Contemporary Issues of Businesses with Special Reference to Business Ethics and Accounting Frauds

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Abstract:
Accounting fraud involves improper maintenance of accounting books or deliberately non-adherence to generally accepted accounting principles. However, accounting information should be prepared to convey a true and fair view of a company’s commercial dealings and ultimately of its business. The primary objective of every company is to ‘create shareholders value’. However, frauds and scams damage companies’ reputation and crush their brand image. It is found that absence of ethics is a recipe for poor corporate governance, leading to the risk of dents in company goodwill. The present study is conducted to analyze and correlate business ethics and accounting frauds’ and ways and means to understand warning signals/alarming bells for some suspicious circumstances while analyzing financial statements of any organisation. Both primary and secondary data were collected and analysed while preparing this research paper.

Key Words: Business Ethics, Accounting frauds, Ethical violations in accounting, financial statements.

Introduction: Business is a complex economic activity in which a large number of tangible and un-audible factors are involved. Business involves its owners, customers, products and services, financial transactions, employees of the organization, governmental and legal regulations etc.

The primary objective of every company is to ‘create shareholders value’. However, in reality, the truth seems to lie elsewhere. If we open newspaper with global news any day, and chances are that we will find news of some fraudulent incidents taking place somewhere in the world. Be it bribery, scandal, violation of product safety, toxic dumping, banking scams, tax evasion etc.

Fraud and corruption are words that are often used interchangeably. However, these two are different although similar in some aspects. Fraud uses misrepresentation to obtain an unfair advantage. Fraud is intentional error, the deliberate concealment of a material fact or the failure to disclose a material fact. Examples of fraud include falsification of account holders’ signature to withdraw money from their bank accounts or submission of false invoices to obtain payments. Corruption, on the other hand, is the illegal use of an official position to secure an advantage through breach of trust. Examples of corruption include government official’s unduly favouring particular people or organisations on receipt of unlawful payment in cash or kind.

As per the Global Fraud Survey 2013-14 of the Economist Intelligence Unit claimed that ‘Fraud on the rise’. And the worst is overall 70% of companies reported to have suffered from at least one type of fraud in 2013. This is unbearable development. Considering this fact in to account, many questions arises, who commits fraud? What are the key trends in fraud and scams? Why is fraud committed? What motivates people to commit frauds? The questions go on and on.
Need of the Study: As we all know that company is an artificial legal entity. It can buy, sell, borrow, lend and produce. Shareholders own the company. However, it is the directors and the top management who run a company, decide when to declare bonus shares, how much dividend is to be declared etc. But can it mislead and cheating? Thus, the issue arises that when a company commits fraud then who should be held responsible-its management or its shareholders? Should the whole of management be held responsible for fraud? Sometimes, fraud is committed by only a few people who keep others in the dark. Many times we see that companies have been penalized for wrong doing. But why do such people risk their reputations, which they have built over the years with hard work and sweat? Researcher strongly felt to discuss all these issues along with different types of frauds.

Objectives of the Study: The study aims to analyze and correlate business ethics and accounting frauds’ and ways and means to understand warning signals/alarming bells for some suspicious circumstances while analyzing financial statements of any organisation. Thus, in particular, the study sets the following broad objectives:

a) To study the intension of committing accounting frauds from business ethics point of view.

b) To find out various major ethical violations in Accounting called as frauds and its impact on the owner of the organisation and overall financial affairs.

c) To provide suggestions in the form of indications while studying or analysing financial statements by common lay man.

Research Methodology: Research paper is prepared with the help of both primary and secondary data. As far as primary data is concerned, researcher has conducted interviews of 5 Practicing Chartered Accountants to understand the practical views on different types of accounting frauds. Questions were also raised relating to various ways of frauds that top management with the help of accountant commits and also asked regarding how to identify frauds while analyzing or reading financial statement from the common lay man point of view. In addition to this, information also collected from secondary sources such as books and journal available in the library.

1. Why do companies commit accounting related fraud?

Information generated by accounting is the prime means to interpret the health of an enterprise. If accounting records are altered, reports generated will obviously give an incorrect picture, which would normally be rosier than what the reality was. After the analysis and interpretation of both primary and secondary data, researcher found below reasons of committing frauds.

(a) Every time a question arises in the mind that why do people cheat or committee frauds? The answer found that ‘It is a short cut to a success’. Some people are so ambitious that they want to win by hook or by crook. Some people cheat because they feel no one is watching. Some cheat for the thrill of it. However, not everyone cheats.
But few are. Hence the challenge is to shift the bad from good. Thus researcher found that greed is the only answer that comes to mind.

(b) Sometimes the management refuses to convey that business is slowing down hence fudging sales figures to show growth.

(c) There are stock price pressures on listed companies and hence fraud in the books of accounts is an easy way of showing positive financial figures and keeping a company’s share price high in stock markets.

Findings of the study i.e. major ethical violations in Accounting: Researcher found that there are various ways and Methods adopted by fraudsters. It is almost impossible to describe each of these in the paper. Therefore, few of them are elaborated in the form of findings.

1. Problematic sales revenue booking: it is found that due to the pressure of top management that sale should be increased by hook or by crook. To meet its unrealistic profit targets. The company forced recording of deferred sales (with actual sales taking place later) in its books of accounts, even when goods were not dispatched to buyers. The buyers did not even ask for the deliveries and the risk for the goods remained with the seller. It results gross over-reporting of sales and fraudulent accounting. It shows the purpose of showing growth in an organisation by depicting an increase in its activity level. It also normally portrays higher profits. It shows that company’s sales are growing the investing community are usually happy and look positively at it. Thus incorrect booking of sales means that the revenue should not have been considered under accounting principles, but was booked to show a better than normal picture. This is a fraudulent act.

2. Recording sales pending fulfillment of contractual obligation: In this, organisation records sales of booking sales against contracts that had not even been signed. Many of the contracts were signed after the end of the quarter, and yet, sales were booked against these contracts much before they were signed. However, sales could not have been against unsigned customer contracts. Such types of recording of sales results in good profitability, when it is actually incurring losses. However accounting principle says that revenue should be recognized in companies’ books of accounts when obligations undertaken under a contract are fulfilled and not before.

3. Stretching of accounting Period: Normally, public listed company needs to publish its financial results once every quarter. If the period of one quarter can be extended beyond three days fraudulently, then its revenue figures will get overstated. For example, a quarter has 90 days, However, if a company can bring forward seven days from the next quarter, its revenue figures will be
overstated by one week, and its corresponding profits will also be overstated. This is a fraudulent accounting practice.

4. **Tampering with Revenue Recognition Policy:** It is found that companies are not following consistency principle in recording revenue items. However, every company needs to normally follow consistent principles in calculating its revenue. Consistency in its policy of recognizing sales helps users of its accounting reports compare sales of a given period appropriately with corresponding previous periods. Any change in its method of recognizing revenue, should be reported specifically in its financial statements, so that users of these reports are given adequate notice of the change in its policy. Any non-disclosure is a fraudulent act.

5. **Mark to Market to Enhance Revenue:** In case of assets or liabilities, where market prices are volatile, these are shown in the balance sheet on a mark to market or fair value basis. It means that if the market value is higher or lower than the procurement value, the cost of the acquisition of the asset needs to be replaced by the market value, which is fluctuating in nature. This method of valuation is usually used in cases of stock-in-trade. Fluctuations in market prices affect the profits or losses of companies, being the unrealized profits or gains. It is found that the concept of valuation has often been misused to show fraudulent profits.

6. **Bill and Hold:** it is found that sales are booked in accounting books, prior to the shipment of products. This arrangement involves invoicing by the seller to the buyer of the goods, but the seller holds the goods on behalf of the buyer, without shipping the goods to the former. This is commonly known as a bill-and-hold transaction. However, it is common sense that revenue can only be booked after shipment of goods to the buyer or when the title of the goods has been transferred from the seller to the buyer.

7. **Showing Bogus Sales: Back –to Back Arrangement of Goods Return:** one of the basic principles of revenue recognition in companies’ books of accounts is that delivery of goods or services must take place. However if there is a hidden arrangement between a seller and a buyer that goods supplied will be returned, no sales can be recorded. If the arrangement of goods being returned by a buyer can be kept under wraps, their original delivery can be fraudulently shown as sales.

8. **Showing Sales without Dispatching Goods:** It is observed that sales were shown to increase a particular quarter’s reported earnings and were corrected in one of the ensuing quarters. A sale is a commercial activity involving transfer of ownership of goods or
services from a seller to a buyer in return for a consideration, usually money. However, when none of this happens, but sales are shown in a company’s accounting books, this amounts to creation of bogus sales.

9. Loans Taken from Banks and Shown as Sales: Loans are debts that are liabilities and need to be returned. Anything that is a liability and repayable cannot be treated as an income in accounting books under any stretch of imagination. However, it is found that loans taken involve inflow of funds, fraudsters sometimes align this with sales realisation and falsely show it as their revenue.

10. Misreporting Special Earning as Regular Income

11. Showing One-time Income as Regular Income: One-time income usually arises from sale of assets or by restructuring of businesses. It should not be treated as a regular revenue income stream, but a one-time capital gain or exceptional income, depending on the type of transaction. However, sometimes organisations show one-time gains as part of their revenue income to dupe the unsuspecting investor community.

12. Shifting Non-operating Income to Operating Income: Appraisal of operating income enables us to gauge whether a business is a consistent performer. Operating income arises from the regular operations of the business and is recurring in nature. This includes sale of products dealt with by the company. Non-operating income includes revenue flowing from irregular sources. Some companies tend to classify non-operating income as operating income. Such reclassification involves falsification of accounting disclosure.

13. Shifting Operating Losses to Non-operating Ones: Operating losses in an organisation are generally expected to recur to the confusion of investors. Companies therefore tend to shift their operating losses or costs to the non-operating sections in their income statements. These incorrect classifications result in misleading investors by giving an incorrect picture of their business.

14. Failure to write down excess or obsolete inventory: the financial results will give an incorrect picture.

15. Failure to write down non-collectable debtors

16. Failure to write down bad investments

17. Failure to record invoices received late from vendors

18. Valuing LIFO to FIFO cost of sales to increase profits.

19. Manipulate profit figures to avoid tax: Payment of tax to the government can be avoided by showing an enhanced cost that may not ordinarily be deductible for the purpose of calculating tax or by avoiding disclosure of income. Wrong calculation, erroneous cost booking can all lead to lowering of
tax liability. It is a ready place for fraud.

Warning Signals/Alarming Bell for some Suspicious Circumstances: After the overall study, researcher found that there is no standard definition of warning signals or alarming bell for suspicious circumstances. However, while reviewing financial statements there are few accounting ratios or numbers and non-accounting signals which indicate warning signals of frauds mentioned below.

(a) Growth in revenue, but stress on cash flow: Generally, increased revenue should mean an enhanced cash inflow. However, if a company has significant cash flow difficulties, there could be the possibility that its revenue recognition policies are improper. Such situation may result insolvency in the future.

(b) Fluctuations in cash flow ratio: Sales ultimately need to convert to cash. If there are bogus sales booked, cash flows will show a fluctuating trend. Cash flow trends can be analysed by calculating cash flow yield. Thus positive net income, but negative operating cash flow yields results warning signals.

(c) High cash balance, but equally high debt: If a company’s debts are high, but it has surplus cash, there is something wrong. Company went under debt stress. Why did it have such huge debt when there was nearly a corresponding figure in its cash balance?

(d) Debtors high in comparison to sales: Any abnormal increase in debtors is an area of concern. Sales shown fraudulently will either sit in accumulated debts or reduced cash inflow.

(e) High inventory: Inventories are held for conversion into sales and ultimately into cash within a reasonable time frame. However, very large inventory is a cause of concern. High inventory can be shown to depict enhanced profits by including bogus or non-existent stocks.

(f) Excessive operating margins: Reporting very high operating margins could be a creation of the imagination. It could occur due to bogus sales being booked.

(g) High prepaid expenses: If the ratio between a company’s prepaid expenses to its operating expense is very high, it could imply that a major part of its operating or regular expenses are not being shown as a cost in its income statement.

(h) Fluctuating sales returns: Sales made but returned by customers for whatever reason, including quality-related issues, are a common phenomenon. However, if there are severe fluctuations in returns from customers, this needs to be taken note of it. It could imply that bogus sales reported earlier are being corrected in the particular quarter without any specific and separate disclosure.
(i) **Very high compensation given to senior management for change of control.**

(j) **Related party transactions:** Such transactions imply that a company is buying and selling to and from parties or companies, in which either a board members’ is interested or the company has a share.

(k) **Lack of internal controls:** If an audit report includes adverse comments or there is any reason to believe that there are inadequate internal controls in a company, this is a huge indication of fraud.

**Conclusion:** Considering all the above discussion, interpretations and findings, researcher would like to conclude that fraud is deliberate error committed intentionally and is very difficult to find out in the normal course of action. Frauds and scams damage companies’ reputation and crush their brand image. However, with their differing purposes and intentions, enforcement of strong ethics is not often in their agendas. This absence of ethics is a recipe for poor corporate governance, leading to the risk of dents in company goodwill. It is also found that ‘It is a short cut to a success’. Some people are so ambitious that they want to win by hook or by crook. Some people cheat because they feel no one is watching. However, not everyone cheats. But few are. Hence the challenge is to shift the bad from good. Thus researcher observed that the individual greed and pressure of the top management are the answers that come to commit frauds. It is also found that even audited books of accounts remains frauds as it is because auditors are not normally supposed to detect fraud. In fact, external auditors detected very few and general level frauds.

**References:**