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SHARE PRICE MANIPULATION AT THE STOCK EXCHANGE MARKET. IS A PYRAMIDAL SCHEME CURRENTLY RUNNING?

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Abstract

Fraud in corporations is a topic that receives significant and growing attention from regulators, auditors, and the public. Increasingly external auditors are being asked to play an important role in helping organizations to prevent and detect fraud which is not an easy task and requires thorough knowledge about the nature of fraud, how it can be committed and concealed. Sometimes, even in a giant listed company, collusion between managers and the Board of Directors occurs, eluding auditor´s control and misleading the market. Through this paper, the researcher presents eventual accounting frauds committed by top level executives of a multinational firm, based on artificially altering the outcomes for each year, with the aim of personal gain by receiving huge bonus payments for the achievement of goals as part of their variable remuneration, providing false information to the market. The foregoing, with the total complicity of the Directors. The mentioned collusion might be proved since all of these frauds were reported to the Board, but no corrective measures were taken and no internal investigations were ever conducted. Moreover, the whistleblower sustains he was harassed by his superiors until forced to leave the firm. This results in a share value manipulation, increasing artificially the price in order to show the company (a two digit billions of USD net annual revenues) as a very attractive one to invest. As well known, every listed company must send annually an audited report to the authorities. The combination of four elements, detailed in this paper, are the pillars of a possible "Ponzi´s Scheme" found out by the researcher at the Stock Exchange Market.

Keywords: Share price, Stock Exchange Market, Accounting frauds, Audit firms, Ponzi´s scheme

INTRODUCTION

The investigation of literature review initially concerns about the basic concepts of auditing and audit risk, and then followed by fraudulent accounting which has direct impact on audit risk.

According to Nur Haiza, Muhammad Zawawi & Zahirul Hoque (2008), Management accounting innovations refer to the adoption of modern forms of management accounting systems such as activity-based costing, activity-based management, time-driven activity-based costing, target costing, and balanced scorecards. In addition, research in management accounting innovations indicates the dominant use of sociological-based theories and increasing use of field studies.

A clear distinction between traditional and contemporary management accounting techniques is the latter are strategic-focused that combine both financial and non-financial information, as sustained by Chenhall & Langfield-Smith (1998).

According to Hansen & Mouritsen (2007), management accounting is regarded as performance number '*at a distance*' whereas operations management is considered as '*hands-on*' activities in operations. In addition, the literature demonstrates that tensions always exist when the management accounting system needs to keep pace with technological advancement, denoted as accounting lag by Dunk (1989) and productivity paradox by Young & Selto (1991).

According to Grandlund & Lukka (1998) the convergence of management accounting practices in the world is the results of global competition, advanced information technology, multinational institutions and consultancy firms.

The practice of management control may change as various aspects of the firm could be integrated via information technology, as sustained by Dechow, Grandlund & Mouritsen (2007). Pitifully, this fact also creates a "*grey zone*", where corrupted actors currently play.

Certainly, a clear boundary should be established between management accounting practices and accounting information system. Extensive researches have been carried out to study the link between the management control system and organizational characteristics which were mainly based on contingency theory, as argued by Chenhall, (2003).

The literature has identified the contextual factors that affect the use and usefulness of management control systems such as environmental dimensions, technology, size, strategy, and organizational structure. Researches also examined the various tools of management control system: economic value added, costing system, financial and non-financial performance measures and budgeting, among others.

The aim of this paper is not just to unveil eventual accountancy frauds and corporate corruption, but to add to our understanding on the management accounting literature by providing the attributes of management accounting practices and operations management researches.

THE CURRENT SITUATION

As well sustained by Dyck, Morse & Zingales (2019), the media is filled with news of major corporate corruption. Might be the cost to implement governance mechanism to drive fraud to zero is too high for a no fraud regime to be optimal.

Currently, external auditors are increasingly being asked to play an important role to prevent and detect fraud in the organizations. Lennox & Pittman (2010) argue that empirical studies of earnings management, audit pricing, and audit reporting provide extensive evidence that the Big Five public accounting firms are associated with higher quality financial statements.

Earley, Odabashian & Willenborg (2003) for the contrary, blame on the more lenient litigation landscape having a disproportionate impact on Big Five quality as well as market conditions that led them to increasingly pursue lucrative consulting contracts to the detriment of their independence on audit engagements.

As per Vona (2008), "*fraud investigation from the accounting perspective naturally arose from the investigative tenets of auditing. Unfortunately, auditing standards, although requesting that auditors look for fraud, do not provide a way to adapt the existing audit tools to detect fraud".*

Kicil & Kasbasi (2018) argue that accounting scandals experienced in the 21st century has shown that, independent auditing firms do not always fulfill their duties completely. For this reason, legislation was introduced and Public oversight bodies were also established in the United States of America, Europe and Asia.

Despite this, the risk of accounting scandals still continues, because laws, regulations, arrangements and introduction of public oversight bodies are delayed and they are not completely meeting the expectations of the permanently changing market conditions.

Albrecht (2004) sustains that "*whenever management fraud has been studied, it has always been found that is the CEO and CFO who are most involved*".

Directors of listed companies now own only a few percentage of the company's stock and thus do not internalize much of the cost of their decisions.

Hill sustains in his article published in the Vol 23 of The Wisconsin International Law Journal, that:"*The recent worldwide corporate collapses resulted in a reconsideration of the appropriate role of the Board and the nature of its interaction with management"*

There are four different definitions of corporate fraud: i) financial reporting violations that are detected by auditors and other internal controls identified as fraud detectors in Dyck, Morse & Zingales (2010), ii) Accounting and Auditing Enforcement Releases (AAER) from Dechow et al. (2011); iii) financial restatements due to an intentional misapplication of an accounting rule (Audit Analytics); and iv) all material SEC 10b-5 securities.

As will be shown, our case study fits with the third definition: severe financial reporting violations, and failure to apply accounting rules. Financial restatements are caused by a misapplication of an accounting rule. Securities fraud is a broader concept than financial misreporting violations, since any fraud leads to a securities fraud, but not vice versa.

Wang (2013), developed a bivariate probit to identify factors affecting the propensity to commit fraud and the vulnerability of fraud to detection, while Zakolyukina (2018) uses a structural model of earnings manipulation. Both of them suit very well to our case study.

It seems crucial to estimate hidden corporate fraud costs. Dyck, Morse & Zingales (2019) argue that it is hard to calculate them. Is possible to estimate these costs by looking at the changes in stock prices of companies that are likely to have committed a fraud, but were never exposed as fraudulent, like in our case study.

Fortunately, Beneish, Lee & Nichols (2013) perform this exercise, calculating at least a 10.9% difference in returns, as a very conservative estimation of frauds cost to the new stakeholders. This estimation can be used to encourage rigorous cost-benefit analysis of regulation.

As per Kassem & Higson (2012), detecting fraud is not an easy task and requires thorough knowledge about the nature of fraud, why it is committed, and how it can be concealed.

Cressey's fraud theory explained why trust violators commit fraud and was widely used by regulators, professionals, and academics. This work has been conceptualized as "*the fraud triangle*". However, critics of the fraud triangle argued that it cannot help alone in explaining fraud because two factors cannot be observed: rationalization and pressure. Additionally, other important factors like capabilities of the fraudsters, are ignored.

Some researchers suggested that the rationalization side should be replaced by personal integrity because it can be more observable. Other authors recommended that the motive side needs to be expanded to include also non-financial factors like ego and coercion, while others experts suggested a fourth side to be added to the fraud triangle which is *"fraudster's personal capabilities".*

In our specific case study, market´s expectations as well top Managers and Directors compensations pressure, appear as the main reasons behind the corruption.

According to Levi (2008), "*globalization of crime is part of contingent relationships between settings, with their rich and varied opportunities (reflecting patterns of business, consumer and investment activities), the abilities of would-be perpetrators to recognize and act on those opportunities (the 'crime scripts' perspective),and their interactions with controls,* *including law enforcement (touched only lightly upon here). Constructs of ‘organized crime’ should be (and are becoming) less obsessed with the structure of groups than with what people need from the largely illicit and largely licit worlds to go about the business of fraud. In other words, analysis of ‘organized-ness’ is becoming decentred and re-understood as much in terms of the settings in which offending and its precursors can take place as in terms of the acts themselves”*.

A BRIEF REVIEW OF SOME OF THE REPORTED ACCOUNTING FRAUDS

Gordon Institute of Business Science of the University of Pretoria published in SAJEMS (2006) the paper entitled “Using Benford´s Law to detect Data error and Fraud: an examination of companies listed on the Johannesburg Stock Exchange*”* sustaining that ”*Accounting numbers generally obey a mathematical law called Benford’s Law, and this outcome is so unexpected that manipulators of information generally fail to observe the law. Armed with this knowledge, it becomes possible to detect the occurrence of accounting data that are presented fraudulently. However, the law also allows for the possibility of detecting instances where data are presented containing errors. Given this backdrop, this paper uses data drawn from companies listed on the Johannesburg Stock Exchange to test the hypothesis that Benford’s Law can be used to identify false or fraudulent reporting of accounting data. The results support the argument that Benford’s Law can be used effectively to detect accounting error and fraud*”.

Therefore, the tools to prevent fraud are available, the question that arise is if the will to audit also exists. Rezaee (2002) argue that the independent auditor is indeed the *public watchdog,* but, we’ve continued to see too many situations where was asleep, toothless or too old.

As explained by Silverstone & Sheetz (2007), in a conventionally created corporation, ownership of the entity is signified by the issuance of registered shares. Registered shares are exactly that: shares whose ownership is registered on the books of the entity.

Determination of actual ownership and control of the entity at any given point in time is a simple matter of referring to the books. Bearer shares, in contrast, are unregistered. They are owned solely based on possession or physical control of the actual share certificate. There is no registered owner, and determination of actual ownership and control of the corporate entity is difficult where possible at all.

Although some countries now prohibit the issuance of bearer shares, in a number of countries such forms of corporate ownership are still commonplace. This is the situation in our case study.

Several accounting frauds were committed by top level executives with the complicity of the Board of Directors of a giant multinational listed firm, under a pattern of fraud based on artificially altering the outcomes for each year, with the goal of personal gain by receiving bonus payments for the achievement of goals as part of the variable remuneration (the managers) and share price increase when vesting options or stocks (managers and Directors), providing false or misleading information to the market.

All of these frauds were reported and fully documented by a whistleblower within the organization using the proper channels, but no corrective measures were ever taken and no internal investigations were ever conducted, but all of them were covered up by the Board of Directors.

The whistleblower acted with absolute transparency and honesty, reporting the accounting frauds promptly and through regular channels within the same organization and the compliance audit firm.

Moreover, the whistleblower sent several electronic mails to the compliance audit firm, receiving one month later just a brief response communicating that they will take care of the issue, but no requesting from him the offered documentation.

Is important to remark that by the opposite to the Code of Ethics of this Company, based on its provisions that protect and assure the whistleblower, he was harassed by his superiors until forced to leave the firm.

No disciplinary process was ever conducted that would have allowed the investigation, dismissal or corroboration of the alleged facts and the imposition of appropriate sanctions for the internal accounting frauds reported.

The management of a company is always responsible for establishing and maintaining internal control structure and financial reporting procedures. The CEOs and CFOs must be held accountable for the certification of controls and procedures, and must disclose all significant control deficiencies and all acts of fraud of which they become aware. Since are the market, shareholders and creditors are involved, any Report must be true and reliable.

Some of the accounting frauds reported and documented by the whistleblower were:

a) Non-existing goods for a huge amount were included in the auxiliary inventory book that was reported by the subsidiary CEO to the Board of Directors.

b) An enormous downward adjustment of the inventory of goods in the warehouse, never informed, was processed in the accounting software directly by the CEO.

c) A large surcharge was paid, in the framework of a supposed bidding process for the purchase of equipment.

d) The CEO instructed the CFO to register permanently expenses as investments, to reduce their impact in the current annual Ebit, dividing the amount in five years.

Albeit these frauds implies annual millionaire amounts, for the researcher was more important to find out the reasons why these frauds were always covered up by the Board of Directors.

Maybe this case at a subsidiary is not just an isolated one, but a sample of a worldwide corporate mechanism of accounting frauds, that benefits the managers and Directors as well.

THE FOUR PILLARS OF THE STOCK MARKET PYRAMIDAL SCHEME

The first question is how can be possible on the current modern times, in our over connected world, to recreate the sadly famous Ponzi scheme?

The answer is as simple as tough: failure of the basic audit principles.

All stock exchange companies must be audited. But, the audit industry is worldwide concentrated in just five large corporations. More than the 70% of the total audit market is shared by them. There´s no need to explain that the competence between them turns into a real battlefield. The direct consequence of this competition is not just lower prices and wider services package offers, but also more flexible audit processes and less rigid controls, pursuing customer retention.

Every company must send annually an audited report to the Stock Exchange Market authorities. This is also the case, for instance, of an African multinational listed company, integrated by several divisions in different countries and continents. The company uses Ebit valuation method, but registers expenses as *investments* to mitigate the impact in the annual performance, depreciating in a five years term.

This perverse mechanism allows the company to show better outcomes, since it is valued using the Ebit method (Earnings before taxes and interests). For each national IRS it´s not a problem at all, because instead eluding taxes, the company doesn´t deducts expenses.

Let´s assume this firm is divided into geographical zones, supervised by different CEOs, CFOs and auditors.

As per the corporate organigram, every subsidiary sends its reports to the local branch of one of the Big Five audit firms. Later, the local CEO moves forward the report to the corporate CFO & CEO, who gather all the information and present a Consolidated Report to the government and Stock Market authorities.

Tax year in South America runs from January to December, instead from June to July, like in Africa. Therefore, local IRS Audited Balance cannot be ever faced with the P&L Annual report informed by the multinational to the authorities.

The multinational group reports to the market its outcomes consolidated by divisions, not by countries. The foregoing means that nobody can really check the accuracy of the data Informed to the authorities, since different periods of times were considered and the data per country remains undisclosed. The manipulated consolidated reports are signed by the audit firm, which main interest is to retain its large customer.

Certainly, a serious Stock Exchange Market (such as New York or London) would never accept this kind of reports, but, it´s feasible in a less rigorous one, neglect or corrupted.

The combination of the four elements: different periods of time considered, data consolidated by divisions, unduly audited processes and a non-trustable Stock Exchange Market, are the pillars of this unveiled Pyramidal scheme. It reminds to Ponzi since the mechanism needs the continuous entrance of new investors. The result is a share price manipulation, a shining bubble that creates a high demand for a few shares offered, increasing artificially the price.

Although the company achieves poor profits in its commercial operation, It´s seems as an excellent investment for the new stockholders, since the share price is always rising. Kedia & Philippon (2005) argue that misreporting occurs more frequently at greater investment firms.

In our case study, acquisitions and expansion are crucial to show a growing prosper business, even the real gain for the stakeholder is when he vests a few of his shares, collecting the artificial price gape. Maybe it shines, but certainly it´s not gold, the last one will turn off the lights.

CONCLUSIONS AND RECOMMENDATIONS

The confidence of shareholders and the investors were hurt after the accounting scandals and fraud, which started especially at the beginning of the 21st century.

It was felt that, there was a need to supervise independent auditing institutions and to have an independent administrative authority with public power in order to ensure re-emergence of the lost trust environment and to avoid irregularities.

In order to prevent accounting scams, effective legislative must be passed on in the most effective way by public authorities. Accounting scandals and frauds through accounting history showed that, it was not enough to have independent auditors. With the enactment of laws, the establishment of public oversight bodies to oversee independent audit firms began.

Sharing the recommendation of Dada, Owalobys & Okwua (2014) published in their paper “Forensic Accounting, A Panacea to alleviation of Fraudulent Practices in Nigeria” “*is recommended that anticorruption commission will establish a forensic accounting unit and* *experts should be employed to ensure proper investigation of cases of fraud to assist the courts in effective prosecution of persons accused of fraudulent practices".*

The aforesaid is valid for the entire African continent, since according to the findings in our case study, the existing laws, regulations and arrangements did not suffice to avoid accounting scandals and fraud.

To improve this paper, more information can be obtained from the Big Five accountancy firms, interviews with insiders in depth, and so on, and this would be carried out in the form of qualitative research methods.

Hereby the author expresses his willingness to cooperate in any investigation that is initiated to clarify and sanction this Stock Exchange Market fraud, providing supporting documentation.

ABOUT THE AUTHOR

BA Social Sciences, granted by Tel Aviv University, MBA (honors degree & highest thesis qualification) from Universidad de Santiago de Chile and PhD in Business Management, awarded by The University of Bolton´s Institute of Management, Greater Manchester, United Kingdom. His Doctoral thesis tutor was Dr Robert Wood, Emeritus Professor at the Alliance Business School, The University of Manchester. The Preface of his last book, recently published in The United States, was made by the President of Uruguay, Dr Julio Maria Sanguinetti.

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