The continuum from legitimacy to fraud

Finance

The Continuum from Legitimacy to Fraud

Introduction

How to do business legally? For some companies and corporations this question may sound in a different manner: how to do business illegally? Actually, it may sound weird, but modern accountants and managers have often to make this Hobson's choice. When an individual crosses a boundary between legal and illegal practices, he can find himself at the crossroads. A continuum between legitimacy and fraud in earnings is a challenging question and it can hardly be solved at once. First of all, it is relevant to outline a concept field of " fraud" and " legitimacy" in earnings management. Trochim & Donnelly (2008) would help us to identify and work with these two basic concepts of our research. Other studies by Schram (2006), Shank (2006) and Patton (2002) consider the process of identification and further interpretation of the key concepts of the study, i. e. " fraud" and " legitimacy".

First of all, let us think about the meaning and the essence of the concept of " fraud". There is no doubt that this concept is often considered beyond the economic discourse. Nevertheless, when accounting practices are on the way, it is possible to restore in our memories a concept of fraud too. In case an accountant, financial manager or any other party involved in the earnings management is noticed in the process of deception, then the reason for fraud occurs (Shelton, Whittington, and Landsittel, 2001). It is possible to correlate a concept of fraud with the following definition of “ earnings management”, which stands for financial gains management in a certain company or organization. Thus, there is a favorite background for the occurrence of fraud, a malpractice of hiding or inventing ephemeral earnings. Hoffman et al (1996) underline that fraud can occur in the result of the external pressure, when CEOs of the company, stakeholders or any other party interested in fake financial indicators of the company make the accountants to promote illegal nature of their earnings management.

From legitimacy to fraud

There is no doubt that every company is able to hide the real figures of income and the sharp corners of their financial operations can be smoothed. In the result of this type of fraud, the company is able to promote its stable financial growth and development. Nevertheless, there are many examples illustrating negative consequences of fraud in earnings management. Let us refer to a famous case of Enron, when the accountants of the company were subjected to financial fraud and in the result of their malpractice hundreds of employees suffered losses.

Shelton et al (2001) make an emphasis on fictitious transactions, which are dominant factors in possible earnings management. It should be mentioned that fair earnings management is one of the primary concerns for different companies. The companies and their CEOs are often looking forward to their profits increase in the face of challenging market environment. For this purpose a potential success of the company depends on financial position and goodwill of the company. Very often flexible practices in earnings management are often misleading and result in fraud. Levitt (1998) underlined that flexibility is relevant to the companies in case they want to be proactive in the market. Nevertheless, flexibility in management practices can lead the accountants to leakage of information, gaps in financial statements or some other malpractices.

Conclusion

On the example of Enron case study, it is evident that the accountants were subjected to the external pressure of the third parties and authorities of the company. Enron lost its money, employees suffered huge financial losses and retired employees lost their pensions. Ethical issues are of crucial importance nowadays. For example, accountants should conduct their flexible policies, but they should take appropriate measures to prevent a potential hazard for the Company. The accountants should be professionals in their spheres of interest, but at the same time they must follow different rules and regulations of their practices (Statement on Auditing Standards, 2010). Therefore, open, flexible and proactive practices in accounting are a must (Trussel& Rose, 2009). Ethics in accounting practices is a favorable background for professional activities in this field. It is impossible to correlate concealment and auditing, but it is better to bridge the ethical gap in accounting practices of the company and illegal businesses of the companies. Directors, managers and accountants are involved in fraudulent practices nowadays and goodwill of many companies is often undermined. It is appropriate to set the limits between a legal continuum of accounting practices and unethical breach of financial laws.

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