RESEARCH PAPER

Measuring fraud and earnings management by a case of study: Evidence from an international family business

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Abstract  The aim of this study is to estimate the probability of fraud and earnings management for a specific Spanish family business, Pescanova. In the context of financial statements, the Beneish model is used to detect fraudulent behavior. Our findings reveal that Pescanova presented propensity to commit fraud and carried out aggressive accounting practices before the disclosure of its financial problems. The manipulation index and the probability of manipulation are used as indicators of fraud and earnings management. Results also show that Pescanova made aggressive accounting practices, through the manipulation of Day’s sales in receivables index and Total accruals to total assets. Next, we provided evidence that the Sales Growth index and Leverage index are aligned with the position of technical default shown by the pre-bankruptcy board of Pescanova. Our main contribution is demonstrating the validity of the model for the case of Pescanova. Therefore, the application of the Beneish model might have detected fraudulent behavior, in the years prior to Pescanova’s collapse.

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Detección de fraude y de manipulación de beneficios a través de un caso de estudio: evidencia de una empresa familiar internacional

Resumen  El objetivo de este estudio es estimar la probabilidad de fraude y de manipulación de beneficios para una empresa familiar española, Pescanova. En el contexto de los estados financieros, se utiliza el modelo Beneish para detectar el comportamiento fraudulent. Nuestros resultados revelan que Pescanova presentaba propensión a cometer fraud y que llevó a cabo prácticas contables agresivas, antes de revelar sus problemas financieros. El índice de manipulación y la probabilidad de manipulación, han sido usados como indicadores de fraude.

Introduction

Financial statements fraud and earnings manipulation have probably existed since the beginning of commerce. Smith (1778) recognized the shortcomings of the modern corporation including the erosion of shareholder value due to losses from fraud and abuse (Dorminey, Scott Fleming, Kranacher, & Riley, 2012). Over the last 60 years, several studies have been developed to achieve a better understanding of the motivations and means of fraudulent behavior (e.g. Hogan, Rezaee, Riley, & Velury, 2008; Jones, Krishnan, & Melendrez, 2008).

Financial statements fraud is known for having dramatic consequences on corporations and their stakeholders. The 2016 Report to the Nations published by the Association of Certified Fraud Examiners (ACFE), 2016 estimated the cost of fraud to be around 5% of businesses’ annual revenues. Globally, this might well be translated as $3.7 trillion of economic losses due to fraud approximately. Thus, given the high costs associated with fraud, identifying models that accurately predict fraud is really important. In this vein, fraudulent financial statements involve the intentional misstatement of an organization’s financial results of economic position (Anand, Tina Dacin, & Murphy, 2015).

The existing literature regarding earnings management is really extensive, with a recent evolution derived from the well-known cases of fraudulent companies (e.g. Enron, WorldCom, AIG, Parmalat, Bankia, among others). In the wake of such cases, a new research stream began to jointly appoint earnings management and aggressive earnings manipulation to detect extreme cases of earnings management – fraudulent earnings and non-fraudulent restatements of financial statements (Trumpeter, Carpenter, Desai, Jones, & Riley, 2013). Therefore, a relationship between earnings management and fraud was established.

Although a number of studies have been conducted on fraud in disciplines as psychology, criminology, and sociology, much remains to be done on accounting research to offer insights and guidance to managers, policy-makers, and regulators in relation to fraud (Free, 2015). The screening of new models for fraud detection is perhaps one of the most critical accounting research activities, but it is often poorly performed. Also while some studies have been conducted on earnings management and fraud under the jurisdiction of USA, little empirical research has been developed in others jurisdictions (Abdul Aris, Maznah Mohd Arif, Arif, Othman, & Zain, 2015). Thereby, a gap still exists in analysing earnings management and fraud in the accounting research field and in other jurisdictions rather than in that of the USA.

Bearing in mind all the previous considerations, the aim of this study is to estimate the probability of fraud and earnings management, generated from a particular Spanish family business through the utilization of Beneish model. In this vein, we also advance in the family business field to the extent that to the best of our knowledge, this is the first study that applies the Beneish model to a Spanish family firm.

Using a ‘case-based’ research approach, we check whether the Beneish model fits the data presented by Pescanova before disclosing their financial problems and their accounting discrepancies. Pescanova is an international Spanish food company that in 2013 made a public announcement of an existential discrepancy between the firm’s accounting and the bank debt. Due to the successful investigation from the forensic accountants (KPMG), the pre-bankruptcy corporate board (Deloitte) demands a restatement of the 2011 financial statements of the company.

As De Massis and Kotlar (2014, p. 16) stated case study research is particularly appropriate to answer how and why questions or to describe a phenomenon and the real-life context in which it occurred. Thereby, our case study contributes to assess the validity of a fraud detection model in other jurisdictions rather than that of the United States, as we could assume, ex-post, that earnings were managed and fraud was committed. The model’s utility is demonstrated since we had access to the bankruptcy management reports, whose results confirm those shown by the Beneish model.

Our findings reveal a significant propensity to commit fraud and aggressive accounting practices from Pescanova in the previous years to its collapse. Post-collapse bankruptcy corporate board reports reveal the same results than those offered by the Beneish model. These outcomes can be explained in the light of the agency theory (Jensen & Meckling, 1976) as to whether firms without separation of ownership and control are more likely to be involved in earnings management and fraudulent behaviors than their counterparts with separation of ownership and control (Ramdani & van Witteloostuijn, 2012).
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