

# CHAPTER ONE

## INTRODUCTION

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### 1.1 BACKGROUND

In recent years, a number of South African companies have experienced problems with accounting irregularities\*, specifically referring to the manipulation of accounting records in order to artificially adjust the financial statements. This causes damage to the financial health† of a company. Among companies that have experienced such problems in the past are: Macmed, NAIL, Beige, Masterbond, Saambou, Regal Bank, Unifer, Leisurenet and NRB. Some of these companies have survived, but most of them collapsed after the irregularities were discovered.

Internationally, two of the largest and most well-known bankruptcies in the 1990's have occurred as a result of accounting irregularities, namely those of Enron and WorldCom (Altman & Hotchkiss, 2006:3). The cost of such activities is not borne by the perpetrators, but by customers, investors, creditors, the government and insurance companies. Apart from the financial losses incurred, there are also other losses, such as decreased sales, decreased productivity, poor credibility and an adverse impact on people's professional ethics. The possibility is not excluded that, when one person gets away with it, others may be inclined to believe that they will also be able to get away with it.

As far back as 1995, the United States Chamber of Commerce already estimated that the aggregate annual cost of fraud to companies in America exceeded \$100 billion (Glover & Aono, 1995:3). The 2012 Report to the Nations (ACFE, 2012:4) reports that the impact of occupational fraud based on the estimated 2011 gross world product,

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\* This study makes use of the term "accounting irregularities". The reason for this is that accounting irregularities encompass a wider range of accounting misdemeanours that are perhaps not completely criminal and thus not included in the criminal activity called financial statement fraud. Financial statement fraud refers to fraud incidences involving the intentional misstatement or omission of material information in the organisation's accounting system in order to cause changes to the financial reports with the goal to make the company appear more, or less, profitable (ACFE, 2012:10).

† When reference is made to "financial health" in the study, the meaning is particularly aimed at the state of the company in terms of the truthfulness, trustworthiness and transparency of its accounting data and published financial statements.

translates to a potential projected global fraud loss of more than \$3.5 trillion. Participants in the survey estimated that the typical organization loses 5% of its revenues to fraud each year.

According to the Federal Bureau of Investigation (FBI), white-collar crime is the fastest-growing illegal activity in the USA (Martin, 1998:47). On the local front, the South African Police Service (SAPS) reports that South Africa lost R3,4 billion due to commercial crime in the first six months of 1999 (Minnaar-Van Veijeren, 2000c:38) and according to more recent crime statistics, the incidence of commercial crime is on the increase. (South African Police Service, 2011). A total of 88 388 cases of commercial crime was reported in 2010/2011 compared to 84 842 cases reported in 2009/2010, an increase of more than 4%. It is also important to consider that these figures reflect only the reported cases. There may be many more instances of commercial crime that are never reported.

It may be difficult to determine whether accounting irregularities are increasing or decreasing, because reliable statistics are not readily available. It is certain, however, that they are changing their appearance because of greater transparency, faster and more open communication, and the amounts appear larger because of inflation (Du Plessis, 2001:4). Other reasons for their change in appearance include the globalisation of trade and the use of technology. The two reasons last mentioned create opportunities for crimes to be committed across borders. The speed and volume of transaction handling have also increased thanks to changing technology. The Internet and other networks make it easier to gain access to an organisation's data. Records of current assets, such as cash and inventory, are increasingly stored in computer systems as electronic information. It is therefore becoming easier for criminals to manipulate records and misappropriate such assets. No company is immune to the onslaught of accounting irregularities and it is becoming the responsibility of all interested parties – not only managers – to be aware of irregularities and how to prevent them, so as to protect the financial health of the company they have an interest in.

Governments and professional organisations around the world have started to devise and implement laws and guidelines with the goal of preventing accounting irregularities from occurring. These measures include, amongst others, the Sarbanes-Oxley Act from America, the Turnbull Guide on corporate governance from the United Kingdom and the King Report in South Africa. However, these may not be as effective as need be. De Vay (2006) has proven in a doctoral study that the Sarbanes-Oxley Act is not effective in detecting and thereby assisting with preventing irregularities in the accounting system of a company.

Denis (2012:4) states that one of the only ways to reduce the occurrence of accounting irregularities is by creating an expectation that there will be negative consequences for failing to prepare and provide accurate financial reports. However, researchers claim that legal and regulatory systems may be too “blunt” as an instrument to handle the problems of inappropriate managerial behaviour. Debates about the nature and extent of the role of legal and regulatory procedures are especially important in an era of increasing calls for the regulation of corporations and markets.

According to Cressey (1986:195), there is a wide-spread belief that accounting irregularities will decline in frequency and severity if more people know more about them and if that knowledge is used to prevent them. Hussain, Kennedy and Kierstead (2010:72) concur that employees need to be educated so that they can better understand accounting irregularities, the internal controls and their role in the companies they work in. They found in their research that companies should not only rely on a yearly audit to detect accounting irregularities. It is thus imperative that more individuals know what to look for. The problem of a lack of education in the field is also identified by DeZoort, Harrison and Schnee (2012:289). They found that tax professionals face increasing pressure to help manage the problem of irregularities but that tax literature lacks clear guidance in the area.

It may be true that punishing and incapacitating violators of the law can perhaps help to reduce accounting irregularities, but a better strategy may be to implement sufficient

measures to prevent irregularities from happening in the first place. Apart from prevention, Martin (1998:49) claims that forensic accounting techniques are able to reveal an irregularity before it becomes a large problem. The establishment of such techniques, which can possibly be learnt by anyone with limited accounting knowledge, may help employers and employees to detect irregularities sooner and prevent damage to the financial health of a company. One upside is that there will always be evidence in the accounting records, however hard perpetrators may try to hide their activities. It is virtually impossible to destroy all evidence of inappropriate activities in the accounts.

A significant amount of research has been done on accounting irregularities, but most of the existing literature on the occurrence of accounting irregularities emanates from the USA. Works in which the detection and identification of accounting irregularities are discussed tend to focus on auditors' responsibility for detecting and identifying such irregularities. Thus far, there has been little academic writing and research in South Africa on the topic of accounting irregularities. More detail regarding some of the researchers and authors who contributed to the field is available in Appendix A.

Most of the research articles on accounting irregularities in South Africa are published in business magazines and not in accredited journals, for example Christophers (2005), Colapinto (1998), Dawson (2001), De Souza (2006), Du Plessis (1997, 1999a, 1999b, 2001), Kirby (2005) and Minnaar-Van Veijeren (2000a, 2000b, 2000c). This compromises the standard of such research done in South Africa, since research done in other countries is mainly published in accredited scholarly journals. Only a few of the South African studies about accounting irregularities deals specifically with the methods of detecting irregularities that can damage the financial health of a company and identifying its occurrence.

The characteristics of companies where managers and/or employees engage in unethical and inappropriate activities tend to be similar in many respects, for example characteristics relating to auditor relationships, debt, culture, liquidity and internal control structures. But there are also inconsistencies between different studies, for example

characteristics relating to profitability, debtors, inventory levels, the industry the company operates in, the level of growth and the size of the company. Such characteristics present one of the aspects of accounting irregularities that this study aims to address and discuss. Other gaps in the literature result from the fact that little attention has been paid to the detection of accounting irregularities and its identification by all interested parties. The only study found in the course of this research that addressed this problem directly was that of Du Plessis and Koornhof (2000). They looked at the measures that creditors and investors could use to detect such irregularities.

There are various ways to assess the soundness and usefulness of financial statements. Auditors generally use such assessment methods when they carry out audits. However, it may not be equally possible for other interested parties, such as creditors and investors, to use these methods. This is because they may lack access to the internal information available to internal parties such as managers. This study sets out to determine whether the financial health of a company can be revealed by means of possessing knowledge of the characteristics of vulnerable companies and by doing a thorough analysis of the published financial statements of a company, which are available to any interested party. If it is possible to use these means of detection, investors, creditors and other interested parties will be able to reduce their risk of being deceived.

## **1.2 IMPORTANCE OF THE STUDY**

An upsurge in financial accounting irregularities in the current economic environment ensures that the detection of financial accounting irregularities is a topic of great importance for academics, researchers and industries (Sharma & Panigrahi, 2012:37). Accounting irregularities have larger implications than many managers realise. In addition to harming the financial health of the company in which the irregularities happen, it can potentially also affect economic markets. An example in a South African setting of the effect of accounting irregularities is illustrated in what happened to

Saambou Ltd. early in 2002, when a rumour about accounting irregularities within the company caused the share price to fall by twenty percent (Ngaujake, 2004).

According to Rezaee (2002:7), the potential harmful effects of accounting irregularities include, but are not limited to: undermining the quality and integrity of the financial reporting process and jeopardising the integrity and objectivity of the accounting profession. Ryan, Scapens and Theobald (2002:99) claim that the use of accounting models for decision-making are already of limited use because of their historical information content and their strict recognition and measurement rules. The existence of irregularities in accounting systems makes accounting information even less useful for decision making. Accounting irregularities therefore diminish the confidence of capital markets and market participants in the usefulness of financial information and therefore these irregularities make the capital market less efficient. This in turn, has the potential to affect a nation's growth and prosperity adversely. If the parties affected by the accounting irregularities decide on legal action, this action can possibly result in litigation losses. If discovered, the careers of the individuals involved in perpetuating the accounting irregularities will inevitably be destroyed. In severe cases, accounting irregularities can even lead to the destruction of the normal operations and performance of companies allegedly involved and therefore can result in economic losses or even the bankruptcy of the company. For the rest of the industry, occurrences of accounting irregularities will encourage a higher level of regulatory intervention.

For the above reasons, it is essential to attempt to prevent the incidence of accounting irregularities or at least attempt to detect incidences as soon as possible. The identification of specific characteristics that can perhaps be used to earmark and then analyse a company for accounting irregularities will assist interested parties in protecting their interests in a proactive way.

### **1.3 PROBLEM STATEMENT**

As indicated in preceding paragraphs, literature on the ability of a financial analysis in order to reveal the financial health of a company in a South African setting is limited. This is especially the case if one looks at the presence of possible irregularities in the accounting system. Most of the research material that is available only discusses the theory behind accounting irregularities, while very few studies relate to the identification of the irregularities. A few studies from other countries have investigated the use of a financial analysis in revealing the financial health of a company when it comes to possible accounting irregularities. However, many of these studies recognise the need for further research. Few studies have thus far been done about the use of financial analysis to reveal financial health and the possibility of accounting irregularities in South African companies, specifically with reference to interested parties such as creditors and investors who may not have access to internal company information.

As a result of the limited research that is available in the field of accounting irregularities, this study is firstly an exploration into the broad subject area of accounting irregularities. It aims to break new ground in a largely unknown field because the emphasis falls on those interested parties that do not have access to all the company information and also do not have access to or knowledge of auditing and analytical techniques. This makes it an explorative study as it investigates an area that has not been researched much in the past. It will include investigations into previous research of accounting irregularities.

The study does not aim to create a forensic process or an audit, but establishes the means for interested parties outside a company to analyse the published financial statements of a company to assess the possibility of the presence of irregularities in a company's accounting system.

The decision-usefulness of published financial statements can be impaired by accounting irregularities. The research problem can be expressed in the following statement: ***Certain interested parties of a company have limited access to the necessary resources needed in order to evaluate the financial health of a company. The use of financial analysis and interpretation in conjunction with clear characteristics or indicators from published financial statements can make it possible to investigate and comprehend the financial health of a company.***

#### 1.4 RESEARCH OBJECTIVES

The research objectives of the study are to answer the research problem by means of the following:

- An investigation into the characteristics, as identified by researchers locally and abroad, that are displayed by companies with a higher risk of suffering from the occurrence of accounting irregularities.
- A survey of the media by means of a literature review to identify case studies of companies that had allegations of accounting irregularities made against them.
- The analysis of the case study companies in a quantitative and qualitative way to determine whether the characteristics that are displayed by companies with a higher risk of suffering from the occurrence of accounting irregularities (refer to the first objective), hold true in practice.
- Statistical analyses of the share price data of the case study companies in the form of an event study, a regression analysis and a structural break analysis, in order to determine when and under what circumstances significant changes happened.



- Conduct a survey involving the creators and the users of financial statements in order to observe their experience regarding the usefulness of financial statements to reveal financial health. This is done by means of questionnaires that are designed to derive conclusions of what practitioners tend to experience in practice and what their feelings are regarding the use of financial statements and accounting data in an analysis of the financial health of a company. The results of the questionnaire are analysed statistically to indicate the value of the hypotheses that flows from this objective (the hypotheses is discussed in more detail in Chapter Four).

The research objectives are discussed in detail in Chapter Four.

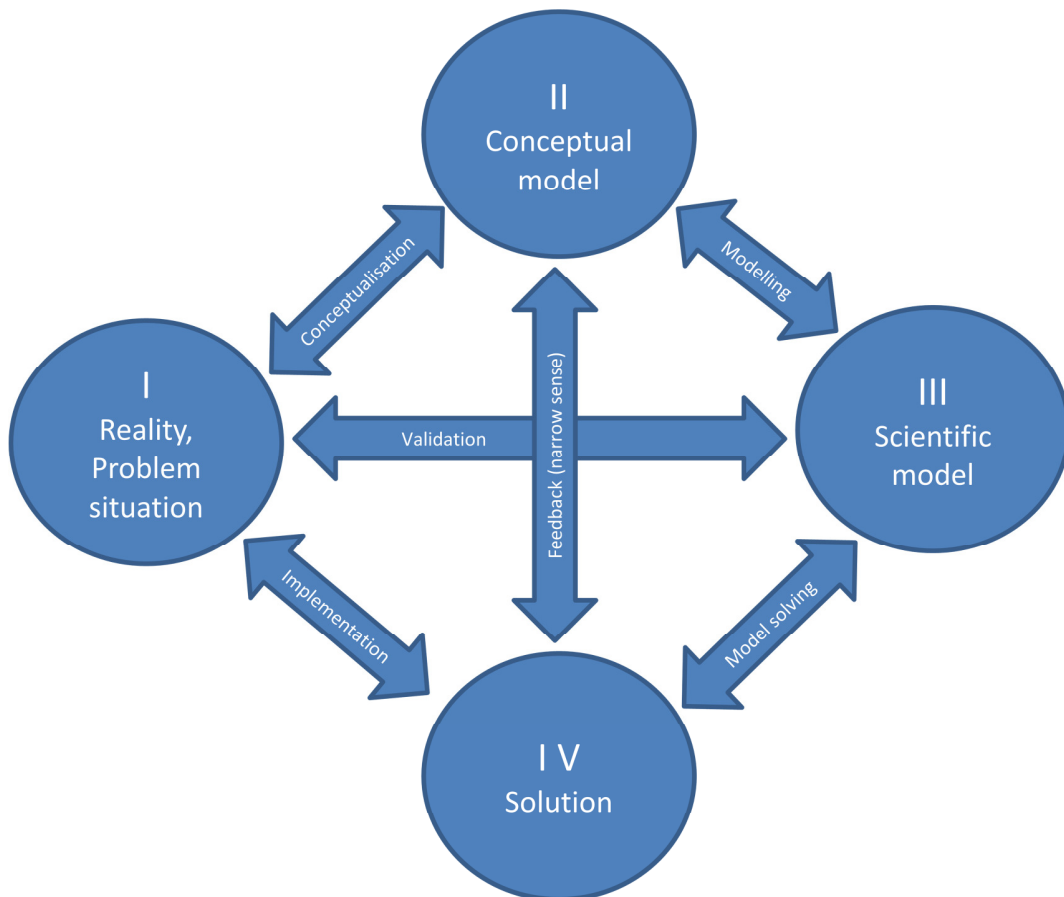
## **1.5 RESEARCH METHODOLOGY**

In order to conduct structured research that adds value, one needs to establish and follow an appropriate methodology. In order to give structure and meaning to a research project, it is necessary to make use of a research model. Such a model can be developed from scratch, or an existing research model can be adapted and applied to a new study. The last-mentioned option is applied in this study, making use of a model developed by Mitroff, Betz, Pondy and Sagasti (1974) in a research project. Mitroff et al. (1974:46) indicated that there are certain aspects of science which can only be studied from a whole systems perspective and that anything less than a holistic view will fail to pick up some of the most essential characteristics. The model was again mentioned and discussed by Mitroff and Kilmann (1977:114), where they referred to the model as a “whole systems model of science”. In the rest of this study the model is referred to as the “Mitroff model”.

Koornhof (2001:255) found that the model by Mitroff and Kilmann has an element of flexibility that makes it appropriate to a wide spectrum of research, especially in less formal, experimental and naturalistic research. This makes the model ideal for this research.

The Mitroff model guides the researcher through the necessary research inquiry procedures that ought to be followed to solve a particular problem. The model can be used in a wide spectrum of research beyond the realm of systems theory.

**Figure 1.1: The “whole systems model of science” or the “Mitroff model”**



**Source:** Adapted from Mitroff and Kilmann (1977:114)

The diagram is interpreted as follows:

- Each circle represents what is referred to as a “phase”
- The lines connecting the circles are referred to as “steps”

As observed in a study by Koornhof (2001:260), the model is a valuable tool in accounting research, especially in areas where there is a range of research approaches and methods:

- its circles and activities help to delineate the scope of research;
- the circles also assist the researcher with segmenting the research project into chapters;
- the various research activities suggest an appropriate and logical sequence of chapters;
- the model prompts appropriate thought processes at various stages in the research project; for example, lateral thinking during conceptualisation and logical reasoning during modelling;
- it encourages a holistic approach to scientific endeavour;
- it supports a process-related approach, because the model has no specific beginning or end and provides for continuous feedback;
- it provides legitimacy to an exploratory and non-formal research topic;
- it dispels misconceptions about research; such as that
  - research should cover all activities identified in the model;
  - research must be validated;
  - research must be implemented; and
- it highlights alternative research approaches and styles that can be adopted.

For the purposes of this study, the Mitroff model is used to structure and divide the document as described below.

Phase One of the model (Phase I: Reality, Problem situation), explains the background and the motivation behind the study. Phase I is comprised of Chapter One (my introduction), as well as Chapter Two and Chapter Three of this dissertation. Chapter Two takes the form of a literature review about accounting irregularities and Chapter Three is a literature review on corporate finance techniques and theories on the detection and identification of accounting irregularities. These chapters explain the problem situation and state the reasons why such a study is necessary.

Step One (Conceptualisation) is the activity involved in preparing a research methodology for the empirical research, which is presented in the next Phase. Therefore Phase Two of the model (Phase II: Conceptual model) is the presentation of the research methodology developed in Step One and is presented in this document in Chapter Four, which is concerned with the research methodology used for the empirical research. Chapter Four sets out the idea of the study, how the research will be conducted and the ultimate aim or model that is to be the outcome of the research.

Step Two (Modelling) is the activity involved in the actual research as described in Chapter Four. Phase Three of the model (Phase III: Scientific model) relates to the actual empirical research and is described in Chapters Five, Six, Seven and Eight. The chapters contain the following:

1. an identification of the characteristics that are prevalent in companies with a risk for accounting irregularities;
2. the identification of case study companies that are to be analysed;
3. an analysis of the case study companies in a quantitative and qualitative way as well as a statistical analysis of the companies by means of event studies and regression and structural break analyses; and
4. a survey of the experience of people involved in the preparation of annual reports as well as the users of annual reports.

Step Three (Model solving) is the activity involved in describing the empirical research results so as to present it in a way that can be understood and used by the readers of the study. Phase Four (Phase IV: Solution) is represented at the closure of the study in Chapter Nine, where the outcome of the empirical research is discussed and recommendations are made regarding the ability of financial statements to reveal the financial health of a company.

Step Four (Implementation) is the activity involved in analysing the actual research results and stating how they can be implemented in practice. It relates the results of the research back to the original problem situation.

Step Five (Feedback) and Step Six (Validation) fall outside the scope of this study.

In the rest of the document an indication is given in each chapter as to which part of the Mitroff model is being addressed.

## **1.6 NATURE AND FORM OF RESULTS**

### **1.6.1 Outcomes of the study**

The interim findings of each section of the study are presented at the end of the relevant chapter. Descriptions are included to support the findings. The integrated findings from all the sections and possible solution(s) to the research problem are discussed in detail in the final chapter.

The aim of this exploratory study is to identify whether there is any benefit to be had from an analysis of published financial statements. If such a benefit exists, it can help parties other than internal management, such as the board of directors, investors, creditors, the Receiver of Revenue and the government to detect and identify accounting irregularities that may harm the financial health of a company.

Beneish, Lee and Nichols (2012:25) state that efforts to prevent accounting irregularities involve both public and private initiatives. On the public side, accounting and security market regulators can help prevent them by means of legislation and enforcement actions. On the private side, parties such as investors can play a role by identifying organisations that are likely to have manipulated earnings and hold them accountable through market-based disciplinary mechanisms.

## 1.6.2 Outline of the thesis

Following on from this chapter, the rest of the study follows the format set out below.

Chapter Two is a literature review with a detailed background of irregularities of various kinds. The study looks at accounting irregularities that may impact on the financial health of a company. Other types of irregularities are also discussed in order to make the distinction between different types of irregularities clear. Since the study is an exploratory one, looking at a relatively new area of research, the aim of the literature review is to integrate the observations and findings that other researchers have made, rather than critically appraising other researchers' work.

Chapter Three looks at the use of financial analysis as a method to detect and identify irregularities. This is discussed with reference to previous research.

Chapter Four gives a detailed account of the research methodology and research methods that are applied in the study.

Chapter Five looks at characteristics displayed by companies that pose a greater risk for accounting irregularities. The information comes from the work of various researchers and writers from around the world, including South Africa. There appears to be a number of quantitative and qualitative characteristics that are displayed by companies with a higher possibility of having accounting irregularities.

Chapter Six discusses five companies that, through media searches, have been identified as having had allegations of accounting irregularities against them.

Chapter Seven contains the results of the empirical analyses of the identified case studies. Firstly, the annual reports of the companies that were identified are analysed. Secondly, the annual reports of the companies are compared to the weighted average total of all the companies in the sector and to individual companies without known

accounting irregularity allegations in the same sector. This forms part of a quantitative analysis and a qualitative analysis. Thirdly, statistical analyses, specifically event studies and structural break analyses are performed on the share price data of the identified case study companies.

Chapter Eight contains details about the results of a questionnaire survey distributed to a random selection of compilers and users of financial statements.

Chapter Nine summarises the findings from the analyses of the case studies and the survey results and sets the stage for further research.

## CHAPTER TWO

### **CORPORATE MISCONDUCT AND ACCOUNTING IRREGULARITIES**

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#### **2.1 INTRODUCTION**

This chapter forms part of Phase One of the Mitroff model as described in Chapter One. The aim of this chapter is to give the reader an idea of the reality of the problem by means of a literature review.

The study deals with the means available to interested parties to reveal the financial health of a company, specifically relating to the presence of possible accounting irregularities in the accounting system and the published financial statements of a company. In order to provide background to the reader, this chapter explains how accounting irregularities manifest in the financial statements. This is best done by means of a literature review about the end result of accounting irregularities, namely fraud. The chapter therefore commences with general definitions of fraud and the different terms that are used when fraud is discussed. This is followed by information about the different types of fraud, why fraud occurs, how fraud is perpetrated, who is responsible for fraud detection and control and finally how fraud is detected and identified.

In extreme cases accounting irregularities can evolve into financial statement fraud, which has the potential to cause the downfall of a company. However, even if a worst-case scenario like that does not realise, it may still cause damage to the reputation of a company and result in unnecessary monetary losses for not only the company, but also its investors and other related parties.

For the reasons mentioned above, it is important that everyone with a stake in a company knows what accounting irregularities are, what they look like and how they can possibly be prevented. This chapter gives an overview of the different kinds of fraud with specific attention given to accounting irregularities. The aim is not only to familiarise the



reader with accounting irregularities and fraud, but also to give reference to studies that have been conducted in this field.

## **2.2 WHAT IS FRAUD?**

Robertson (2002:5) defines fraud as “all the means that human ingenuity can devise, and which an individual may resort to in order to get an advantage over another person by false suggestions or the suppression of the truth.” It includes the following: surprises, tricks, cunning, dissembling and any other unfair way through which another person is cheated.

Locally, Ernst and Young South Africa (2003) define fraud differently, namely as a crime that has elements of intentional and unlawful misrepresentation which cause prejudice, most often taking the form of misappropriation or false accounting. The South African legal definition of fraud, according to the Prevention and Combating of Corrupt Activities Act, Act 12 of 2004, is a crime of deliberately misleading or deceiving someone to cause that person financial loss or other harm.

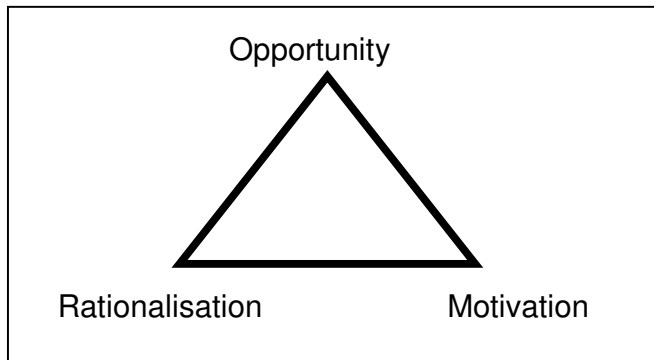
In this study, the focus is mostly on occupational fraud, which refers to fraud that takes place in the workplace. This is formally defined by ACFE’s Report to the Nation (2012:6) as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organisation’s resources or assets.” This definition is very broad, including any form of misconduct by employees, managers, and executives. Occupational fraud schemes range from occurrences as simple as the theft of company supplies to actions as complex as sophisticated accounting fraud.

### **2.2.1 The fraud triangle**

Even though there are different versions of the definition for fraud, the essence of fraud remains the same in that it encompasses all activities that are intended to deceive those that are not involved in the fraudulent activities, with the end result of unduly benefiting

those that perpetrate the crime. The fraud triangle (as depicted in Figure 2.1) explains the elements of fraud. In order for fraud to occur, all three these elements are usually present.

**Figure 2.1: The fraud triangle**



**Source:** Adapted from Wells (1997:11)

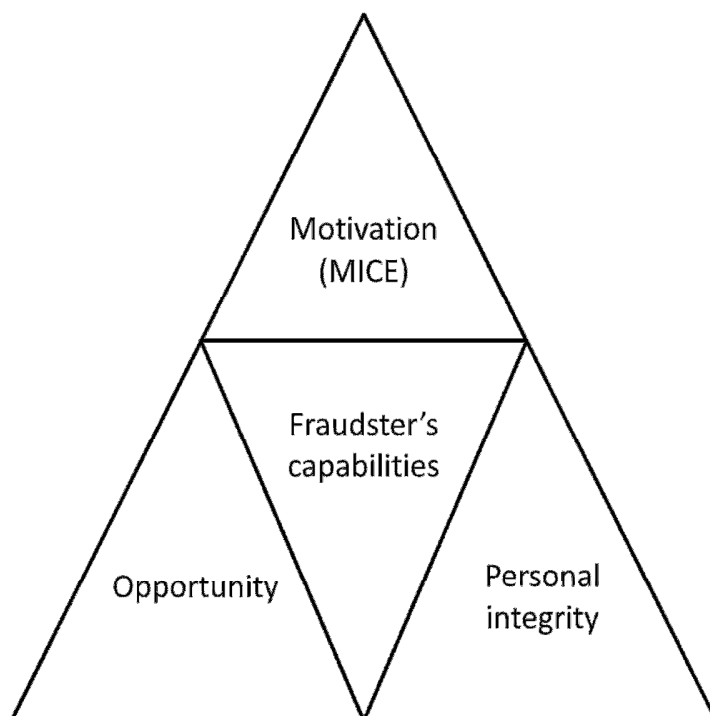
Robertson (2002:185) explains how the three elements from the fraud triangle make fraud possible. The three elements work together in the following way:

- Motive (incentive) is the pressures that a person experiences. These are to be “psychotic” (related to habit), egocentric (related to personal prestige), ideological (believing that the cause is morally superior) or economic (related to a need for money). When a person who is involved in an organisation acts in a different way than he/she normally would, it may be an indication that the person is experiencing difficulties. Such difficulties may act as motivation to use fraudulent means to get out of the situation.
- Opportunity is an open door to solve a problem by violating a trust. It is important that interested parties in a company do what they can to ensure that the opportunity to commit fraud is limited. This is mostly done by means of control measures. Normally, the higher the position of a person in the organisational hierarchy, the more trust is placed in him/her and the greater his/her opportunity to commit fraud.
- Rationalisation refers to the ability to convince oneself that an act is acceptable according to moral and ethical values even if it is not. Fraudsters find a way to rationalise their actions and make it acceptable to themselves. This will, however,

only come out if and when a case of fraud is detected and identified. While the perpetrator is involved in a case of fraud, rationalisation will act as a further means to hide the fraud.

Kassem and Higson (2012:195) find that researchers interpret the fraud triangle differently, especially the motive-section. The model developed by them is displayed in Figure 2.2

**Figure 2.2: An updated fraud triangle**



**Source:** Adapted from Kassem and Higson (2012:194)

The contribution made to the fraud triangle by Kassem and Higson (2012: 194) is evident in the mention of a model called “MICE” to define motivation. It stands for the following: money, ideology, coercion, and ego. Ideological motivators justify the means where perpetrators act inappropriately to achieve some perceived greater good that is consistent with their beliefs. Coercion happens when individuals may be unwillingly pulled into a scheme. Ego can also be a motive in cases where individuals do not want to lose their reputation or position of power in front of their society or families and resort

to inappropriate means to keep up appearances. Kassem and Higson also added another element; namely, a fraudster's capabilities to commit a crime.

The fraud triangle, whether looking at the old or the new model, helps one to understand why fraud is committed in the first place. It also gives interested parties a guideline as to what they have to look out for. It is important that people realise fraud is a reality and that most people are capable of committing fraud or run the risk of being defrauded.

### **2.2.2 White-collar crime and its perpetrators**

Fraud is often referred to as white-collar crime, but Minnaar-Van Veijeren (2000c:38) explains that fraud is a separate crime found within the ambit of white-collar crime. White-collar crime in general is also referred to as commercial or economic crime. While white-collar crime includes fraud, it includes other elements as well, such as bribery and corruption, industrial espionage, insider trading, conflicts of interest and money laundering (Du Plessis, 1997:11). Minnaar-Van Veijeren (2000a:37) states that there are a number of characteristics that are inherent to white-collar crime and that distinguish it from other crimes like robbery and assault. The crime usually involves premeditation, as well as careful planning and deception because of its complexity. There is normally a concealed misappropriation or deception, meaning that it is not openly visible. There may be a diffusion of responsibility and a diffusion of victimisation. Other characteristics indicate towards a lack of violence and the presence of an element of fraud and/or corruption, forgery, theft, money laundering and other elements. These characteristics prove that white-collar crime is different from other types of crime and they make it more difficult to detect and identify the crime. These crimes are often seen to be "rational" and the criminal often has the opportunity to commit such crimes through his/her working conditions.

Additional to the inherent characteristics of white-collar crime, it seems as if the criminals involved in such crimes display behaviour different from that of other criminals. In Elliot and Willingham (1980:214), it is noted that criminals who perpetrate white-collar crime

are often older, have no tattoos, have higher IQ scores, are mostly female, have a higher education qualification, do not use drugs and have fewer entries on their arrest and conviction records. Robertson (2002:182) additionally found that most fraudsters are married, are members of a church, are educated beyond high school, have no arrest record, range in age from their teens to over 60 years, are generally socially conforming, tend to have an employment tenure of one to 20 or more years and usually act alone.

Research has shown that fraud is more likely to be perpetrated by those in positions of trust (Mitchell, 1997:104) – thus by employees that have been part of the company for a long time, or by managers. It was also found that fraudsters score higher in tests of self-esteem, self-sufficiency and motivation for achievement, social conformity, and self-control, kindness, empathy, optimism and family harmony. It seems that white-collar criminals are more like the average person than other criminals.

Other factors that provide further proof of the ordinariness of fraud perpetrators are related to the size of the frauds committed by different perpetrators. These have been established by ACFE, based on research figures from around the world (2012:39-60):

- losses due to fraud by managers and executives are generally greater than those by non-managerial employees;
- however, more occurrences of occupational fraud result from activities by employees and managers;
- more frauds are committed by those who have worked for the organisation between one and five years;
- the longer the time period that the perpetrator has worked for the victim organisation, the larger the loss;
- males account for more fraud cases than women;
- losses caused by men tend to be higher than the losses caused by women;
- more frauds are committed by employees in the age group of 45 to 55 years;
- when looking at median loss per age group, the highest median loss is caused by perpetrators in the age group of 50 to 55 years;
- the more educated the perpetrator, the higher the loss from the fraud tends to be;

- the most frauds happen in the accounting department, followed by operations and sales; and
- the largest frauds happen with executive management, the finance department and the board of directors.

If these observations are true, it provides proof that white-collar crime can perhaps be more difficult to detect and identify than other crimes, since the perpetrator is likely to be an ordinary citizen who appears to be the same as any other. It is rumoured that most people are shocked when they hear someone was involved in white-collar crime. It is normally a person that one would least likely suspect.

Wells (1990:82) uncovered six myths that people tend to believe about fraud. The main points are summarised as follows:

- Myth 1: Most people will not commit fraud. This is untrue because fraudsters come from all walks of life. The research by the ACFE shows that it tends to be the person least suspected. Those in top positions and pillars in the community are often believed to be innocent, but it must be borne in mind that they occupy the best positions and have the best opportunities to commit fraud without being caught.
- Myth 2: Fraud is not material. Small frauds have the potential to quickly become material. A lot of small incidents also quickly add up to a lot. For these reasons all types and sizes of fraud need to be considered as important.
- Myth 3: Most fraud goes undetected. Fraudsters generally become overconfident in their actions and their frauds become too large. It has the consequence that the fraud becomes easier to detect.
- Myth 4: Fraud is usually well concealed. After being detected it is often found that most frauds were not well concealed in the first place and could have been detected easily through the careful observation of people and records.
- Myth 5: Prosecution deters others. It has been found that fraud detection provides others with pointers on how to perpetrate a fraud without being caught rather than to deter fraudsters from committing the crime.

Through these myths, it becomes apparent that people tend to misjudge not only the extent of fraud but also who commits it and how it can possibly be detected and

identified. If one accepts that fraud is always a possibility, it becomes clear why everyone, including parties external to the operations of a company, should make an effort to prevent, detect and identify cases of fraud.

## **2.3 FRAUD WITHIN A COMPANY – CORPORATE FRAUD**

In South Africa corporate fraud is as serious a problem as it is in any other country. Corporate fraud cost the economy R40 billion per year around 2001 (Dawson, 2001:14). Fraud within a company is seen as a more serious problem than fraud committed against a company by outsiders. This has led to a growing awareness of the dangers of corporate fraud and of methods to detect and prevent its occurrence. Improved governance systems and increased disclosure have resulted, but it remains to be seen whether these do in fact reduce the occurrence of fraud.

The *ISA 240* (IAASB, 2012) defines corporate fraud as "an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage". Robertson (2002:59) calls corporate fraud an occupational crime, meaning that it is a crime committed by individuals within an organisation while they are engaged in their occupations. The categories which he uses for occupational crime are; first, crime committed for the benefit of an employing organisation; second, fraud committed by state officials through the exercise of their authority; third, fraud by professionals as professionals; and fourth, fraud committed by individuals as individuals.

### **2.3.1 The fraud triangle in corporate fraud**

The elements of the fraud triangle are visible in corporate fraud. Moyes and Hasan (1996:41) have identified the factors of the fraud triangle that apply to corporate fraud as situational pressures from management or the corporation (motivation); opportunities that allow and encourage fraud to be committed (opportunity) and management that justifies conduct as acceptable with plausible but untrue reasons (rationalisation).

Rationalisations that are often heard is that "everybody does it", "it is worth the risk", "it is only temporary" and "the company makes substantial contributions to society that will be lost if the company goes under". When considering crimes such as tax evasion, the rationalisations can perhaps be that it is all right to steal from the government because "it is socialistic", "it is large enough to handle it", "laws are counterproductive" and "the laws were set by an opposition political party to reduce competition".

### **2.3.2 Measures that are put in place to prevent corporate fraud**

Fraud, especially on behalf of the company, comes with a certain organisational culture. It does not mean that a company engaging in unethical or fraudulent activities has to have a negative culture. In many cases, it is a positive one where individuals identify with the goals and well-being of a company and want what they believe is best for the company and for themselves. Characteristics associated with fraud include loyalty, cohesiveness, trust, aggressiveness and other attributes that are mostly valued by companies as traits they prefer in their employees (Elliot & Willingham, 1980:177). Corporate fraudsters may therefore act with the best intentions and often do not realise that they are acting fraudulently. Robertson (2002:55) is of the opinion that management behaviour is the main cause behind corporate fraud, as managers are the primary influence in unethical decision-making. They "set the tone at the top" and create what becomes the ethical norm.

It is an indication of the seriousness of the crime that several statements and suggestions have been introduced in the USA on how to prevent corporate fraud (National Commission of Fraudulent Financial Reporting, 1987). In the period from 1985 to 1987 alone, the Financial Accounting Standards Board (FASB) issued nine statements to enhance the quality of generally accepted accounting practice (GAAP); the Securities and Exchange Commission (SEC) issued eleven financial reporting releases; and the National Commission of Fraudulent Financial Reporting released 49 recommendations to prevent and detect fraud.



In South Africa, the King III report on corporate governance (Institute of Directors, 2009) gives clear guidelines on the internal control measures required to assist in the prevention of fraud. Reporting on internal controls has become compulsory (Cameron-Ellis, 2000:66) in order to increase the awareness of directors and thus reduce the incidence of fraud. However, it remains difficult to prevent fraud and to measure its scope – it is a crime that is difficult to trace because people do their best to hide their actions. Measurement is made more difficult because fraud is often not reported and/or the perpetrators are not prosecuted.

Krambia-Kapardis (2002:267) suggests that corporate fraud is difficult to detect because the people who commit the crime are often familiar with accounting procedures and thus know how to cover it up. Peter, Jerry and Danjuma (2012:153) find from various studies that external auditors rarely detect fraud perpetrated by management in the course of their audit assignment because management is in an ideal position to override internal controls and to conceal the accounting irregularities perpetrated by them. There is also often a built-in conflict of interests because the managers who hire the auditors are the ones being investigated; therefore they are able to hide those specific things they do not want to be detected. If these observations hold true for a company, fraud is likely to go by undetected. Therefore it is helpful if parties other than managers are aware of fraud and realise that its occurrence is not as unlikely as one may believe.

### **2.3.3 Types of corporate fraud and its impact**

*ISA 240* (IAASB, 2012) places fraud in companies into two main categories. The first is misstatements in the accounting system of an organisation and the other refers to misstatements resulting from a misappropriation of assets. The misappropriation of assets falls under employee fraud, while misstatements from fraudulent financial reporting are also called accounting, financial statement or management fraud. These types of fraud are discussed below.

The Institute of Internal Auditors (IIA, 2001) Practice Advisory 1210.A2-1 identifies some examples of fraud that are aimed at benefitting the organisation. They are the sale or assignment of fictitious or misrepresented assets, improper payments (bribes) to government officials, the intentional improper representation or valuation of assets, liabilities or income, intentional improper transfer pricing, intentional improper related party transactions, and intentional failure to record or disclose significant information, prohibited business activities and tax fraud. While corporate fraud is mostly committed on behalf of the company, some perpetrators commit fraud for their personal benefit.

Fraud perpetrated against an organisation for some benefit to the perpetrator are, for example, accepting kickbacks or bribes, diverting a transaction that would have been profitable to the organisation to an outsider or employee, the theft of money or property, the intentional concealment or misrepresentation of events or data, or false claims submitted for services or goods not actually provided to the organisation.

Fraud has a wide-ranging impact on a company. Firstly, fraud can potentially have an adverse effect on share prices. Schilit (1993:12) found that the share prices of companies with fraud allegations against them tend to decline rapidly. In a study by Dechow, Sloan and Sweeney (1996:27), it was found that the share prices of firms were severely affected by reports of earnings manipulations. Fraud also has an adverse effect on efficiency, productivity and innovation, because financial (and in some cases non-financial) resources are diverted and allocated to non-constructive activities. Glover and Aono (1995:4) have identified other losses associated with fraud; such as, lower sales, lower employment, lower productivity and poor credibility.

Davia, Coggins, Wideman and Kastantin (2000:34) hypothesize that the full extent of corporate fraud will never be known. They place fraud cases into three categories, namely fraud that has been prosecuted (20% of cases), fraud that has been discovered but not prosecuted (40% of cases) and fraud that has not been discovered (40% of cases). This means that only 20% of fraud cases are exposed to public scrutiny, while

the rest are hidden and their details lost. As with an iceberg, where the largest part lies hidden beneath the surface, most corporate fraud cases are hidden from view.

## **2.4 MISAPPROPRIATION OF ASSETS – EMPLOYEE FRAUD**

In this study, the focus falls mainly on fraud by managers, or accounting fraud. However, for the sake of completeness, employee fraud is also briefly discussed.

Misappropriation of assets is the act that occurs most often in this category of corporate fraud. Misappropriation is simply the theft of an entity's assets with the goal of obtaining a benefit without having to pay for it. The asset may be anything in an organisation, ranging from a pencil to a computer or even something larger.

Robertson (2002:181) formally defines the misappropriation of assets as taking property or money from an employer by fraudulent means. It involves falsification of some sort and consists of three stages; namely, the fraudulent act, conversion of the money or property to the fraudster's use and the cover-up to avoid detection.

According to Connelley (2003) there are a number of methods through which employee fraud is committed. The most prevalent amongst those involve misuse or misappropriation of company assets; for example, skimming a cash sale, stealing a daily deposit, stealing inventory or scrap, scrapping and selling good inventory, stealing fixed assets, personal use of assets, stealing cheques, stealing paycheques, diverting loan proceeds and underpaying dividends while diverting the rest.

Robertson (2002:73) refers to the alteration of documents, the kiting of money between two bank accounts, fictitious accounts receivable, the embezzlement of scrap proceeds, false charges to inventory accounts, over-billing, conflict of interest, using assets as collateral for a loan, borrowing money to earn interest, overtime abuse, withholding tax and personal expense reimbursement. There are a multitude of other schemes being

used to defraud companies and even more schemes are most probably still being thought out.

Even though employee fraud as a separate subject is not included in this study, it may be worthwhile to note that, if such schemes are detected in a corporate environment, other types of fraud such as accounting fraud may perhaps also be committed. It sometimes happens that a company develops a “culture” that fosters fraudulent conduct, especially if the management of a company do not properly address the issue.

Financial statement fraud as the end result of accounting irregularities have been discussed extensively in the previous paragraphs. From this point onward, the focus of the document moves away from financial statement fraud and rather falls on the accounting irregularities that generally occur before financial statement fraud occurs.

## **2.5 CORPORATE MISCONDUCT BY MANAGERS – ACCOUNTING IRREGULARITIES MANIFESTED IN THE FINANCIAL STATEMENTS**

Accounting irregularities refers to the falsification of an organisation’s accounting records to make the financial statements appear either more, or in some cases less profitable.

### **2.5.1 Defining accounting irregularities**

Quinn Mills (2003:82) is of the opinion that the main objective of accounting changed during the 1990’s; from revealing organisational information to concealing organisational information. He even goes as far as claiming that accountants have become allies in management attempts to improve financial results. The extent of judgement that is allowed in the interpretation of accounting rules can possibly make it easier to hide information.

This was also the observation by Cronje and Gouws (2011:55), who observed that the preparers of financial information use an accounting language that needs to be interpreted correctly by users to enable them to understand and use the information appropriately. In order to convey the meaning of accounting successfully, the sender and the receiver of a message need to use the same method to encode and decode the message. However, it does not always happen that this communication process happens smoothly and it can happen that the preparers of financial information abuse the fact. This provides the opportunity to mislead the users of financial information by means of the use of language.

Quinn Mills (2003:85) also quotes Turner, who was the chief accountant at the Securities Exchange Commission (SEC) in the late 1990s, saying that fraudulently misstating financial results is part of “day-to-day business operations in accounting firms and on Wall Street”. If this is in fact the case, it becomes a cause for concern when investors and other interested parties could not rely on their most readily available source of information about the companies that they have an interest in. It is therefore necessary that everyone becomes knowledgeable about accounting irregularities in order to expand the base of individuals who are able to detect and identify its occurrence.

Savage (2003:6) reported on a regular fraud survey done by the audit firm Ernst and Young’s Forensic Services. They found that 50% of perpetrators of accounting irregularities hold positions in management. The reasons he suggested are the growing complexity of businesses and accounting practices, as well as a recessionary environment. This can be seen in that younger businesses tend to fail more frequently than older more established ones (Altman & Hotchkiss, 2006:13), giving managers in younger businesses more incentive to improve performance, albeit through unethical means. Modern managers also have more access to information and opportunities through the Internet.

The report of the National Commission on Fraudulent Financial Reporting (1987) – also called the Treadway Commission – defines fraudulent financial reporting as "intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements". This is also the definition that Robertson (2002:105) refers to. A document currently being used by auditors, *ISA 240* (IAASB, 2012), defines fraudulent financial reporting as intentional misstatements in the accounting records, including omissions of amounts or disclosures in financial statements to deceive financial statement users.

For the purposes of the law, to have a case of accounting fraud, a company must have issued financial statements that contain false or misleading information about the company's financial condition or results (Davia *et al.*, 2000:15). The perpetrators must also have had the intention to defraud a third party, like a creditor or investor.

Accounting irregularities have to be clearly distinguished from non-fraudulent earnings management and accounting errors. Non-fraudulent earnings management implies that a legitimate GAAP method is chosen because it has a favourable impact on the financial statements (Rezaee, 2002). This may, for example, involve deciding on certain inventory valuation or depreciation methods. Errors, on the other hand, are unintentional mistakes that appear in financial statements.

As errors happen without intent, they are normally easier to detect. However, those who perpetrate accounting irregularities go to great lengths to conceal intentional misstatements in order to make it more difficult to trace. Sherman, Young and Collingwood (2003:6) compare irregular accounting entries to "landmines" in the books of a company. They are hidden in the books and records of companies and may never "detonate". However, in a case where such an "accounting landmine" is discovered or "detonated", its effects can potentially have a devastating impact on investors, creditors, and the public's confidence.

## 2.5.2 Reasons for accounting irregularities

Elliot and Willingham (1980:47) claim that accounting irregularities occur because managers are mostly seen to be outside the system of internal control. Since they are the guardians of internal control measures, it becomes easier for them to bypass such controls. Tiggos (2002:34) also observes that no controls can ever completely control management's actions, because "(m)anagement controls internal control". The board of directors has the power to govern the activities of managers, as they are the representatives of the shareholders. However, it is difficult for them to oversee *all* the day-to-day activities of managers. It was found that boards rarely ask probing questions about management's activities. Therefore managers are basically free to do as they please. Rezaee (2002:35) claims that a lack of non-financial information, a lack of information about intangible assets and a lack of forward-looking information also provide opportunities for irregularities, as managers are not obliged to discuss such aspects of the business.

Companies are all different and, for this reason, GAAP allows for different interpretations of standards and different interpretations of financial statement line items based on the subjective judgement of management. In their research efforts Shi, Dharwadkar and Harris (2011:40) provide preliminary evidence about the importance of the social context for accounting choices and recommend that future researchers consider both the monitoring and social context factors simultaneously in order to better understand an organisation's accounting choices. Cieslewicz (2012: 246) also claims that a fraud model can only be appropriate for use internationally if it takes into account societal-level influences.

The subjectivity inherent in the accounting rules makes it easier for managers to perpetrate irregularities, since it provides opportunities to manipulate the statements to present better or poorer results, depending on the needs of management. GAAP is also full of exceptions (Sherman *et al*, 2003:149) which help managers to be more "creative" in their practices. Exceptions to financial statement standards have been introduced to

ensure that a company is able to present true and fair results, even if a particular accounting standard is not applicable or useful in the particular circumstances. In some cases it happens that managers even seek out exceptions that they can use to manipulate results (McBarnet & Whelan, 1999:103). Even though managers are obliged by law to fully disclose any departures from GAAP (McBarnet & Whelan, 1999:41), it is not to say that they will in fact do so. Therefore, such exceptions can perhaps be manipulated by a company if a specific GAAP requirement will cause the company's results to appear different from what the company's management desires.

Fridson and Alvarez (2002:4) indicate that the goal of financial statements is to provide information that accurately measures the profitability and financial position of a company. However, the managers who are responsible for those figures want to present a favourable picture to interested parties, because volatility is often seen as a negative sign. Since the financial statements are the responsibility of management, accounting irregularities occurs mostly with the knowledge and consent of management. According to Quinn Mills (2003:104), accounting irregularities also occur in some cases with the knowledge and consent of parties other than managers. He found, for example, that banks may be convinced to structure loans to companies in such a way as to conceal the debt from investors.

### **2.5.3 Means to prevent accounting irregularities**

The various interested parties that are likely to be affected by accounting irregularities need to take positive action in detecting and identifying such cases. Robertson (2002:63) has found that the victims of accounting irregularities could be persons inside and outside the organisation. The potential victims of accounting irregularities are therefore ideal gatekeepers to prevent or otherwise detect cases of accounting irregularities. The National Commission on Fraudulent Financial Reporting (1987:26) lists the following victims of irregular financial reporting:

- banks and financial institutions (lenders);
- shareholders (investors);



- suppliers;
- customers;
- merger partner's defrauded statements reflecting more than the company's actual worth;
- underwriters who distribute securities;
- financial analysts who give investment advice based on faulty information;
- the company's accountants who become subject to investigation;
- insurance companies which receive large claims;
- management and directors of the company who suffer a loss of reputation and standing;
- employee shareholders;
- honest employees and managers who suffer from guilt through association; and
- public confidence lost through media attention.

According to Morley (1984: ix), the government and tax gatherers also belong on the list. All these individuals and institutions have to be aware of accounting irregularities and the likelihood of their occurrence. Being familiar with the characteristics and relationships that are normally observed in the financial statements in cases of accounting irregularities can possibly help these parties to take a proactive approach in safeguarding their interests.

## **2.6 THE MOTIVATION BEHIND ACCOUNTING IRREGULARITIES**

In order to better understand what accounting irregularities entails; it is helpful to understand the reasons why they are committed and the motivations of the people who are involved.

According to Hussain, Kennedy and Kierstead (2010:72) the root of the problem lies with managers that continuously experience pressure to increase profits as well as the competitive tendency to grow in business. Schilit (1993:3) claims that accounting fraud happens for three basic reasons: it pays, it is easy to do and it is unlikely that one will get caught. Firstly, managers would rarely engage in accounting irregularities if they did

not expect to benefit from it. Secondly, there is the ease with which the accounting irregularities are accomplished, because there are a number of options to choose from in the case of some accounting principles. Finally, poor controls and good hiding techniques make accounting irregularities difficult to detect.

Rezaee (2002:30) claims that managers of a company have three options when financial results are not as favourable as they would like the public to believe. The first is to publish the adverse results, receive an unqualified audit opinion and face the consequences. The second is to violate GAAP in order to present results that are more favourable. However, in that case the auditors are likely to detect such manipulation and issue a qualified audit opinion. The third option is to engage in the manipulation of accounting records to report better results. If it goes undetected by the auditors, the company ends up with the best outcome of the first two options, namely an unqualified audit opinion and favourable financial results. It therefore appears to be more beneficial for managers to adjust the financial statements by fraudulent means.

Robertson (2002:105) has found that accounting irregularities are mostly committed because management tries to make earnings look better. This method is usually covered up through valuation judgements and by manipulating the timing of entries and valuations. There are other reasons for accounting irregularities: encouraging investment, demonstrating higher earnings per share (EPS), dispelling negative market perceptions, obtaining financing, receiving higher acquisition purchase prices, demonstrating compliance with financing covenants and receiving performance-related bonuses.

Kravet, Myers, Sanchez, and Scholz (2012:29) state that the manipulation of financial statements is used to create false improvements in reported financial performance before negotiations for acquisition start to increase share prices. These inflated share prices facilitate share-based acquisitions because they lower the purchase price. They found a positive association between misstatements and acquisitions. They observed that misstatements associated with acquisitions were more serious than are other

misstatements. This is an important observation because previous research speculates that acquisition-related misstatements arise as a result of the complex accounting that is involved in merger and acquisition transactions.

Although accounting irregularities are usually associated with cases where misconduct is performed on behalf of a company, there are cases where managers use their own influence to manipulate company records for their own benefit (Elliot & Willingham, 1980:8). In such cases, the financial statements have the potential to harm investors and creditors because assets that they believe to exist do not really exist.

Sherman *et al.* (2003:158) state that, apart from managers, investors and all other interested parties are partly to blame for accounting irregularities. They are the ones who tend to keep score of company performance and encourage better performance. When circumstances either within or outside of the control of the company cause poor performance, those who are responsible for the accounting reports may be tempted to try and enhance performance by means of “creative” accounting.

Ethicality is a subjective concept, meaning that it is not the same for all cultures and also not the same for all individuals. What one person may find acceptable is totally unacceptable for another. Each person has to decide for him or herself what is ethical and what not (Els, 2007:13). The line between what is ethical and what is not is therefore thin and managers are motivated and pressured to operate as closely as possible to that line and sometimes even to cross it. Rezaee (2002:183) identifies additional reasons for management to dance close to or over the line, that being that they might have the perception that the benefits outweigh the costs, that of having internal and external pressures to show more favourable results, as well as having an attitude of “living dangerously” and desiring the personal satisfaction involved in taking risks.

In some cases, however, inappropriate misstatements are not necessarily connected to the morals of the perpetrator. Adu-Boateng (2011:94) finds that accountants do not put

away their moral reasoning when they face an ethical decision about, for example, the methods of earnings management. The accountant's interest is intertwined with a company's interest, since the accountant's well-being is tied to the company's well-being. Therefore, an accountant's moral reasoning may be explained by collectivism (a search to promote the common good), and it is reduced due to situational factors (like earnings management) which sets out to promote the company's interest. Individualism features when a situational pressure gets the upper hand over moral reasoning. It thus happens that accountants may decide to select unethical earnings management over other interests in order to enhance the financial performance and position of a company.

Adu-Boateng (2011:95) therefore claims that an accountant's choice of unethical practice may be the result of situational factors combined with moral reasoning. Opposing factors, namely moral sensitivity and situational pressures in decision-making result in the choice dilemmas. Research findings show that individuals make different ethical choices given differing situations. As an example, the results of the research by Adu-Boateng indicate that accountants tend to engage in unethical earnings management when their firms face financial hardships. It then stands to reason that managers have the ability to create situations that influence ethical choices.

Du Plessis (1999a:2), identified that a number of pressures or motivations lead to accounting irregularities. Examples include market expectations (especially those of analysts and investors), earnings deterioration affecting the bonuses and share options of senior management, inability to meet profit expectations and poor performance that cause delays to projects and expansion plans. From a South African viewpoint specifically, Els (2007:144) identified four factors that may have an impact on the ethicality of managers and the occurrence of accounting irregularities:

- globalisation – misunderstandings about what is ethical in terms of business transactions may occur;
- democracy – in a democracy power is given to the people and as a relatively young country the culture of respect for human rights is still being developed; and

- cultural diversity – different cultures have different views on what is ethical and South Africa has many different cultures living together.

### **2.6.1 Categories of accounting irregularities related to motivations for its occurrence**

Turner, in Elliot and Willingham (1980:101), suggests the following categories of accounting irregularities, which also relate to the reasons why they occur:

- financial statements as the vehicle to commit irregularities, with the company as the receiver of the benefit (for example, where performance is manipulated to display better results in order to obtain credit, financing or capital investment, results inflated to conceal poor performance by management and to evade taxes);
- financial statements as the vehicle to commit irregularities with the perpetrator as the receiver of the benefit (for example, where accounting records are manipulated to create a desired change in the company's share price - this may involve increased share values so that management have the option to sell at higher prices, or decreased values so that management have the option to purchase at lower prices; manipulation also benefits them by hiding poor performance);
- financial statements as the vehicle to disguise irregularities with the company as the receiver of the benefit (for example, by concealing the sale of fictitious or misrepresented assets, by concealing business activities that are not allowed by law, or hiding improper payment such as bribes); and
- financial statements as a vehicle to disguise irregularities with the perpetrator as the receiver of the benefit (for example to disguise irregularities where the perpetrator receives benefits through acts of embezzlement).

The National Commission on Fraudulent Financial Reporting was jointly sponsored by five major professional associations in the United States, namely the American Accounting Association, the American Institute of Certified Public Accountants (AICPA), the Financial Executives International, the Institute of Internal Auditors, and the National

Association of Accountants (now the Institute of Management Accountants). The Commission conducted a number of studies into the causes of accounting irregularities and published the causes identified, together with some guidelines in the *Report of the National Commission on Fraudulent Financial Reporting* in October 1987. The Commission's findings suggest that accounting irregularities occur most often as the result of environmental, institutional or individual forces and opportunities (National Commission on Fraudulent Financial Reporting, 1987:23). These forces and opportunities add pressures and incentives for individuals and companies to perpetrate accounting irregularities. A well-known incentive is an improvement in the financial appearance of the company, in line with the goal of obtaining a higher price for a share or a debt offering, or to meet the expectations of investors. Other incentives are related to personal gain in the form of gaining bonuses or promotions and escaping penalties.

A fraud report by Ernst and Young South Africa's Forensic Services (2003) states that the main aim of false accounting is to present the affairs (therefore more than just earnings) of a company as being in a better position than they actually are. A common feature of such irregularities are the necessity to falsify records, alter numbers, and, in extreme cases, to keep two separate sets of accounting books. This was also the finding by Sloan and Sweeney (1996:1), who show that, to attract external financing at the lowest possible cost, managers may attempt to influence investors' perceptions of the firm's value.

## **2.6.2 The issue of creative accounting**

Apart from accounting irregularities, the issue of creative accounting arises. Shah, Butt and Tariq (2011: 536) define creative accounting as the use of accounting knowledge to influence the reported figures while remaining within the jurisdiction of accounting rules and laws. Therefore, instead of showing the actual performance or position of the company, they reflect what management wants to tell interested parties. Honest managers may therefore use creative accounting in a legal way to make results appear better, but they have the potential to become accounting irregularities if the conditions

that lead to creative accounting are not alleviated and managers have to perpetrate even more egregious acts to maintain the front they created with creative accounting practices.

Creative accounting is therefore often seen as negative if it is used with the intention to mislead or deceive interested parties (Du Plessis & Koornhof, 2000:73). Unfortunately deception is the reason why it is used most of the time, as many of the benefits of accounting irregularities can possibly be obtained from creative accounting practices that still fall within the ambit of the law (McBarnet & Whelan, 1999:5). Consequently, creative accounting does not constitute accounting irregularities. However, creative accounting may be thought of as unethical and unacceptable to society, depending on the moral standards of the observer.

Shah, Butt and Tariq (2011: 536) find that the abuse of creative accounting practices will never be completely stopped. The improper use of creative accounting practices has been able to fool interested parties in the past (e.g. Enron) and it is likely to continue to do the same. Business transactions can be complex and diverse while the latitude available in the accounting standards and policies may make it difficult to handle the issue of creative accounting. Creative accounting solutions are not necessarily wrong. It is the intent and the magnitude of the disclosure which determines its true nature and justification.

Creative accounting is therefore considered to be a "Type 2" accounting irregularity (Tippog, 2002:37), because it is not an accounting irregularity *per se*, although it does intend to deceive the users of financial statement information. Both "Type 1" (as previously discussed) and "Type 2" accounting irregularities fall within management's discretionary powers and are also referred to as "pure" accounting irregularities. These types of accounting irregularities appear to be almost impossible to stop, because they occur within the management domain and there are no controls to prevent them from happening. One needs to be aware that different individuals' ideas of what is ethical and

what is unethical differ. There is always the possibility that accounting irregularities may be occurring.

## **2.7 HOW ACCOUNTING IRREGULARITIES ARE PERPETRATED**

When one wants to detect and identify accounting irregularities, a good starting point is to have some knowledge about how accounting irregularities are generally perpetrated. This will give one an understanding of how the irregularities may be manifested in the financial statements. The paragraphs that follow give a broad overview of the types of methods that are used to perpetrate accounting irregularities.

Nieschwietz, Schultz Jr and Zimbelman (2000:204) categorise the types of most prevalent accounting irregularity acts (in order of severity) as follows:

- Type 1: Asset overstatement;
- Type 2: Events not recorded;
- Type 3: Revenue overstated;
- Type 4: Specious accounting judgements;
- Type 5: Expenses recorded incorrectly; and
- Type 6: Omitted or misleading disclosures.

Other irregular activities, according to *ISA 240* (IAASB, 2012) are: deception through falsification, manipulation or alteration of accounting records, misrepresentation of events, transactions or other significant information in the financial statements and intentional misapplication of accounting practices related to measurement, recognition, classification, presentation or disclosure.

Overstated revenue is the method most often used in accounting irregularities, especially in the high-profile accounting irregularity cases in the USA. Out of the 20 cases that were observed by Rezaee (2002:47), all had at least one account of earnings manipulation or revenue overstatement. Several other researchers, for example, Beasley, Carcello, Hermanson and Lapides (2000), Beneish (1997), Fridson



and Alvarez (2002), Gerety and Lehn (1997), Mulford and Comiskey (2002) and Robertson (2002) all found that improper revenue recognition, improper expense recognition, overstatement of assets and inadequate disclosure are the most prevalent methods of enacting accounting irregularities.

Robertson (2002:107) identified that schemes of overstated earnings, overstated assets and improper disclosure are usually accomplished through any one of nine general methods, namely: improper revenue recognition, revenue recognition in the wrong period, improper sales accounting, improper percentage-of-completion, inadequate disclosure of related-party transactions, improper asset valuation, improper deferral of costs and expenses, inadequacies/omissions in disclosures and omissions of expenses, losses or liabilities. Each of these schemes, in turn, is accomplished in a number of different ways. When looking at the multitude of different ways by means of which a company's performance can be overstated, it becomes all the more important that more people are aware of these schemes and are on the lookout for their occurrence.

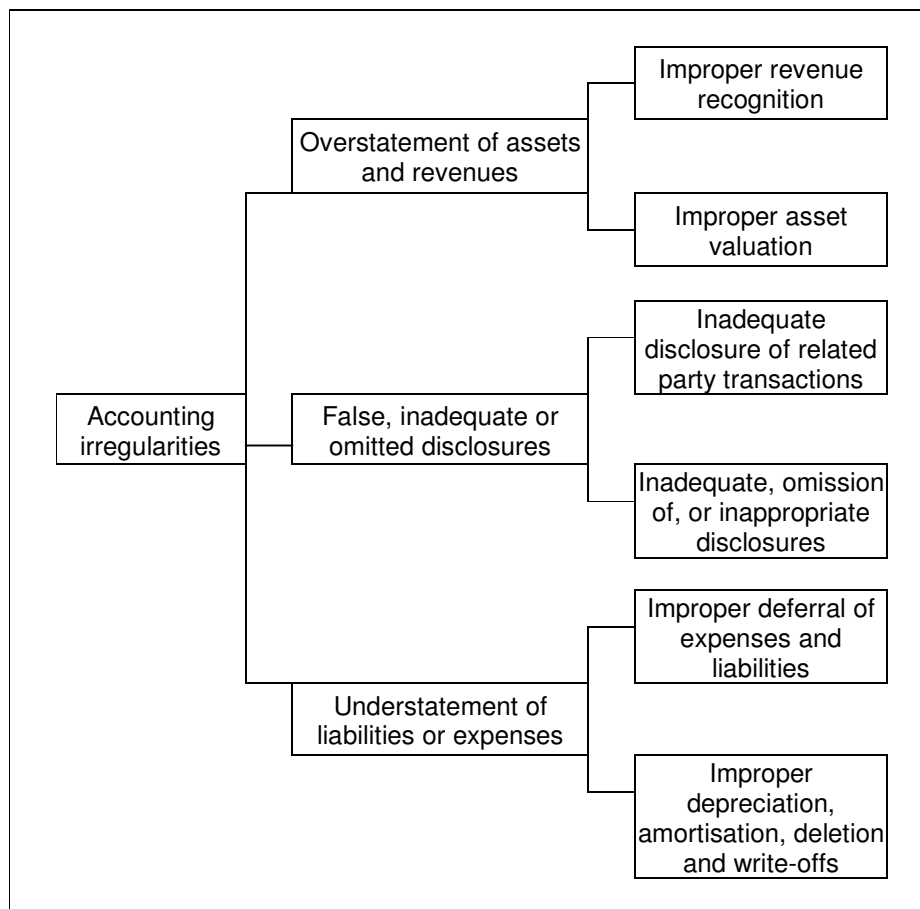
Beneish (1997:277) adds to the schemes the use of false invoices, keeping the books open, recognising revenues too early, the inappropriate use of the matching principle by recording fictitious inventory, failure to write off impaired assets and capitalising expenses. Gerety and Lehn (1997:589) found schemes such as violations related to the deferral of expense recognition, revenue recognition in the wrong periods and false statements about the financial future of the company. Beasley *et al.* (2000:447) indicate that improper revenue recognition also includes false confirmations, conditional sales and modified terms through side letters, unauthorised shipments and consignment sales. Fridson and Alvarez (2002:149) include the loading of distribution channels as a means to overstate revenue, where companies convince retailers to accept larger shipments of goods than usual, while arranging with the retailers to take the goods back after the companies' financial statements have been prepared and published.

As indicated in a categorisation of schemes by Robertson (2002:114), expenses are sometimes understated to make earnings look better than they actually are. DeFond and Jiambalvo (1991:645) note that depreciation methods that lead to increased earnings are often used. This is not necessarily an accounting irregularity, but is unethical; as such methods are not in the interest of all parties.

To add to the already-long list of accounting irregularity schemes, Connelley (2003) identified the misuse of uncertainties about collectability of debt, substantial continuing involvement by the seller, sham transactions, inter-company accounts with unconsolidated affiliates, concealment of accounting irregularities through inventory accounts, inventory overstatement, manipulation of fixed assets to conceal other accounting irregularities and contract and bidding irregularities.

To facilitate clarity and understanding, the most common methods of accounting irregularities can be schematised, as displayed in Figure 2.3.

**Figure 2.3: Common methods of accounting irregularities**



**Source:** Adapted from Rezaee (2002:89)

Sherman *et al.* (2003:106) recognised the use of related-party transactions in accounting irregularities. According to them it is a problem also recognised by the American Institute of Certified Public Accountants (AICPA). The problem is that the definition of a related-party transaction is not in all cases clear enough and places placing the decision of whether or not to disclose (and to what extent to disclose related-party transactions) in the hands of a company's management. This situation should, however, become less of a problem with the adoption of stricter accounting standards worldwide.

However, if related-party transactions are misused successfully, it can possibly have the effect of inflated earnings and a false impression of growth (Sherman *et al.*, 2003:109).

Activities that are hidden when related-party transactions are not properly disclosed include

- borrowing or lending interest-free or well below market rates;
- the sale of real estate at prices that differ from the appraised values;
- non-monetary exchanges of property;
- loans with no due date or repayment terms;
- sales with a commitment to repurchase;
- accruing interest at above market rates;
- loans to parties that are not able to repay;
- advancing company funds to a debtor unable to repay the debt in order for the debtor to repay and thus helping the company to avoid the cost of an uncollectible debt;
- services or goods received at very little or no cost;
- payments for services never rendered or at inflated prices;
- sales at below market rates to unnecessary “middle men” who make a profit when reselling the goods; and
- purchases of assets in excess of market value.

Mulford and Comiskey (2002:172) point out that there does not need to be anything wrong with any of the above-mentioned actions, unless they are misused. For example, a side letter is sometimes used to clarify or modify agreements, but it also has the potential to be misused through liberal rights of return, excusing the debtor from payment or giving the debtor the right to cancel an order at any time. An innocent practice is therefore sometimes manipulated for a purpose it was not intended for.

As one learns more about the schemes that individuals and companies employ to change accounting records to make financial statements appear more favourable for their purposes, it becomes clear that a lot will have to be done to eliminate their occurrence completely. However, knowing more about the accounting irregularity schemes that are used is a first step in empowering one to detect and identify such occurrences.

## **2.8 THE RESPONSIBILITIES FOR CONTROL, DETECTION AND IDENTIFICATION OF IRREGULARITIES**

According to the Prevention and Combating of Corrupt Activities Act, Act 12 of 2004 (South Africa, 2004), the duty to detect and identify irregular activities rests on a person with authority, which is defined as the managers, the secretaries, the company directors and the members of close corporations. In terms of the Prevention and Combating of Corrupt Activities Act, auditors do not have any duty to report irregularities. Auditors may be in a good position to detect irregularities by virtue of the fact that they have the opportunity to include in their investigations discussions with the client's personnel, expectations from previous years, analytical reviews, and general auditing procedures, tests of detail (analysis and review, obtaining evidence and scanning) and estimates of value (Hylas & Ashton, 1982:757). Rezaee (2002:204) claims that internal auditors are in an especially good position to detect problems because of their responsibility to continuously monitor the internal control system. This gives them opportunities to identify and investigate any red flags that signal the likelihood of accounting irregularities. Many of these information sources and procedures are not available to investors, creditors or other parties with an interest in the company, which makes any such investigation more difficult for them to accomplish.

It should be recognised however that apart from the benefits of their position, accounting irregularities in particular can be difficult to detect, as the management of a company and those charged with the governance thereof, are often in a position to override established controls. There are natural limits to what anyone without inside information into an organisation can reasonably accomplish.

Rezaee (2002:141) recognises the importance of the role of the board of directors in identifying and preventing the occurrence of irregularities. The board is chosen by shareholders and has a responsibility to protect the interests of those shareholders, as well the interests of other interested parties. The board of directors therefore has to control and monitor the actions of management and has to oversee the adequacy and

effectiveness of internal controls, audit functions and the financial reporting process. Quinn Mills (2003:97) mentions that executives and directors have a fiduciary responsibility to shareholders. This responsibility includes three duties: firstly, to read documents and literally “do their homework”; secondly, not to prefer their own interests above those of the company or its shareholders; and thirdly, a duty to disclose all material facts. However, due to the extent of decisions and actions that have to be delegated to managers by the board of directors, there is often some risk that management may abuse that power and act inappropriately.

As early as 1987, the National Commission on Fraudulent Financial Reporting indicated that the main responsibility for reliable financial statements lies with the company's management, as management is responsible for setting the tone and establishing the control environment. The Commission's definition of internal control clearly states that one of the responsibilities of management is ensuring the reliability of financial reports. This is also the view of AICPA (2002), especially where issues of legality and ethics are concerned. DeFond and Jiambalvo (1991:646) and Robertson (2002:232) recognise the importance of a good control environment too. Managers ought to work closely with lawyers, investment bankers, financial analysts, business advisors and others to ensure the most reliable financial reports. Apart from managers, the National Commission on Fraudulent Financial Reporting (1987) also recognises the importance of what the public understands about inappropriate financial reporting.

The USA legislative structure imposes a duty on a company and its management to be aware of what employees are doing, putting more of the onus of detecting irregularities on the individual managers and employees. Some USA court decisions have already found that companies had an obligation to know that the chief financial officer was stealing (Colapinto, 1998:29). The introduction of the Sarbanes Oxley Act in the USA was supposed to make managers more careful and diligent in their efforts to establish strict internal controls (Vaksman, 2004:19). The Act was set in place to regulate the accounting and financial reporting process and made it possible for managers who knowingly misreport results to be punished. De Souza (2006:23) reports that the Act has

already had an impact on South African companies with ties in the USA, and many companies are now in the process of becoming compliant with the Act. However, it has been proven through research by De Vay (2006:112) that the Sarbanes Oxley Act is not completely successful in preventing accounting irregularities and that it may be a waste of time and resources.

Under South African law, according to section 77 (Liability of directors and prescribed officers) of the Companies' Act 71 of 2008 (South Africa, 2008), an individual manager may be held responsible for accounting misconduct. A manager no longer has the opportunity to hide behind the company and let it pay for his or her mistakes. The management and/or owners may also be held liable for losses if the court believes they could have prevented the accounting irregularities from happening. This approach is bound to result in better internal control procedures.

There has therefore been a realisation that other parties are also responsible for helping authorities in the detection and identification of accounting irregularities. Many accounting irregularity cases have been uncovered through whistle blowing where employees and other interested parties complain or disclose their concerns (McBarnet & Whelan, 1999:34). The ACFE has found that, of the larger accounting irregularities (over \$1 million) investigated in the US, 43% were detected by tips (ACFE, 2012:14). This implies that it is important for all parties with an interest in a company to be aware that financial statements are not to be trusted completely (Glover & Aono, 1995:8). Everybody therefore needs to be on the lookout for questionable practices and activities.

It is important that investors know what they can potentially gain from financial statements and other public company reports. Based on this information, they are then able to formulate their own opinions on how secure their investments or other interests in a company are.

## **2.9 DETECTION AND IDENTIFICATION OF ACCOUNTING IRREGULARITIES**

Davia *et al.* (2000:37) claim that auditors discover only 20% of detected accounting irregularity cases. The remaining 80% of detected accounting irregularities are discovered by accident. The percentage of accounting irregularities discovered by accident might be even higher, as the study did not take into account how many of the discoveries by auditors are also accidental. Fortunately, accounting operates on a double-entry basis (Beneish, 1997:284), which means that perpetrators cannot adjust income or expense accounts without also affecting an asset account. It follows that sudden changes to receivable or inventory turnover ratios indicate that sales, for example, may have been tampered with.

### **2.9.1 Red flags that act as indicators of accounting irregularities**

In order to detect and identify accounting irregularities, red flags have the potential to act as useful indicators to detect irregularities. Red flags are all the conditions that are more likely to be present in the case of irregularities (Du Plessis & Koornhof, 2000:75). Such red flags are useful to all interested parties who observe financial statements and who are concerned about irregularities (Krambia-Kapardis, 2002:267). Mulford and Comiskey (2002:186) mention that the informational content of notes to the financial statements should not be underestimated. Any number of red flags may very well be seen if one knows what to look out for.

A first item to analyse is the quantitative, or financial, section of an annual report. Auditors usually use analytical procedures to trace irregularities in financial statements. In an analytical review, the auditor predicts or arrives at some expectation of what the book values ought to be and compares these with the actual values (Kinney, 1979:149). Lendez and Korevec (1999:49) suggest that analytical procedures should also be used by management. This gives them an opportunity to detect unusual transactions and disclosures, which enhances the probability that accounting irregularities will be detected.



## **2.9.2 Making use of auditing or financial management procedures to detect and identify accounting irregularities**

Because accounting irregularities are often detected by accident, the use of analytical procedures by all interested parties may assist in increasing the chances of accidental discovery. Any additional analyses that are performed over and above the norm would increase the chance of detection and identification. However, Daroca and Holder (1985:1) comment that, in order to detect the presence of irregularities, analysts need some knowledge of accounting principles and practices. Their research focuses on analytical procedures used by auditors and accountants, but which can also be used by managers, investors and creditors. In an analysis of financial statements, Daroca and Holder (1985) find that it is useful when financial statements are compared with previous periods and with anticipated results if they are available. A further method he recognises is to study the relationships between the elements of the financial statements to identify patterns and changes to patterns. There are thus multiple ways to analyse the financial statements for possible cases of accounting irregularities.

Kinney (1979:153) quotes Professor Lev, who recommends a method to analyse whether accounting irregularities are present, namely by restating the financial statements. He restates financial statements in percentages of a significant amount, for example, sales. The details of this method (also called vertical analysis) are described in Chapter Four of this study. The method is believed to be useful in predicting bankruptcy and is associated with unexpected income changes; therefore it may be effective in detecting irregularities.

Financial ratios are also considered to be useful, as they help to indicate areas where the level of an account can be explained by another account (Kinney, 1979:164). Because accounting operates on a double-entry basis, manipulation of one account means that another account also needs to be manipulated. Ratios can possibly be helpful in identifying such cases.

It is best for interested parties to focus on objective information, because subjective information is sometimes difficult to obtain. Rosplock (2001:24) claims that a thorough investigation should preferably include at least the following areas of concern:

- an historical analysis of the income statement and balance sheet;
- a ratio trend analysis;
- an examination of common-sized financial statements;
- comparisons with the industry;
- a cash flow trend analysis;
- assessments of the consistency of the income statement items;
- a check on increases or decreases in sales and the reasons for such changes;
- an analysis of aspects that affect levels of performance;
- an analysis of the trend of earnings before interest and tax (EBIT);
- a look at net worth, which is a method to observe assets and liabilities;
- an analysis of accounts payable;
- an awareness of long-term debt, especially where sales are low and unprofitable conditions prevail;
- a look at fixed assets;
- knowledge of the current ratio; and
- knowledge of the total debt/equity ratio.

Observation and knowledge of at least these areas will increase the chances that discrepancies are detected and identified. Any dramatic changes to trends can possibly be indicators of an increased risk for accounting irregularities and ought to be monitored closely.

### **2.9.3 Other means to detect and identify accounting irregularities**

Mulford and Comiskey (2002:185) mention a number of steps that may be useful to possibly detect premature or fictitious revenue, which is one of the most common methods of producing accounting irregularities:

- understand the organisation's policy regarding revenue recognition (in this regard, the revenue recognition note gives a good indication of the methods the company employs when recognising revenue; when a company's policies for revenue recognition are better understood, questionable practices are detected more easily);
- examine the accounts receivable (prematurely reported revenue takes a long time to be collected, while fictitious revenue may never be collected; so, if there are strange increases in the accounts receivable, it may be an indication of wrongful practices - as soon as the accounts receivable are noticeably different from the credit terms offered, this is a warning signal; managers who recognise revenue prematurely or recognise fictitious revenue would attempt to cover up the act through increased assets or decreased liabilities); and
- check physical capacity (if the company does not have the capacity to generate the reported revenue, there may be a problem; note that different measures are to be applied for different companies, such as revenue per square metre, revenue per employee, revenue per property, plant and equipment).

These methods can potentially be applied by most interested parties; even those that are not directly part of the company, since the information that is required is mostly available in the annual report.

Apart from the quantitative section of an annual report, the qualitative section also contains some useful information. Rosplock (2001:24) recognised that, apart from financial information and ratios, using industry and economic data to determine trends, bankruptcy and cash flow risk, the information disclosed in notes together with the rate of financing and substantial suits, liens or judgements that could affect the company are also useful. Most of this information is found in the notes that accompany the statements, making it readily available to all interested parties. A similar observation was made by Ames, Brazel, Jones, Rich and Zimbelman (2012:C28) who found that non-financial measures such as the number of employees, square metres of operations, customer satisfaction and the number of customers can be useful to assess the risk of accounting irregularities. They claim companies that commit accounting irregularities may have a hard time falsifying non-financial measures.

Sherman, Young and Collingwood (2003:64) identified various areas of qualitative disclosure that need to be observed for possible red flags. These areas include large inventory write-offs, provisions for expected losses, changes in measurement methods, changes in the customer base, geography and technology, as well as mergers and acquisitions. The notes also indicate whether or not the company is hiding its debt by not reflecting it as a liability on the balance sheet and whether or not assets are classified correctly.

Schilit (1993:19) makes it clear that the quantitative sections of an annual report should not be considered the most important instruments to detect and identify accounting irregularities. He recommends the auditor's report as a useful tool, especially when referring to whether a qualified report was given and/or if an opinion was withheld. Additional useful information comes from the proxy statement for pending litigation and executive compensation, the footnotes for accounting policy changes, related party transactions and other contingencies or commitments, the chairman's letter to determine the forthrightness of management and any other quantitative documentation that may give more information on management practices, disputes/disagreements and past performance. All these documents need to be observed for discrepancies or significant occurrences. It is especially useful if statements made in such narrative reports are compared to statements made by competitor companies in the same industry in order to verify their truthfulness.

Glover and Aono (1995:7) also point out that a lot can possibly be learnt from observing other subjective aspects such as the corporate culture, the employee turnover, the average employee tenure, the nature of customer complaints, product quality, employee morale and employee benefits, the corporate board meeting minutes and various policies and procedures. Information which can perhaps be helpful and that is usually included in the financial reports is information on legal battles, credit ratings, investment in employee development, warranty expenses, and comparisons of wages with industry averages. Industry trait information is also publicly available – it is found in industry trade

journals, business periodicals and newspapers from which new trends can be observed. However, it requires a lot of time and effort to research these, something a private investor or other interested party may not have.

Measures to detect irregularities, such as discussed in the preceding paragraphs, are only applicable in certain circumstances (Elliot & Willingham, 1980:95), because there are multitudes of ways through which irregularities are perpetrated. This is on the increase, because perpetrators are constantly devising new methods to commit their crimes. If more varied methods are used in analyses to detect and identify irregularities, the chances of coming across it are higher. It can be detrimental to a study of financial statements if the study is too limited. However, even with limited data, it remains possible that the correct mind-set will help to detect an increased risk of accounting irregularities.

## **2.10 REDUCING THE RISK OF BEING DEFRAUDED**

It has been recognised that a greater awareness of accounting irregularities may help people to detect irregularities earlier and to prevent its occurrence. Regular monitoring is essential to raise awareness (Cameron-Ellis, 2000:66). As the old adage states: "Prevention is better than cure." All parties that have an interest in a company, especially personnel, ought to learn what risks for irregularities there are and what such irregularities look like so that the chances of early identification increase.

There are many steps that the managers of a company can take to reduce the risk of accounting irregularities and their subsequent effect on the company. These include factors such as the following, mentioned by Ernst and Young (2003): pre-employment screening, physical security and access controls, employee monitoring and appraisal, a fraud policy, an anti-fraud corporate culture, encouraging whistle-blowing, a contingency plan and insurance.

One method to reduce the likelihood of accounting irregularities is to put in place fraud and ethics policies. These policies are generally available to external parties, but otherwise they can be requested from the company. It is important, however, that a company adheres to its own policies. A fraud policy normally includes a definition of disciplinary offences and states what action will be taken against perpetrators. It also indicates which actions constitute irregularities, what constitutes a conflict of interest, the duty of employees regarding confidentiality and inside information, gifts and entertainment and anything else that might be important. The more detail is included, the better. A fraud policy does not mean that a company will not be affected by irregular action, but it does give some indication of the moral and ethical culture that the board of directors and management attempt to instil. When evaluating a company's accounting irregularity risk, its fraud policies and procedures is a logical first place to observe.

Internal control is one of the best means to protect a company from accounting irregularities. However, even though the scope of internal control has broadened over the years, it cannot be completely relied upon (Davia *et al.*, 2000:119). Internal controls need to be adapted continuously to changing circumstances, because it is likely that there will always be someone who is searching for ways to evade controls and who will find a way to do so. However, investors have no control over the management and internal controls of a company. If control measures are not in place, investors and other parties face the risk of being done in. Over-confidence may have negative results. For that reason, all parties with an interest in a company have to proactively search for possible accounting irregularities, without relying only on internal controls and chance.

For an outsider, like an investor, a first step may be to get to know the industry in which the company operates. Some industries can be more prone to accounting irregularities as a result of the type of activities companies in a particular industry perform. Trade journals may play a positive role in this regard. A second step is for interested parties to get to know the company that they have an interest in. Training is also helpful if it will lead to a better understanding of the financial statements. As mentioned previously, it is believed that much can be learnt from financial statements, especially from the notes that accompany the annual report. Quinn Mills (2003:247) sums up this argument by

stating that investors should “learn how the game is played” and set reasonable expectations.

Some aspects of a company, like its culture and internal controls, are not available for observation by outside parties and therefore also cannot be judged by them. That makes it all the more important for any interested party to be aware of the risks and to take reasonable steps to find out as much about the company as possible. Sherman, Young and Collingwood (2003:159) also emphasise the importance of investors recognising that there are no shortcuts to successful investing. They ought to make an effort to inform themselves by going out and getting data before it comes to them. A vast amount of information is available, especially on the Internet. That is not to say that an individual investor will be able to detect accounting irregularities, but being observant helps to some extent.

Unfortunately, the only information available to individual investors, if they want to gain some insight into the operations of the companies they invest in, is often the financial statements of a company (Kirby, 2005:21). The Promotion of Access to Information Act 2 of 2000 can help investors to get access to more information, but then they should have adequate reason and a substantial foundation for their request.

The Ernst and Young South Africa Forensic Service’s (2003) Fraud Guide, that forms part of Ernst and Young’s documentation on fraud risk and prevention, aims to help senior management understand more about accounting irregularities, its risks and warning signs. Documents such as these, which facilitate better understanding, can also be useful to individual investors and creditors. Furthermore, many of the aspects of detecting and identifying accounting irregularities that are mentioned in the auditing standard *ISA 240* (IAASB, 2012) can be applied to individual investors or creditors. These include professional scepticism, discussing the company with others and making general inquiries.

## 2.11 SUMMARY

Companies have a degree of accounting irregularity risk that is inherent to their management and accounting functions. This has been proven by the number of large companies that became victims of accounting irregularities. If the risk of accounting irregularities in a company is severe, the company has the potential to spiral down into accounting irregularities.

There are a number of ways that managers and other employees can use to manipulate accounting records and financial statements of a company for their own and the company's benefit. The most frequently observed schemes are summarised in Figure 2.2 as depicted earlier in the chapter.

Legislation has placed a responsibility on managers to detect accounting irregularities. Apart from those intimately involved in the operations of a company, such as managers, employees and internal auditors, some responsibility can also be placed on investors. It is their responsibility to gather facts about companies they want to invest in and to make sure that the investment is safe. However, no method of accounting irregularity detection and prevention is fool proof; and managers with unethical objectives in mind tend to attempt to find new ways to trick the public.

For that reason it is imperative that as many individuals possible be aware of the risk of accounting irregularities and the indicators that may accompany such occurrences. Hence the motivation for this study – to give all interested parties a means to detect and identify accounting irregularities.

In Chapter Three the use of financial analysis as a method to detect and identify irregularities is discussed. Similar to Chapter Two, the chapter is also in the form of a literature review, making reference to previous research.