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Financial Fraud and Managers, Causes and Effects

Mohamed Bechir Chenguel

Abstract

The financial scandals which have appeared in recent times have placed fraud at the heart of economic and financial issues. Fraud by executives has disastrous consequences as it results in huge losses for investors and creditors, and especially for the company itself. Most of these frauds were often in the form of accounting and financial manipulation, and they have evolved to change forms. We are going to analyze the aspect of fraud, how it can appear. Then we will try to see the aspects that lead to committing fraud, which are generally an organizational framework favoring fraud, and the psychopathic personality of the fraudulent manager. And finally, we will take a closer look at the role of governance oversight mechanisms and the role they must play in fighting fraud.

Keywords: fraud, disclosure, control mechanisms, psychopathic leader

1. Introduction

Financial fraud committed by managers have multiplied in recent years; however, they constitute a highly delicate phenomenon in the world of finance. Each year, fraud causes significant losses to the shareholders and creditors of the targeted companies, which hinders the proper functioning of the capital markets. Fraud is generally committed by executives who are very often involved and are subject to legal action by financial market regulators.

The revelation of a fraud tarnishes the reputation of several participants in the financial markets, thereby affecting investor confidence in the market and penalizing all businesses [1]. In fact, any fraud announcement leads investors to question the competence and vigilance of financial market regulators, and even auditors, financial analysts, boards of directors, and credit rating agencies, all these actors have their share of responsibility.

In addition to the financial losses suffered by investors, other losses are added, such as the socio-economic costs related to job losses [2], and can even go as far as the disappearance of the whole entity. But the question that arises is as follows: Given the financial losses and reputation suffered, why do business leaders or entrepreneurs engage in fraud and manipulation? Can we determine the individual and organizational responsibilities that lead to fraud committed by leaders and entrepreneurs?

What tools and strategies are available to a board of directors to detect and prevent such fraudulent practices? We will try to answer these questions, by proceeding as follows: we will first carry out a synthesis of the main types of fraud committed by managers. Secondly, the motivations of the main actors and

to identify the attributes, whatever it is individual or organizational likely to lead to fraud. Third, we will focus on the profile of the fraudulent leader. And finally, we will present the recommendations for the various actors responsible for the integrity of the financial markets which are the boards of directors, the regulatory bodies, the accountants, and the auditors.

2. The manager's frauds

Fraud or embezzlement committed by business leaders can take many forms but often boil down to the following maneuvers:

- misappropriation of assets;
- manipulation of financial results; and
- lack of disclosure, incomplete or misleading disclosure.

2.1 Misappropriation of assets

Misappropriation of assets is mainly carried out by means of the so-called related party transactions where the offending manager initiates commercial or financial transactions between the company he manages and the subsidiary companies [3]. For example, a holding company may carry out several transactions with companies or entities controlled by the members of its management team, allowing them to make significant gains. So the leaders could profit and transfer several millions to companies that they personally created. This investment strategy cannot be controlled or approved by the board of directors. Managers can therefore be led to invest even in companies in liquidation, without anyone controlling them, and the discovery by the board of this misappropriation of an unauthorized action of the funds of the company would not have heavy punishment; the offending manager will simply be dismissed.

2.2 Handling of financial statements

The manipulation of financial statements most often relates to an excessive or excessively exaggerated recognition of revenue, and an undervaluation of operating expenses or an overvaluation of assets [4]. The extent of accounting and financial manipulation by companies is difficult to pin down due to the multitude of events, prosecutions, and counter-prosecutions that have characterized this field. However, according to the information available, it generally seems difficult to verify accounting or financial information such as the increase in profits. Indeed, a swelling generally reflects the nonrecognition of certain operations or even an overvaluation of negotiable securities, tax credits receivable.

2.3 Misleading disclosure absent

When the disclosure of financial and accounting information, which should be made by the officers of the companies, is absent or misleading, the companies may be liable to fines of up to millions. What is certain, acts of fraud such as embezzlement and manipulation could not have existed if the company's disclosure practices had been carried out in accordance with the rules and the transparency required by the regulations [5]. For example, we disclose financial information in the balance

sheet which will give information on marketable securities classified as current assets. However, these securities are not really negotiable or cashable in the short term, but their recovery can be spread over several years. To detect these anomalies or to verify the authenticity of this information, it is necessary to analyze the notes of the financial statements and compare them with the balance sheets and the financial statements.

Thus, certain information disclosed may be disguised or unrealistic, especially in the case of accounting for transactions between the parent company and its subsidiaries; indeed certain transactions have not been properly accounted for and presented in its previous financial statements.

The errors that are generally made concerned mainly the following elements in previous periods:

- products;
- cost of goods sold;
- selling fees;
- general and administrative costs;
- depreciation of fixed assets;
- interest expense;
- exceptional items;
- charge of income taxes;
- tax credits receivable;
- production costs;
- related party accounts receivable;
- fixed assets; and
- creditors and charges payable and income taxes receivable.

2.3.1 Consequences of reporting all of these fraud allegations

In a few months, following the announcement of various allegations of fraud and embezzlement, the action plummeted and then the company was sold. In most cases, the companies have either declared bankruptcy and been wound up or undergone a judicial restructuring where the shareholders have lost everything.

3. Why do leaders make fraud?

In addition to financial losses, leaders certainly lose their leadership positions, control of their business, and especially their reputation [6].

How did they commit the frauds they were accused of while the company was open with a board of directors made up of influential people? Why did they go

down that path, risking everything they had worked for? In general, a manager or entrepreneur will engage in fraud if the organizational context is favorable to commit fraud and also if the manager displays a profile likely to commit the act of fraud.

3.1 Fraud following the favorable organizational context

The opportunity to commit fraud arises when controls are absent or even failing. Thus, fraud will be easier to carry out since the manager will be free and without control within the company. Indeed, senior managers who can circumvent existing controls, especially if the external governance mechanisms such as regulations, or internal ones such as the board of directors, are insufficient or even ineffective [7]. When they commit fraud, the managers of a company know very well the administrative machinery and have access to data and systems, and when the latter are involved and part of the shareholders, this will make them in a position of strength, while reducing the role of the board of directors to which they belong. Managers can therefore exercise absolute control over the company. It can therefore be said that there was no counterweight to their authority within the company. For example, the CEO can be a more or less significant shareholder, which gave him an edge over the other members of the board of directors.

Another opportunity that favors fraud is the pressure geared toward high performance; this generally manifests itself during stock market bubbles. In fact, rapid deflations of stock market bubbles are very often accompanied by the manifestation of fraud committed by business managers [8]. Indeed, the stock quotes of several companies always reflect expectations of optimistic profits, which implies very high growth rates. Any profit announcement that does not meet stock market expectations will result in a sharp drop in the stock price. In this context, if the performance of the company begins to decline, the management of the company will be forced to manipulate the accounting results to ensure that the earnings per share announced meet or even exceed market expectations. Investors then imposed a stock market valuation, at an increasing, unrealistic rate, which pushes managers to fraud, by favoring accounting manipulations. Also, the stock market bubble will be liable to lead to fraud or manipulation of the financial statements if the directors have a remuneration strongly focused on the appreciation of the stock market price or focused on results or profits.

The governance role: the board of directors was composed of the different members—the founders, the directors of other partners, and the audit committee of the company.

Independent directors: board members must have experience and expertise in the areas of business of the company. They must ensure the control of management systems and the various strategic operations. It can therefore be argued that most of the information at their disposal concerning the company came from its management. The lack of expertise on the part of the board led to failure to perceive the warning signs of manipulation or embezzlement.

3.2 Is the fraudulent manager a psychopath?

In addition to the organizational context, the manager's psychological profile can lead him to commit fraud. Indeed, some research on criminological thinking on financial fraudsters have agreed that there are psychological peculiarities specific to financial fraudsters, which are very similar to the peculiarities of the psychopath [9]. In fact, like all psychopaths, specialized fraudsters always give the image of a healthy, rational, and apparently normal personality, which would mask their true nature.

In order to recognize the psychopathic fraud leader, three aspects of the leader's profile are typical: always having a rationalizing speech in order to justify their actions, and an arrogant attitude.

3.2.1 A rationalizing speech

The people implicated in a fraud are always able to justify their action by minimizing the extent of its serious consequences.

The fraudulent leader has the ability to rationalize bad decisions that are not even ethical.

3.2.2 Exaggerated arrogance

Fraud also has a dimension attached to the attitude of individuals. Indeed, engaging in fraud at the risk of collapsing a society reflects an attitude of trust, arrogance, and exaggerated narcissism on the part of fraudulent leaders. Such leaders will first favor a centralized decision-making process in their hands, persistence, and stubbornness to pursue their strategies. These leaders will be free from anxiety because they are convinced that ultimately their will and their decision will prevail [10]. It can therefore be said that an ambitious, arrogant, and self-confident leader always engages in fraud by never thinking that he will be caught. According to them, the controls or the people responsible for prevention or detection are of lower intelligence.

They always do so, the first successful fraud will reinforce the behavior to be pursued in this way of fraud. It will continue to make decisions unilaterally and centrally. Relations with collaborators and employees are very superficial and instrumental, the only goal being the achievement of their strategic or operational vision.

4. Role of control mechanisms

The auditors, the members of the board of directors, and the regulatory bodies play a very important role in carrying out the fraud; in fact the latter constitute the governance control mechanisms, the main role of which is prevention against any financial offense within the company [11]. What can we do about this fraudulent act? What needs to be done is great vigilance and strengthening of the following actors:

4.1 The auditors

The role of the auditors is to detect anomalies, manipulate, and prevent problems and then propose solutions. Auditors are generally retained by the board of directors. The auditors are engaged to investigate and detect fraud; they diagnose the situation of the company in order to detect fraud. Fraud is the weak point of the accounting profession, and it is the responsibility of auditors to detect fraud [12]. This is why it is very important for auditors to take a dynamic approach to fraud prevention and detection. In addition, auditors must go beyond conventional fraud, which is based on detecting the rationality of fraudulent managers, characterized by a psychological profile tempted to fraud, for generally financial reasons. The act of classic financial and accounting fraud is outdated, and the new forms of fraud have changed in nature, and therefore they must be warned in advance. Thus, the fraud has to exceed the direct money gain by the fraudulent manager, to take the form of strategic decisions, with which, the fraudulent manager will generate

future profits. Therefore, the auditors must also control the strategic decision-making process of the company; this imperatively passes by the elimination of the centralization of the information held exclusively by the top executives. Finally, the auditors will have to establish fraud analysis grids to also include behavioral aspects of management during meetings with their employees.

4.2 The board of directors

The role of the board of directors has indeed changed and has evolved in recent years, especially with acts of management fraud, which have emerged, and several practices on good governance have been introduced to better balance power within from the administration board [13]. Among these good governance practices, the following actions can be cited:

- It is necessary to separate the roles between the chairman of the board of directors and the CEO.
- Reduce the number of the board of directors, who hold positions within the company hold regular meetings of the board of directors, with members of management, without the presence of the CEO.
- Make sure that the board can count on a roadmap and expertise in order to properly follow the actions and decisions of management.
- Recruit external directors, well experienced in the field or activity of the company. During meetings of the board of directors, the following points should be raised regularly:
- Update strategic action plans.
- Update the succession plan.
- Discuss the working atmosphere with the CEO and strengthen ties between members of the management.

The board will also have to ensure that the company works in a climate of integrity and ethics, and that its internal or external communication mechanisms are set up with the greatest transparency.

4.3 The role of financial analysts

Financial analysts play almost the same roles as members of the board of directors; they must always verify the information disclosed by companies. They must analyze the financial statements well and detect any contradictions [14].

For example, fraud can appear if the analyst observed a profit which increased over a certain period, while his cash flow generated by the operation (Cash Flow) fell during the same period, this contradiction meant that there is Something is wrong [15]. In other words, if the company posted positive cumulative profits over a period, while its operation posted negative figures over the same period, this is abnormal, since as normal, growing profit, this deficit must not exist, and must be absorbed by bank loans or new equity issues.

Thus, these contradictions, or these differences between profits and cash flows, are often the sign of accounting manipulations.

Analysts will try to answer these questions:

- How is it that the profit increases while the flows are negative?
- How is this drain on the company's liquidity financed?
- Is there a recovery plan?
- A cash budget?
- Are the assets thus acquired liquid?
- Are the assets good quality?

4.4 Role of the chartered accountant: auditor or verifier

The chartered accountant is a privileged interlocutor of companies facing fraud; indeed, thanks to his skills in internal control, and his mastery of accounting procedures, his role is not negligible to fight against fraud, and notify her during her activities to her clients [5]. For the accountant, his investigative role consists in intervening within the framework of his advisory missions in the event of suspicion or fraud detected by the company. Its mission intervenes even before legal action in order to confirm or not the suspicions of fraud. In fact, its services are often requested either by the majority shareholders, or by a parent company operating with its subsidiaries, or by the company victim of a fraud committed by its senior managers.

4.5 The auditor

The auditor may also be invited to investigate if there is a suspicion of customer fraud. Their investigation missions can be either audit or judicial expertise missions, and this mainly depends on the legal aspects of their missions [16]. They must carry out their missions with objectivity and professionalism while respecting the principle of professional secrecy.

4.6 The role of regulatory authorities

The role of regulatory authorities in preventing and discovering fraud is not easy to do. Their main role is to establish the mechanisms that fight against fraud. They must manage complaints, and investigations against fraudsters, and they must ensure that the governance bodies and mechanisms of listed companies play their full role. Financial reporting must be reliable and communicated to the public on time. Establish mechanisms and apply sanctions against any natural or legal person, who tries to defraud or manipulate financial or accounting information, in order to profit personally.

5. Conclusion

The financial scandals which have appeared in recent years have placed fraud at the heart of economic and financial issues. Following this, several measures have been adopted aimed at strengthening the regulatory and legal framework such as the Sarbanes-Oxley law in the United States (July 2002) and the financial security law in France (August 2003).

At the same time, new auditing standards have been created to increase the risk of fraud being taken into account by statutory auditors: SAS 99 standards in the United States, IFA ISA 240 standard internationally transposed in France by NEP 240.

But all of this did not stop the leaders from committing the fraud. In fact, the fraud and the accounting and financial manipulations made by the senior executives of the company have affected the confidence of investors and donors toward the company and its image on the financial market.

To remedy this, financial control authorities and even government authorities have introduced a series of regulations aimed at improving corporate transparency, for example by improving the disclosure of financial information, to which companies must comply, and which they must also publish through their official documents.

The control recommendations must also relate to the risks linked to overinvestment and good governance, via better collaboration of the boards of directors with independent, external directors and above all well experienced in the field of activity of the company and especially use auditors from well-experienced accounting firms.

Author details

Mohamed Bechir Chenguel
University of Kairouan, Tunisia

*Address all correspondence to: bechir.chenguel@gmail.com

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