



A REVIEW OF FIRMS ENGAGE IN FINANCIALREPORTING MISCONDUCT

Prakash Kumar Khemani

Research Scholar, Department of Commerce, Faculty of Commerce
Mansarovar Global University, Bhopal, Madhya Pradesh

Dr. R. K. Patil

Research Guide, Department of Commerce, Faculty of Commerce
Mansarovar Global University, Bhopal, Madhya Pradesh

ABSTRACT

When it comes to money, forensic accountants dig through records for signs of wrongdoing. Please enlighten us on this topic. These are making use of it. Primarily, this is put to use in auditing and investigating monetary information. The information on the companies themselves. Forensic accounting, often spelled "forensic accountancy," is a subfield of public accounting that examines potential instances of wrongdoing in the domain of financial reporting by businesses. In order to assess whether there has been fraud in financial reporting, forensic accountants employ a variety of techniques. That's not a simple job to do. Expertise in both accounting and analysis are used by forensic accountants. Investigating a company's or individual's financial dealings requires analytical and accounting expertise. In situations involving financial fraud, they are often consulted as experts. Forensic accounting has been tainted by fraud or suspicion. Accountants are tasked with researching and verifying the accuracy of their clients' financial records.

Keywords: financial reporting, forensic accounting, accounting misconduct, Market reactions

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INTRODUCTION

Financial reporting misbehavior include fraud, deception, and misreporting in accordance with the definitions provided by Amiram et al. (2017). We select three subsamples in which financial reporting fraud is expressly alleged or is likely to have happened, limiting our attention to instances with the most significant incidents of financial reporting misbehaviour and so reducing the expenses associated with manually obtained data. Our first subsample of shady actors is derived from SEC enforcement cases involving Section 17(a) of the 1933 Securities Act (fraudulent

interstate transactions) or Section 10(b) of the 1934 Securities Exchange Act (manipulative and misleading devices) (Karpoff et al., 2017). Our second subsample of questionable behaviour is derived from securities class-action lawsuits that have raised claims of breaches of SEC Rule 10b-5 and include charges of outright fraud (Dyck, Morse and Zingales, 2013). To avoid using unnecessary cases and potentially spurious litigation, we only employ class action lawsuits that have caused a substantial unfavourable market response. By ranking firms based on how much their stock prices dropped after they



announced restatements, we can isolate the optimal subsample. The considerable drop in stock price after the disclosure of a restatement implies that investors lose faith in the business, perhaps because they feel fraud or serious financial reporting malpractice has happened, even in the absence of formal claims (Dupont and Karpoff 2017).

Benefits of financial reporting misconduct

Performance based compensation: After faking financial results to meet internal/external performance objectives, we estimate the amount of performance-based pay that the offenders are able to get. We estimate the gain in pay by adding the perpetrator's year-end bonus and nonequity incentive plan compensation for the violation period, on the premise that the perpetrators would not have met the objectives without falsifying financial outcomes. We manually gather compensation information from EDGAR proxy statements submitted by the sample corporations.

Stock and option trading gains: A company's stock price would be artificially inflated if its financial performance were not handled, since profits are inflated during the violation period. Therefore, the perpetrator's trading gain would be larger than the gain without misconduct if the stock or option was sold

prior to the discovery of the misconduct. To estimate the additional trading profits due to the higher stock price, we need to make a few assumptions. To begin, let's suppose that all of the stock in the culprits' possession is restricted stock, which has a zero acquisition price. For all intents and purposes, an option's exercise price is equivalent to its purchase price. Second, we assume that sans manipulation, the culprit would not sell any stock or option at the current stock price, thus the trading gain foregone by the manager, absent wrongdoing, is zero. Based on these hypotheses, we estimate the stolen money by adding up all of the trading gains that have been recorded. Profit from trading is determined by multiplying the quantity of stock or options traded by the spread between the selling and buying prices. The trading gain for each culprit is then determined by adding together all the trades made after the misbehaviour started and before it was discovered. From the Thomson Reuters Insiders database, we pull the per-transaction trading volume, stock selling price, option selling price, and option exercise price for each culprit. For the 195 out of 499 offenders for whom we do not have access to their trading history on Thomson Reuters, we estimate that their trading gain was negligible.

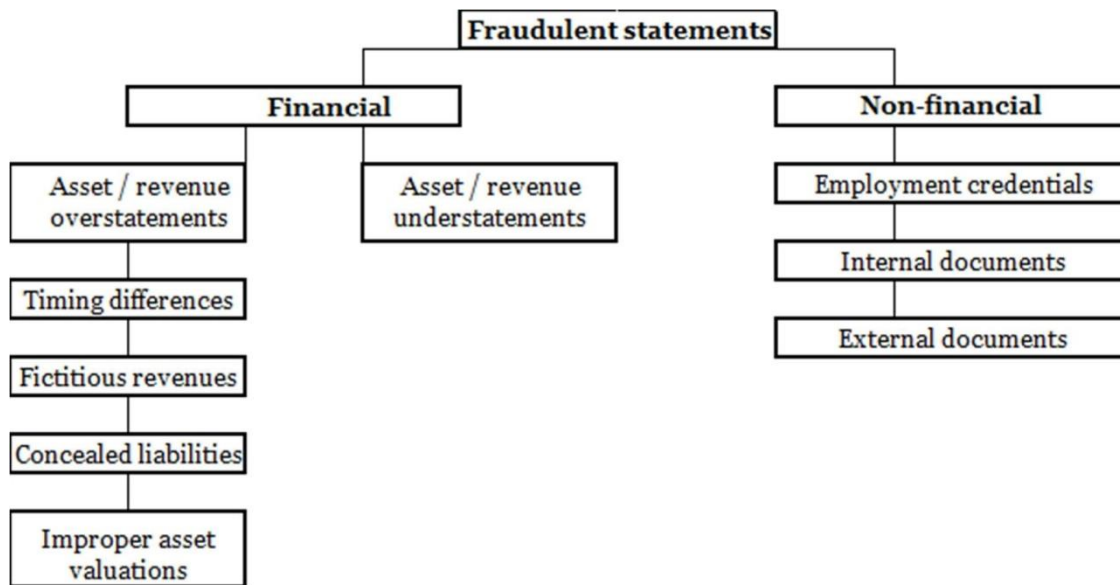


Figure 1: Financial statement fraud

Gain in wealth via stockholding: Even if the perpetrators don't sell their shares of stock during the inflated price period, they still benefit from the gain in value. We assume that a perpetrator maintained the same number of shares from the beginning of the violation period to the first disclosure date in order to evaluate wealth growth through stockholding. Each offender's stockholding is approximated using information about that person's stock ownership found in the proxy statement of the affected firm that was most recently released. 8 We then determine when the stock price was greatest between the start of the violation and the first date of disclosure. Each perpetrator's anticipated financial gain is calculated by multiplying the number of shares they owned before the violation started by the market-adjusted return accrued from the day before the violation began to the day when the stock price peaked. Stock prices are obtained from CRSP, and each perpetrator's stock holdings are culled by hand from the most recent proxy statement filed prior to the original reveal date.

REVIEW OF LITERATURE

Christophe Faugere, (2021): Based on 116 post-event interviews with managers and senior executives gathered over the course of two years, a wide-ranging field study was conducted into 19 significant catastrophes at 19 prominent European insurance and banking companies. Using examples from the fields of behavioural finance, organisational behaviour, and occupational psychology, we show how the Root Cause Analysis (RCA) technique may be used to identify biases in human decision-making. To put it another way, these biases are major sources of operational risk for these businesses. We discover that prejudices inside these organisations (such a broken psychological contract) are often at the heart of the problems that lead to events. Furthermore, we discover that insurance businesses are more vulnerable to cognitive conservatism as a root cause bias, whereas banks are more susceptible to emotional biases (fear and greed). This study's findings have important implications for the ability of financial institutions and insurance providers to meet new requirements that place a premium on the monitoring and management of



operational risk, and more especially, misconduct risk.

Douglas Cumming, (2015): This study summarises the current state of knowledge about the origins, outcomes, and effects of financial market misbehaviour regulation, as well as the possible agency conflicts that may arise. We analyse how regulators are reacting to wrongdoing in the financial markets and point out where regulation and enforcement overlap. To that end, we highlight publications that use natural experiments, rule tweaks, and market design alterations. Possible future research directions are also considered, as is the multidisciplinary aspect of studying financial market wrongdoing.

Poonam Khanna, (2021): In the literature on workplace misbehaviour, the topic of executive recidivism, or recurring wrongdoing notwithstanding disciplinary action, has been understudied. We propose that the perceived justice of punishments an executive receives after the first transgression is related to the chance of recidivism, using ideas from fairness theory and supplementing them with insights from attribution theory. In this article, we take a look at how a frequent management labour market penalty, decreased pay, affects the probability of recidivism. We test and find support for our prediction using a sample of Chief Financial Officers (CFOs) who resigned their posts due to financial malfeasance at their company and then relocated to another public firm in the same role. Our recidivism model is strengthened by the results of many robustness and endogeneity tests.

Asad Ali Rind, (2022): According to the findings of previous studies, a company's physical location is a major factor in making financial choices. It is uncertain, however, whether companies tend to imitate the immoral actions of their local competitors and if corporate social responsibility (CSR) and product market rivalry can reduce this trend. Based on analysis of 23,605 data from the

United States, we conclude that the prevalence of misbehaviour at small businesses is positively correlated with the national mean. The data demonstrates that CSR-driven businesses are not likely to engage in the same fraudulent practises as their regional competitors. However, businesses in highly competitive sectors tend to follow the example set by their less moral competitors. Based on our channel analysis, we conclude that information asymmetry and insufficient monitoring are the primary causes of fraudulent peer effects, which are seen exclusively in small, young, and low-institutionally-owned enterprises. Additionally, the findings indicate that stakeholders should pay greater attention to businesses that are active in sectors where wrongdoing is common.

Junjian Gu, (2022): Recent CEO scandals raise questions about whether or not international experience is correlated with greater financial malfeasance risks, although there is insufficient data to support this claim. This study fills a gap in the literature by analysing the potential for financial misbehaviour among Chinese company CEOs who have worked in foreign markets. All things considered, we find that companies that choose CEOs with international expertise have a lower chance of financial malfeasance. In addition, we discover that the financial misbehaviour risks of businesses are reduced when they choose chief executive officers who have lived and worked in countries that are very different from their own, either economically or culturally. The impacts are stronger for companies that choose younger CEOs, according to cross-sectional analyses. These findings suggest that CEOs with international expertise may reduce the likelihood of financial malfeasance at their companies via improved corporate governance.

Moty Amar, et al (2022): Managers are engaging in earnings management if they

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manipulate the company's reported results to serve their own personal or financial goals. Myopic earnings management is shown. We use quantitative analyses of financial data and qualitative data that captures the perspectives of Chief Financial Officers (CFOs) to demonstrate that CFOs prioritise the near term, where they perceive profits management advantageous to the organisation and themselves. These managers are aware of the potential long-term damage earnings management may do to a firm, yet they nonetheless do it because they are

under pressure to fulfil financial performance expectations. They have come to terms with the fact that their involvement in profits management, however little at first, will likely evolve to ongoing involvement. Earnings management, however, is commonplace. Given the potential for stumbling into fake financial reporting, which may have far-reaching consequences for businesses, people, and the culprit themselves, proof of myopic participation in earnings management is crucial.

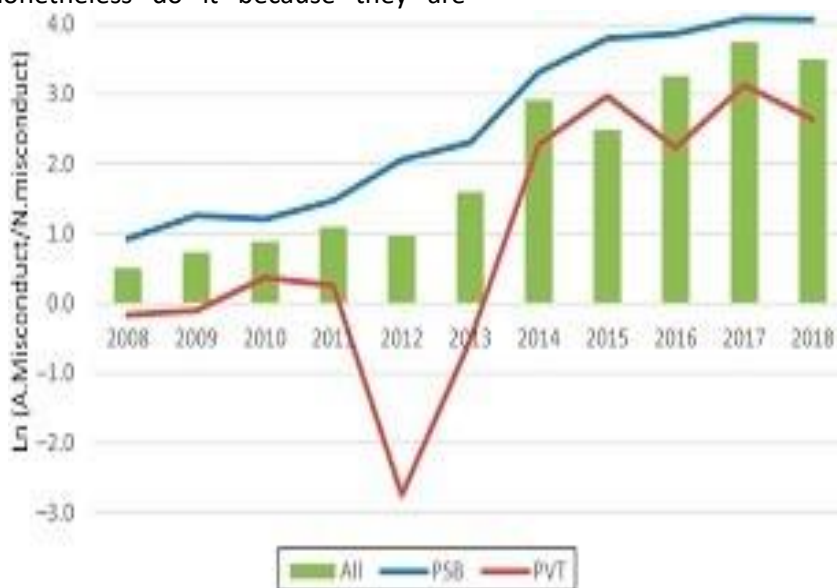


Figure 2: Financial misconduct in Indian banks

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COMPARISON OF RELATED PAPERS

S.No	Author Name	Year	Objective
1	Avishek Bhandari	2020	This study examines implications of institutional investors' dishonesty in their financial dealings for the transparency (or lack thereof) of investee companies' financial statements. Unethical institutions may be exposed by reviewing SEC
			filings detailing Registered Investment Advisors' (RIAs)' breaches of applicable rules and regulations.



2	Shantaram Hegde	2017	It proposes and finds that investors' differing levels of confidence about firm-specific features significantly impact the likelihood that financial statements will be manipulated by management. This study underlines the role that investors' confidence in a company plays in identifying, preventing, and forecasting instances of accounting fraud.
3	Yuqing Zhou	2019	We analyse data from Glassdoor to learn how public disclosures of financial misdeed affect workers' impressions of their companies and their supervisors. Overall firm ratings fell by 0.32 standard deviation, while ratings for career opportunity, salary benefit, senior leadership, work-life balance, cultural value, and recommendation fell by 0.14 to 0.40 standard deviations.
4	Dan Amiram	2018	To this end, we gather data manually on three subsamples of very significant occurrences of financial reporting violations between 2003 and 2015. The ramifications of our findings for researchers, practitioners, and policymakers are discussed.

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CONCLUSION

This study reviews the literature on the effects that institutional investors' unethical conduct has on the portfolio companies that they own. Our hunch is that dishonest institutional investors are less likely to conduct monitoring and are more likely to encourage enterprises to engage in aggressive financial reporting practises. We find that aggressive financial reporting procedures of investee enterprises

are favourably influenced by larger levels of unethical institutional ownership. Additional analyses confirm that the outcomes are predominantly influenced by unethical, institution-level ownership that is not monitored. These findings demonstrate that unethical institutional settings encourage aggressive financial reporting activity on the part of the management of investee enterprises.



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