every company should control itself to produce reliable, accurate financial information to see financial picture of the company. In order to success internal control system plays vital role for companies. The main purpose of the internal control is to protect the active assets of the company and provide the reliability, accuracy of the financial information produced by the company. In the last decade, the investigations have been focused on internal control system mechanism. If the company`s structure is durable it cannot send false signal to users of the financial information. Of course any good internal control system cannot detect all frauds but at least can prevent most of the frauds in the financial statements.

Control weaknesses contribute to fraud. ACFE 2010 has investigated control weaknesses asking survey respondents to identify which of several common issues they considered to be the primary factor that allowed the fraud to occur. So according to this survey; a lack of internal controls, such as segregation of duties, was cited as the biggest deficiency in 38% of the cases. In more than 19% of the cases, internal controls were in place but were overridden by the perpetrator or perpetrators in order to commit and conceal the fraud. ACFE survey also declares that; interestingly, even though hotlines are consistently the most effective detective control mechanism, and even though less than half of the victim organizations had a hotline in place at the time of the fraud, a lack of reporting mechanism was the control deficiency least commonly cited by the CFEs who participated in study.

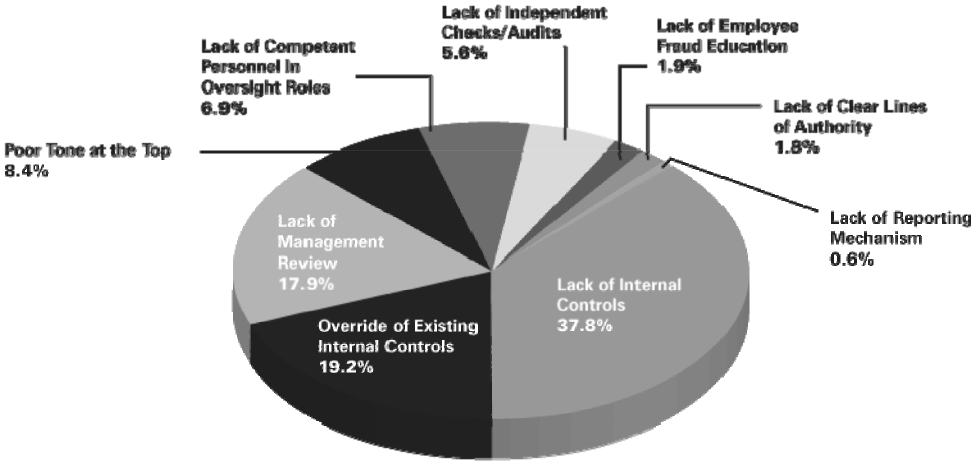

Figure 3: Primary Internal Control Weakness
(*Source*: ACFE, 2010)

In another study made by ACFE 2010 compared the internal control weaknesses at organizations with fewer than 100 employees to those at larger organizations. As we see in Figure 4 small organizations had a noted deficiency in internal controls that allowed fraud to occur. At small companies, a lack of internal controls was cited as the factor that most contributed to the occurrence of the fraud. Control overrides were less common at small companies than at their larger counterparts, because the lack of controls in so many small organizations meant there was nothing to override.

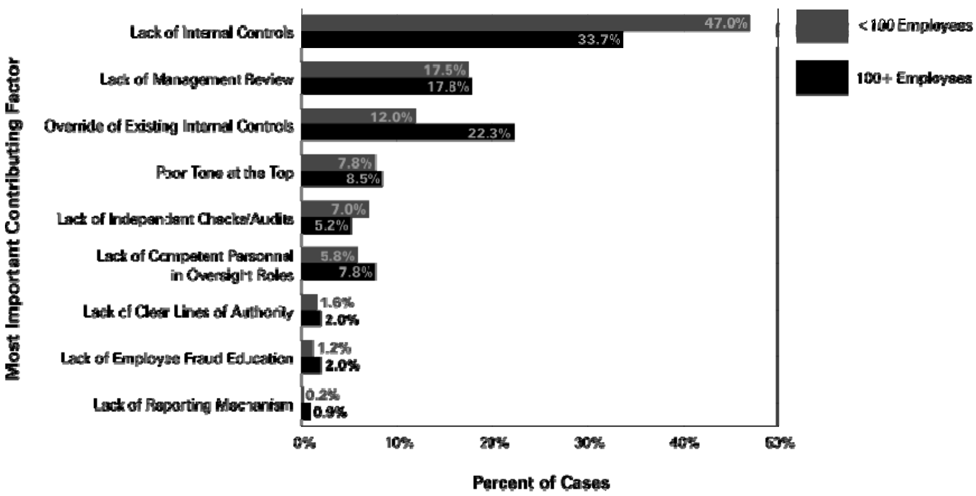

Figure 4: Primary Internal Control Weakness by Size of Victim Organization
(*Source*: ACFE, 2010)

4. Impacts And The Consequences of the Fraudulent in The Financial Information

Unless the control mechanism is weak and the accounting standards more flexible the fraudulent in the financial statements or manipulated financial information will be inevitable. As we leave in global village any positive or negative action effects all over the world. Especially these kinds of negative actions like manipulation financial information done in the developed countries. As the American economy is dominant economy trigger the financial crises as experienced in 2001 Enron energy sector giant. Unless the human interest s are reduced or stopped we as public will hear the fraud term in economy.

Measuring the cost of occupational fraud is an important, yet incredibly challenging, endeavor. Arguably, the true cost is incalculable. The inherently clandestine nature of fraud means that many cases will never be revealed, and, of those that are, the full amount of losses might not be uncovered, quantified or reported. Consequently, any measurement of occupational fraud costs will be, at best, an estimate. Nonetheless, determining such an approximation is critical to illustrate the pandemic and destructive nature of white-collar crime. (ACFE, 2010)

Collapses of the giant companies in USA as dominant economy in the world had effected all financial markets all over the world. Of course process before the financial crises lasted few years. May be the financial crises said that it is coming but lack of the preventing measurements caused the financial crises inevitable.

Financial statement fraud has cost investors more than $500 billion during the past several years (Rezaee, 2002; Cotton, 2002).Financial statement fraud (FSF) has received considerable attention from the public, press, investors, the financial community, and regulators because of high profile reported fraud at large companies such as Lucent, Xerox, Rite Aid, Cendant, Sunbeam, Waste Management, Enron Corporation, Global Crossing, WorldCom, Adelphia, and Tyco. The top executives of these and other corporations were accused of cooking the books and, in many cases, were indicted and subsequently convicted. The collapse of Enron has caused about $70 billion lost in market capitalization which is devastating for significant numbers of investors, employees and pensioners. The WorldCom collapse, caused by alleged financial statement fraud, is the biggest bankruptcy in the United States history. Loss of market capitalization resulting from the reported financial statement fraud committed by Enron, WorldCom, Qwest, Tyco, and Global Crossing is estimated about $460 billion (Cotton, 2002).

The information above indicates that the market participants have been suffered by fraudulent financial information very much. And these frauds cost organizations and society a significant amount of capital. And it seems that the fraud in financial statement will continue to damage the real economy on different areas. Because of the fraudulent or manipulated financial information, while some people getting rich some are getting poor. This is caused by not allocating the resources in productive areas.

Conclusions

As indicated above we can achieve to the results that the fraud is a global problem. This study tried to show the impacts of the financial statement fraud on real economy. Financial losses are significant big and should be prevented as soon as possible. But preventing frauds in financial statements is costly. Companies avoid investing to set up detection system especially in small companies. Companies which manipulate their financial information benefit materially in short-term but in long-term companies are suffering also. Human interests are playing very important role in this case. Avery negative or positive action is connected to human beings. Of course detecting or preventing all frauds in financial statements is rather difficult. At least control mechanism may reduce the number of fraud cases. Some detecting models have been developed by economists. But models are being used after disclosing the financial information to the public.

Regulators, lawmakers and accounting professions have considered new rules, regulations and standards but as we see these measurements have not been sufficient to prevent the fraudulent in the financial statements. We are as academicians must focus on detection and preventing frauds and research the reasons, gaps in the accounting standards. İnterest groups who are interested in companies require to see summary explanation on issues in the decision process, which have effect in the company and if it is based on real documentations. Financial reports have to satisfy the interest groups necessities. Accuracy, transparency and reliability of financial information will give opportunity to the investors to make remarkable decision on their investments. Otherwise the allocation of resources will be transferred to wrong side.

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