

# BANKING INDUSTRY FINANCIAL STATEMENT FRAUD AND THE EFFECTS OF REGULATION ENFORCEMENT AND INCREASED PUBLIC SCRUTINY

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## ABSTRACT

*In October 1987, the chairman of the SEC released his committee's Report of the National Commission on Fraudulent Financial Reporting, stating that "regulations and standards for auditing public companies must be adequate to safeguard . . . public trust" (CFFR, p. 5). Using publicly owned banks and savings and loan institutions as a backdrop, we study the effects of regulation and increased public scrutiny on financial statement fraud. Specifically, we examine how the characteristics of bank fraud have changed over the past two decades. We hypothesize that increased public scrutiny through changes in regulation on banks and savings and loans, as well as general financial statement fraud detection standards have altered fraud strategies. The study further explores key characteristics of management fraud that occur in bank and savings and loan organizations. Results indicate that bank frauds have changed over time, and are now more likely to involve withholding real information than create fictitious information. While the frequency of frauds*

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*did not significantly change over time, the magnitude of each fraud event has declined. This may imply that public regulation and scrutiny may have little effect on the frequency of fraud, but does affect fraud strategies.*

## INTRODUCTION

The *Report of the National Commission on Fraudulent Financial Reporting (CFFR) (Treadway Commission, 1987)* noted that “when the independent public accountant opines on a public company’s financial statements, he assumes a public responsibility. The regulations and standards for auditing public companies must be adequate to safeguard that public trust” (p. 5). This study uses publicly owned banks and savings and loan institutions as a backdrop to study changes in financial fraud strategies under conditions of increased regulation and increased public scrutiny. Understanding how fraud strategies have changed over time under existing public regulation and scrutiny is one step towards developing future public regulation and private guidance. Prior studies have examined financial statement fraud largely as a static issue, and academic research has not yet considered changes in the business environment and the potentially significant confounding effects of the passage of time. This study extends prior research by examining how fraud changes over time.

As a secondary focus, this exploratory study also examines key management fraud characteristics in the banking profession, including publicly owned banks and savings and loan (S&L) institutions. This is important since over 20 years ago, [Ramage, Kreiger and Spero \(1979\)](#) noted that financial institutions have different error characteristics than other industries. Key to improving financial reporting effectiveness is understanding where and how frauds occur ([Nieschwietz et al., 2000](#)), which in turn should help private guidance within the public accounting profession. Appropriate industry regulation, whether public or private, can reduce the incidence of financial statement misstatement. For example, [Maletta and Wright \(1996\)](#) found that companies in publicly regulated industries had fewer routine errors, a lower rate of misstatement, and more audit-detected errors than unregulated companies. In contrast, savings and loan institutions have fallen under close public regulation. However, [Thompson \(1993\)](#) reported that the use of public regulatory accounting principles (RAP) over the private sectors generally accepted accounting principles produced higher reported income and fewer assets supporting regulatory capital. While [Johnson and Khurana’s \(1995\)](#) study offers evidence that private guidance through Statement on Auditing Standards (SAS) have effectively increased the proportion of appropriately modified auditor’s reports. [Nichols, Bishop and Street \(2001\)](#) also reported that recent private (SFAS)

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