FINANCIAL ACCOUNTING FRAUDULENCE IN ENTRUST SECURITIES PLC

I.L. Satham Huzain
M.S. Mohamed Nuzran
Vijayakumar Sanoj
D.G.N.L. Dahanayake
M.K.M. Rifkhan
A.A. Abdun Nafih
A.A.S. Madushanka Athurugiri
M.J. Mohamed Shazni
J.A.D.G. Sanjeewa
R.W.M. Aravinda

ABSTRACT

This study examines how top managers or management of Entrusted Securities PLC used financial accounting methods to engage in one of the biggest corporate scandals in Sri Lanka. Further, the study explains that what factors had led to such fraudulent activities in the company. In order to achieve the objectives of the study, a qualitative based approach was adopted. The researchers conducted a few in-depth interviews as well. The findings of the study confirmed that, there are strong relationship between corporate manipulations and (i) motivation to manipulating earnings, (ii) the relationship between engaging manipulations and source of capital and (iii) domination of management of board of directors. We found that an important motivation for earnings manipulation is the desire to attract external financing at low cost and that this motivation remains significant after controlling for contracting motives proposed in the academic literature. We also found that firms manipulating earing are: (i) more likely to have boards of directors dominated by management; (ii) more likely to have a Chief Executive Officer who simultaneously serves as Chairman of the Board; (iii) more likely to have a Chief Executive Officer who is also the firm's founder, (iv) less likely to have an audit committee; and (v) less likely to have an outside block holder.

INTRODUCTION

Entrust Securities PLC engages in buying and selling government securities for customers in Sri Lanka. Its products and services include treasury bills and bonds, repurchase/reverse repurchase agreements, Sri Lanka development bonds, and investment options for foreigners/Diaspora. The company also provides forecasting services of the financial markets. The company was founded in 2000 and is based in Colombo, Sri Lanka. Entrust Securities PLC is a subsidiary of Entrust Holdings Limited. The organization has two listed subsidiaries – primary dealer Entrust Securities PLC and Multi Finance PLC, a licensed finance company.

The firm had been facing problems for a considerable amount of time resulting in the Central Bank cautioning the company in 2013, of several shortcomings which subsequently got worse, according to the Governor. Several weeks ago investigations commenced into Rs.2.95 billion under the welfare fund of the Ceylon Electricity Board (CEB), which was allegedly invested by Entrust Securities in Government securities. It's a massive scam. They (Entrust) have issued repurchase agreements without underlying government guarantees.

Entrusts competitors allege that part of the crisis may be linked to the Ceylon Electricity Board (CEB)'s EPF funds going missing, which was some years ago. CEB sources said that they had directed Entrust to invest the board's EPF money worth some Rs. 3 billion in 2009. Now, it expects that the amount of fraud may increase up to Rs. 12 Billion.

The Central Bank had given the company three months' notice from 11 November 2015 to assemble a viable and credible restructuring program. Since the deadline, which expired on 5th January, was not met, the National Savings Bank (NSB) has taken over the company.
The Central Bank has ordered a forensic audit conducted by the KPMG auditors, with the discovery of eight other accounts that Entrust monies have gone into. CB had also requested two commercial banks to look into personal accounts of some Entrust directors in an attempt to get the complete trail of cash gone missing in the company. They have already identified that certain transactions through the company have been routed to personal accounts of some top officials.

PROBLEM STATEMENT & RESEARCH QUESTIONS

Financial statement fraud differs from other frauds in the corporate environment in that instead of being the victim or perpetrator of fraud, the company is often the instrument of fraud. This may reduce incentives for companies to control frauds which are perpetrated against third parties, often investors and not against the company itself. In addition, while inside involvement is common and therefore the perpetrators are working within the company's systems, the perpetrators are likely to be in senior management roles and therefore have the power to design or circumvent controls.

A further and consequential difference between financial statement fraud and fraud against the corporation is that financial statement fraud need not have any effect on the corporation's actual business. It is a matter of misreporting business results to outsiders.

This can be achieved by intervention at any stage in the record-keeping process. often without affecting the records used for internal reporting and decision making and often by those who are in possession of the full facts and in a position to base business decisions on their knowledge, without being misled by their own false reports. This therefore attenuates the business case for financial statement fraud prevention.

As an overall conclusion, the fraudulent financial reporting has significantly affected various stakeholders' decisions as they using the information provided through the (fraudulent) financial reporting. Therefore, the research is carrying on the financial reporting frauds in organizations.

Research Question/Hypothesis

1. Is there any impact of efficiency of internal controls and corporate governance structure in engaging manipulation of financial statements of companies?
2. Is there relationship between types of capital structure of the company and Financial Accountings Frauds?
3. Is there any relationship in between management influences in decision of and selection of board of directors?

RESEARCH OBJECTIVES

Overall Objective

- Identify the main factors which could lead the corporate scandals and find the solution to prevent from such frauds.

Specific Aims

A. To identify the relationship between efficiency of internal corporate governance structure of Entrust Securities Plc. and financial accountings frauds

B. To identify the relationship between capital structure of a company and financial accounting frauds.

Capital structure includes equity capital and debt capital. Equity capital rose from owners of company (shareholders) whereas debt capital rose from external sources. E.g. Bank loans, Public notes etc.

C. To identify the relationship, the extent of management influences in board of director's decisions and selection of board directors and the level of engaging in manipulating accounting frauds in a company.

D. To give solutions to prevent fraudulent financial accounting in organizations.

LITERATURE REVIEW

As long as human existed, fraud and betrayal have as well. For some reason, it seems also as though greed for money and success are part of human nature. During the past years numerous amount of corporate accounting scandals have been in the headlines, probably the most known ones have been the Enron case in 2001 and the Lehman Brothers case in 2008.

There has been a limited use of data mining techniques for detection of financial statement fraud. The data mining techniques used include decision trees, neural networks (NN), Bayesian belief networks, case based reasoning, fuzzy rule-based reasoning, hybrid methods, logistic regression, and text mining

According to Kirkos et al., some estimates stated that fraud cost US business more than $400 billion annually. Spathis et al compared multi-criteria decision aids with statistical techniques such as logit and discriminant analysis in detecting fraudulent financial statements. A novel financial kernel for the detection of management fraud is developed using support vector machines on financial data by Cecchini et al.

Huang et al. developed an innovative fraud detection mechanism on the basis of Zipf's Law. The purpose of this technique is to assist auditors in reviewing the overwhelming volumes of datasets and identifying any potential fraud records. Kirkos et al. used the ID3 decision tree and Bayesian belief network to detect financial statement fraud successfully.
Sohl and Venkatachalam used back-propagation NN for the prediction of financial statement fraud. There are other researchers who used different NN algorithms to detect financial reporting fraud. Cerullo and Cerullo explained the nature of fraud and financial statement fraud along with the characteristics of NN and their applications. They illustrated how NN packages could be utilized by various firms to predict the occurrence of fraud.

Calderon and Cheh examined the efficacy of NN as a potential enabler of business risk based auditing. They employed different methods using NN as a tool for research in the auditing and risk assessment domain. Further, they identified several opportunities for future research that include methodological issues related to NN modeling as well as specific issues related to the application of NN for business risk assessment.

Koskivaara investigated the impact of various preprocessing models on the forecast capability of NN when auditing financial accounts. Further, Koskivaara proposed NN based support systems as a possible tool for use in auditing. He demonstrated that the main application areas of NN were detection of material errors, and management fraud. Busta and Weinberg used NN to distinguish between 'normal' and 'manipulated' financial data. They examined the digit distribution of the numbers in the underlying financial information. The data analysis is based on Benford's law, which demonstrated that the digits of naturally occurring numbers are distributed on a predictable and specific pattern. They tested six NN designs to determine the most effective model. In each design, the inputs to the NN were the different subsets of the 34 variables. The results showed that NN were able to correctly classify 70.8% of the data on an average.
Feroz et al. observed that the relative success of the NN models was due to their ability to 'learn' what were important. The perpetrators of financial reporting frauds had incentives to appear prosperous as evidenced by high profitability. In contrast to conventional statistical models replete with assumptions, the NN used adaptive learning processes to determine what were important in predicting targets. Thus, the NN approach was less likely to be affected by accounting manipulations. The NN approach was well suited to predicting the possible

fraudsters because the NN ‘learnt’ the characteristics of reporting violators despite managers’ intent to obfuscate misrepresentations. Brooks also applied various NN models to detect financial statement fraud with great success.

Fanning and Cogger used NN (AutoNet) for detecting management fraud. The study offered an in-depth examination of important publicly available predictors of fraudulent financial statements. The study reinforced the efficiency of AutoNet in providing empirical evidence regarding the merits of suggested red flags for fraudulent financial statements. Ramamoorti et al. provided an overview of the multilayer perceptron architecture and compared it with a Delphi study. They found that internal auditors could benefit from using NN for assessing risk. Zhang et al. conducted a review of the published papers that reported the use of NN in forecasting during 1988–98.

Aamodt and Plaza and Kotsiantis et al. used case based reasoning to identify the fraudulent companies. Further, Deshmukh and Talluru demonstrated the construction of a rule-based fuzzy reasoning system to assess the risk of management fraud and proposed an early warning system by finding out 15 rules related to the probability of management fraud. Pacheco et al. developed a hybrid intelligent system consisting of NN and a fuzzy expert system to diagnose financial problems. Further, Magnusson et al. used text mining and demonstrated that the language of quarterly reports provided an indication of the change in the company's financial status.

A rule-based system that consisted of too many if–then statements made it difficult for marketing researchers to understand key drivers of consumer behaviour. Variable selection was used in order to choose a subset of the original predictive variables by eliminating variables that were either redundant or possessed little predictive information.

Security Investment Model

Security Investment model was developed by Dooley, Daniel V. 2001. According to his model, Investors purchase equity securities in the expectation that their investments will increase in value in two ways - through dividends and through appreciation in the market value of the securities. Market value can be influenced by many factors, but mainly the value of equity securities is based upon the profitability of the enterprise. Value may be measured and predicted by: (a) consideration of past (i.e., historical) performance; (b) assessment of current results of operations and financial conditions; and (c) evaluation of likely future results. Some metrics of corporate performance - past, present, and future - are accounting measures such as:

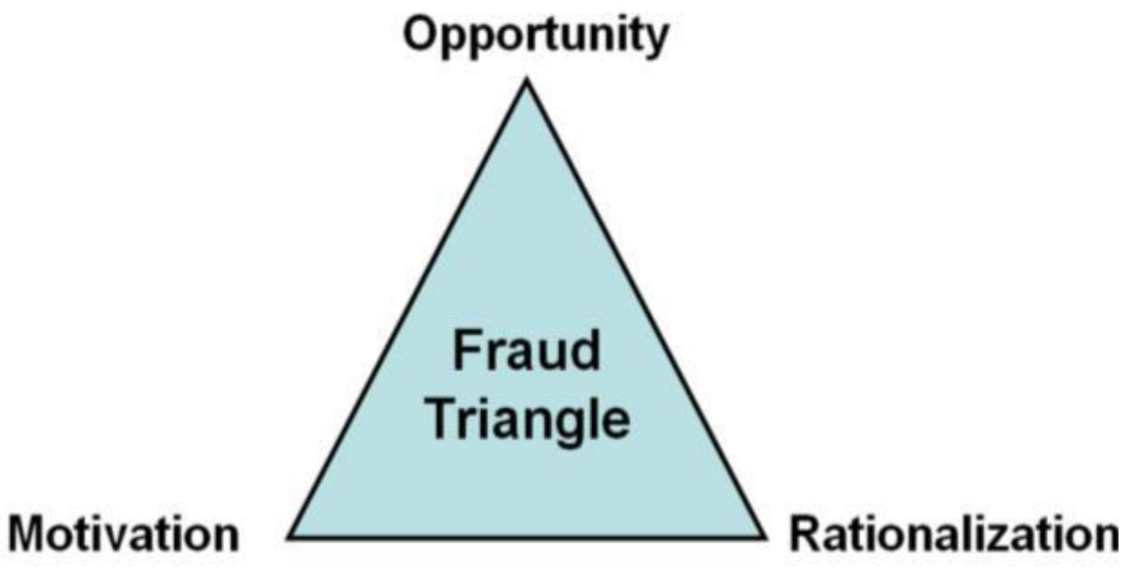
- Revenue and revenue trends
- Profit margins
- Earning and earnings trends
- Cash flows from operations and expected future cash flows

Fraud Triangle Model

Fraud triangle model was developed by criminologist Donald R. Cressey, representing the three factors that push an ordinary person to commit fraud (figure 1)

When financial stability or profitability is threatened by economic, industry, or entity operating conditions, or excessive pressure exists for management to meet debt requirements, or personal net worth is materially threatened, the management will face the incentives or pressures to resort to fraudulent practice. Pressure can come in the form of peer pressure, living a lavish lifestyle, a drug addiction, and many other aspects that can influence someone to seek gains via financial fraud. When there are significant accounting estimates that are difficult to verify, or there is oversight over financial reporting, or high turnover or ineffective accounting internal audit, there are opportunities for fraud. For instance, a cashier can steal money out of the cash register because it is there. If the cashier is required to drop all cash into an underground safe for which he does not know the combination, opportunity will not exist. When inappropriate or inefficient communication and support of the entity's values is evident, or a history of violation of laws is known, or management has a practice of making overly aggressive or unrealistic forecasts, then there are risks of fraudulent reporting due to attitudes/ rationalization. Rationalization is a grey area in the fraud triangle.

Opportunities and incentives exist or they don't. Rationalization depends on the individuals and the circumstances they are facing. Understanding the fraud triangle is essential to evaluating financial fraud. When someone is able to grasp the basic concept of the fraud triangle, they are able to better understand financial frauds, how they occur, why they occur, and what to do to stop them.



.

Figure 1. The Fraud Triangle (UC Merced 2012)

According to Robert Bloom; H. G. Heymann et al', Accounting could be rationalized, from logical argument and empirical investigation, which accountants generally act in the interest of public welfare, then the classical framework, which implicitly defines accounting as a neutral institution concerned only with the objective measurement of economic performance, would be valid. To the extent the accounting profession does not always act in the best interests of the public, the classical framework is less valid and a new framework is needed to resolve new accounting issues. (The Schism in Accounting, 1994).

SIGNIFICANCE OF THE STUDY

The misstatement or omissions in amounts or disclosures of the financial statements are to deceive financial statement users. Financial fraud may involve following schemes; [01] Falsification, alteration or manipulation of records, supporting documents or business transactions. [02] Misrepresentation of events, transactions, accounts or any other significant when preparing the financial statements and [03] Misapplication of principles, policies, procedure used to measure, recognize and report economic event and transactions.

When there is a fraud, financial information should be reversed, and the capital market its participants should regain their confidence through the quality information and their trust through vigilant, active, effective and responsible corporate governance. Financial statement frauds often start with a small misstatement and reports that presumes not to be material but eventually grown into full blown fraud and producing misstated financial statements.

Financial statement frauds are harmful or significant in many ways such as undermines the quality and the integrity of the financial reporting process, Jeopardizes the integrity objectivity of auditing professionals, diminishing the confidence of stakeholders about reliability of the financial information, Make capital market less efficient, adversely affect the nation's economic growth and prosperity.

And also, the fraudulent financial statements may result in huge litigation costs; destroy the careers of the individual who involved in the fraud, Causes bankruptcy or substantially economic loss by the company, Encourage excessive regulatory interventions and Cause destruction in the operation and the performance of the alleged companies.

Based on the explanation given above, it is very clear the significant of the financial accounting fraud it is not only affect to the particular company but also various parties in society.

Vigilant and effective corporate governance can substantially reduce the instances of both employees and management fraudulent activities. Therefore, prevent and detect financial statement fraud will improve the quality, integrity and the reliability of the financial information.

LIMITATIONS OF THE STUDY

The main limitation of the study was gathering data and information for the research. Due to the fact that still the court case is under hearing and the criminal nature of the offence made information gathering very hard. Moreover, Court case records could have been obtained only after the court verdict is given which again hampered the information gathering process. On this ground, the exact reason behind flaws of the internal control and the managers who are in charge of the whole fiasco could not be identified.

Liaising with the company employees were difficult and most of the time they ignored to support us with the information about the incidents. However, on the approval from the appointed administrator, Board of National Savings Bank (NSB) was also acting as a barrier to contact the board of directors of Entrust Securities PLC.

SUMMARY AND CONCLUSION

Despite all the regulation and the monitoring of the Monetary Board of the Central Bank of Sri Lanka and Corporate Governance practices like having Non-executive Directors and Internal Audit Committee, there are still room fraudulent activities and manipulation of final accounting. If this is the case for a listed company in the Colombo Stock Exchange which is a non-banking financial institution, any company could be prone to such fraudulent activities due to inherent limitation of internal controls like collusion and management overriding the internal controls.

Further, this study highlighted the worthiness of internal whistle blowing which brought the issue to the light of regulators and Monetary Board.

Internal Controls should be thoroughly assessed and proactively changed to minimize the chances and likelihood of misappropriation of the organizational resources.

Random inspections and audits could be practiced by regulators and auditors to overcome or detect such mal practices and the board of directors should be strengthened with more non-executive director with maximum independency.

Repurchase agreement that are entered without backing with government securities paved the way for the person who are responsible to transfer the funds to their accounts. The whole problem was covered by the way in which treasury and the back office functioning staff were able to carry out the transaction without alarming the regulators and compliance officers.

References

Anuj S & Prabin K P, 2012, *'A Review of Financial Accounting Fraud Detection based on Data Mining Techniques',* International Journal of Computer Applications (0975 – 8887, vol. 39, No.1, viewed 16 February 2012

Beneish, M. D. (1999). The detection of earnings manipulation. Financial Analysts Journal, 55, 2–36.

Dalnial, H., Kamaluddin, A., Sanusi, Z. M., & Khairuddin, K. S. (2014). Accountability in financial reporting: detecting fraudulent firms. Procedia - Social and Behavioral Sciences, 145, 61–69.

Carcello, J. V., T. L. Neal, Z. V. Palmrose, and S. Scholz. 2010. CEO involvement in electing board members, audit committee effectiveness, and restatements. Working paper.

Dechow PM, Solan RG and Sweeny AP 2010 "Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC", vol.13, no. 1, viewed on 20 April, http://onlinelibrary.wiley.com/doi/10.1111/j.1911-3846.1996.tb00489.x/abstract

Jarrod W and Maumita B, 2016 '*Some Experimental Issues in Financial Fraud Mining*'. Procedia Computer Science, vol. 80, no. 1.

Moncarz.E.S, Moncarz, R., Cabello, A., Moncarz, B., 2006. '*The Rise and Collapse of Enron: Financial Innovation, Errors & Losses'*, http://www.ejournal.unam.mx/rca/218/RCA21802.pdf (Accessed 04.11.2014)

Norazida M, 2014 'Financial statement fraud risk mechanisms and strategies: "the case studies of Malaysian commercial companies"', Universiti Teknologi MARA, 18500 Machang, Kelantan, May, 145

Norazida M and Morrison, 2015, '*Roots of Responsibilities to Financial Statement Fraud Control'*, presented at 7th INTERNATIONAL CONFERENCE ON FINANCIAL CRIMINOLOGY 2015, 13-14 April 2015,

Rasa K, 2015, 'The Model of Fraud Detection in Financial Statements by Means of Financial Ratios', presented at 20th International Scientific Conference Economics and Management - 2015 (ICEM-2015).

APPENDIXES

Appendix 1: Questionnaire

01. Can you explain about the problem?

02. Could you please confirm the value of the fraud as per your knowledge?

03. What could be the reasons for the fraud according to your knowledge?

04. What could have done to prevent the fraud?

05. How the fraud has been identified?

06. What is the significant of the fraud in stakeholder relationship or How it’s affecting to them
    - Investors & Creditors
    - Employees
    - Regulators

07. What are corrective actions could be taken to prevent such fraud in future?

08. How detrimental is the fraud to company’s going concern?

09. What are the steps have taken after the fraud has identified?

10. Is it possible to rebuild the relationship with stakeholders?