PREVENTING FRAUDULENT REPORTING: A EUROPEAN PERSPECTIVE

One of the objectives of the EU single market financial regulation is to increase investor protection by reducing financial statement fraud. The mandatory adoption of International Financial Reporting Standards (IFRS) by the European Commission provides a basis for combatting fraudulent financial reporting in European security markets. This session will provide details on the current status of financial and business reporting in Europe. You will also hear suggestions on how to prevent financial reporting fraud during a discussion of future developments and regulations.

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## Introduction

The 2012 *Report to the Nations* states, “Financial statement fraud, which amounts to just 8 percent of reported fraud cases, is the most costly form of occupational fraud, causing a median loss of USD 1 million.”

These numbers vary a lot year by year, depending on the discovery of reported fraud cases and size of the companies. Famous cases for fraudulent reporting range from Enron (U.S.) and WorldCom (U.S.) to Global Crossing (Bermuda), to Polly Peck (UK), Parmalat (Italy), Satyam (India), to Olympus (Japan), just to name a few ([www.en.wikipedia.org/wiki/Accounting_scandals](http://www.en.wikipedia.org/wiki/Accounting_scandals)).

Even the Lehman Brothers case can be related to fraudulent financial reporting as there was a failure to disclose Repo 105 to investors.

*Financial statement fraud* is defined as “deliberate misstatements or omissions of amounts or disclosures of financial statements to deceive financial statement users, particular investors, and creditors” ([Wells: Principles of Fraud Examination](http://www.acfe.org), p. 299).

Financial misstatements are manifold, reaching from inflated revenues to overstating assets, understating liabilities, and other improper accounting (“creative accounting” and “cooking the books”).

Most often, top executives and related parties are the engineers of fraudulent financial and business reporting: from Eddie Antar (“Crazy Eddie”), Andrew Fastow, Bernard Ebbers, and Dennis Kozlowski to the most amazing Ponzi scheme of Bernie Madoff.

It is fairly easy for a top executive to reduce the price of his or her company's stock, due to information asymmetry.
NOTES

(“one party has more or better information than the other”). Cut-off manipulations and window dressing (“takeovers”) lead to valuable stock options, golden handshakes, and other opportunism.

Regulators have tried to create a level playing field through the development of reporting standards (GAAP = Generally Accepted Accounting Standards) and other means to limit accounting scandals. The U.S. Securities and Exchange Commission (SEC) has been seen as a leader in the development of these tools and for effective enforcements of these regulations.

Europe, for a long time, has lagged behind. This is changing with the introduction and mandate of International Financial Reporting Standards (IFRS) and related technology tools, such as eXtensible Business Reporting Language (XBRL). The objective of the EU single market financial regulation is, as well, to increase investor protection. Appropriate infrastructures for auditing information and their enforcement are still being built. World capital markets are growing and being integrated at a fast pace. We need global standards and regulations to limit fraud in financial reporting. At the end of the session you will hear suggestions on future developments and regulations for business reporting. We will discuss trends such as the Global Reporting Initiative (GRI), integrated reporting and increased use of technology tools as a means to reduce reporting fraud. Examples include global payment, payroll, and expense reporting systems.

**Capital Markets Data**

The size of the global capital market is huge when compared to other investments. The market includes stocks (equities), bonds, certificates of deposit (CDs), futures and...
options, and other investment contracts. Opportunities for fraud are abundant.

The World Federation of Exchanges (WFE, www.world-exchanges.org), which moved from Paris to London in January 2014, provides valuable statistics for us to comprehend the importance of the various markets. The WFE is the trade association of 62 publicly regulated stock, futures, and options exchanges. The market operators are responsible for the functioning of key components in the financial world. Let’s take a look at key data for 2012. Updated numbers for 2013 are always available by the WFE at the end of January, so you can see the importance of speed for these markets.

**Equities**

The total global market capitalization is USD 55 trillion (tn) with 46,332 global listings. The largest market capitalization is in the Americas time zone (23 tn), followed by Asia-Pacific (17 tn), and Europe/Africa/Middle East (15 tn). Total value of share trading amounted to USD 49 tn.

By far the largest exchange is the NYSE Euronext U.S. exchange with a market cap of USD 14 tn, followed by NASDAQ and Tokyo and London.

The largest ten companies by market cap (at the fourth quarter 2013) totalled USD just over 3 trillion (Apple, Exxon, Microsoft, Google). By revenue: the largest entities are Wal-Mart, followed by most oil and automotive companies.

**Bonds**

The total turnover value for bonds (cash markets) was USD 26.1 tn. By far the largest market is the
Europe/Africa/Middle East (23 tn), with nearly half of it traded at the BME Spanish Exchanges.

**Other**
The top three exchanges by value of securitized derivatives are Hong Kong, Deutsche Börse, and the Korean Exchange.

Europe is leading the number of listings of Exchange traded funds (ETFs) with 4605 listings.

It is estimated that the derivatives market has a total notional value of USD 1.2 quadrillion and a cash value of at least USD 12 trillion, providing for a huge incentive for speculation and possibly fraudulent transactions (Source: [www.americablog.com/2013](http://www.americablog.com/2013)).

**Currencies**
Probably one of the most hidden and un-researched areas for fraud are the exchange, the transactions for and translations of currencies. Businesses are affected daily from filings of expense reports (including the exchange of cash) to hidden charges by banks and credits cards and the translation of financial accounts. According to the U.S. Federal Reserve as of June 2013, USD 1.2 tn notes and coins were floating around the world going up to 10.5 tn for the M2 (money supply) (M2 = M1 [basically checking accounts] plus all the money held in money market funds, savings accounts, and CDs under USD 100,000). Market share of the USD is estimated around 45 percent. [www.en.wikipedia.org/wiki/Foreign_exchange_market](http://www.en.wikipedia.org/wiki/Foreign_exchange_market)
Capital Markets Regulation and European Infrastructure

Because of the large controlled and uncontrolled trading volumes in the capital markets, governments—from tax authorities to security regulators—are trying to work together on a global scale to bring order to the markets and with it to reduce fraud, such as money laundering and fraudulent reporting.

The recognized global standard setter for the securities-sector regulation and therefore for global reporting issues for listed companies is the International Organization of Security Commissions (IOSCO, www.iosco.org) based in Madrid. IOSCO is a unique organization. Established in 1983, its membership regulates more than 95 percent of the world’s securities markets in more than 110 jurisdictions. The policy work of IOSCO is conducted by seven committees. One of the committees (C1) deals with accounting, auditing, and disclosure and therefore financial reporting of security issuers.

The Members of the Monitoring Board of the International Financial Reporting Standards (IFRS) Foundation include, at this moment, representatives of the Board of IOSCO, the European Commission (EC), Financial Services Agency of Japan (JFSA), the U.S. SEC, and the Basel Committee on Banking Supervision as an observer. IOSCO also issues an IFRS database.

IOSCO issues research reports, such as “IOSCO Securities Market Risk Outlook for 2013–2014” and other reports like “Cyber-crime in securities markets”. IOSCO’s investor alerts are also helpful to combat fraud.

Now let’s take a look at European Regulation.
European security markets are regulated by individual member states. However, since January 1, 2011, EU-level authorities are responsible for ensuring that rules applicable to the financial sector are implemented adequately. It is a kind of oversight. The authorities are the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and two other bodies: one for pensions (EIOPA) and one for systemic risk (ESRB).

ESMA is the responsible entity for financial reporting issues. ESMA’s five main objectives are:

- Creating a single rulebook across the EU
- Supervision of credit rating agencies and trade repositories
- Supervisory convergence in EU securities law application
- Investor protection
- Financial stability in the EU

**International Financial Reporting Standards (IFRSs)**

ESMA has a clear mandate to enhance supervisory convergence and ensure consistent application of IFRS. Originally, to implement a “financial reporting strategy” adopted by the European Commission (EC) in June 2000, the EU in 2002 approved a regulation (International Accounting Standards [IAS] Regulation, the predecessor of IFRS) requiring all 7,000–8,000 listed companies to follow IFRS starting in 2005. Under the EU IAS Regulation, IFRS must be individually endorsed for use in Europe. The endorsement process involves the following steps: EU translates the IFRSs into all European languages and the private-sector European Reporting Advisory Group (EFRAG) gives its endorsement advice to the EC. The EC in turn gets approval from the EU Council and Parliament. It is a slow but safeguarded process.
There are other EU directives on statutory audits, transparency, and responsibility of board members for a company’s financial statements. In addition the EU has equivalency agreements for financial reporting standards with several countries, including China, Canada, Japan, Switzerland, and the United States.

Since November 2007, the SEC permits foreign, private issuers to submit financial statements prepared using IFRS as issued by the International Accounting Standards Board (IASB) without having to include a reconciliation of the IFRS figures to U.S. GAAP. The SEC has not made a policy decision whether IFRS should be incorporated into the domestic U.S. financial reporting system.

As mentioned, the individual EU member states are responsible for security activities in their countries. For example, in Germany, it is the Federal Financial Supervisory Authority or BaFin (German: Bundesanstalt für Finanzdienstleistungsaufsicht). BaFin supervises about 700 banks, 800 financial services institutions, and more than 700 insurance entities.

BaFin has the right, when it discovers a crime or the suspicion of a crime—in particular insider trading, market manipulation, illegal operation of banking, financial fraud, or incitement to establish stock exchange speculation—to forward it to law enforcement authorities. BaFin is in effect a law enforcement agency and can initiate legal action.

However, most issues relating to accounting standards are dealt with by the Accounting Standards Committee of Germany. For enforcement procedures, they are supported by the Financial Reporting Enforcement Panel or Deutsche Prüfstelle für Rechnungslegung.
Individual company financial statements prepared under IFRS or local German GAAP are filed with a private entity called *Bundesanzeiger* (Federal Registry).

Most of Europe, in fact most countries of the world, are now using International Financial Reporting Standards (IFRS) for financial reporting.

IFRS and IAS are developed and published by the International Accounting Standards Board (IASB), an international non-governmental organization, operationally based in London but legally registered as a not-for-profit entity in Delaware, USA.

The IASB was preceded by the International Accounting Standards Committee (IASC), also based in London and founded in June of 1973 by nine professional accountancy bodies from the U.S., UK, Canada, Australia, Japan, Germany, France, Mexico, and the Netherlands.

In 2001, the old part-time IASC was restructured into the full-time IASB under the oversight of a new IFRS Foundation. In the 12 years since the reform of the IASC, the IASB has produced many new standards it inherited from the IASC. More than 100 jurisdictions around the globe have now adopted IFRS.

The structure and operation of the IASB is very transparent. Organizationally the IFRS Foundation (www.ifrs.org) has 22 trustees (watched by a Monitoring Board, as mentioned before). Trustees come from different geographies and have various backgrounds. The working body, the IASB, has 16 members. The group is required to represent the best available combination of technical expertise and diversity of international business and market experience. Many of
them come from the large global accounting firms and are paid competitively.

Transparency is provided by holding all technical discussions in public (and usually webcasted), providing public access to staff papers, ensuring that the IASB and the related Interpretations Committee (IC) have sufficient information to be able to make decisions based on the staff recommendations. A final standard or interpretation must be approved by at least 10 of the 16 members of the IASB. Accountability is provided through such means as effects analysis and the basis for conclusions (and dissenting views) accompanying an IFRS. The IASB is supported by various advisory bodies that provide input.

The IASB has restarted its project on the development of the *conceptual framework*, which focuses on the following:

- Reporting entity
- Elements of financial statements (including recognition and de-recognition)
- Measurement
- Presentation and disclosure

The IASB published a discussion paper in July 2012 addressing these issues. The comment period closed January 14, 2014.

The IAS 1–41 (with some standards being superseded) and IFRS 1–13 currently cover various financial reporting topics. The standards are supported by interpretations, which are part of IASB’s authoritative literature. The IFRS for small- and medium-size enterprises (SMEs) is a self-contained standard written on fewer than 230 pages, designed to meet the needs and capabilities of SMEs, which account for the large majority of all business entities around the world. IFRSs for SMEs are less complex and
are arranged by topic and are, in combination with the comprehensive IFRS glossary, an ideal learning tool for understanding the full set of IFRS.

There is also an IFRS Practice Statement (not a standard) to assist management in presenting useful management commentary that relates to Financial Statements that have been prepared in accordance with IFRS. It is similar the MD&A required for SEC filings in the United States.

Elements of the management commentary are:
- Nature of the business
- Objectives and strategy
- Resources, risks, and relationships
- Results and prospects
- Performance measures and indicators

Instead of going through each standard, below is an outline of what a typical standard is made up of:
- Introduction: Reasons for issuing the IFRS and main features
- Objective and scope
- Recognition and measurement
- Presentation and disclosure
- Transition, effective date, withdrawal, and amendment of other IFRS
- Approval of the board, basis for conclusions, and implementation guidance

In contrast to the United States, which has codified all the financial reporting standards by topic, the IASB has not yet codified their standards (i.e., sorted them by topic).

For easier international comparison, here is a list of IFRS topic summaries indicating in which standard the topic is dealt with (main standards only):
| Accounting policies, accounting estimates, and errors (IAS 8) |
| Accounting principles and applicability of IFRS (conceptual framework) |
| Agriculture (IAS 41) |
| Business combinations (IFRS 3) |
| Cash flow statements (IAS 7) |
| Consolidated and separate financial statements (IFRS 10 and IAS 27) |
| Disposal of subsidiaries and businesses and non-current assets (IFRS 5) |
| Earnings per share (IAS 33) |
| Employee benefits (IAS 19) |
| Events after the reporting period and financial commitments (IAS 10) |
| Fair value measurement (IFRS 13) |
| First-time adoption of IFRS (IFRS 1) |
| Foreign currencies (IAS 21) |
| Impairment of assets (IAS 36) and intangible assets (IAS 38) |
| Interim financial reporting (IAS 34) |
| Inventories (IAS 2) |
| Investment property (IAS 40) |
| Joint ventures (IFRS 11 and 12, IAS 28 and 31) |
| Leasing (IAS 17) currently under review |
| Operating segments (IFRS 8) |
| Presentation of financial statements (IAS 1) |
| Property, plant and equipment (including borrowing costs) (IASs 16, 23) |
| Provisions, contingent liabilities, and contingent assets (IAS 37) |
| Related-party disclosures (IAS 24) Need work from a fraud standpoint |
| Revenue and construction contracts (IASs 18, 11) revised standard coming soon |
| Service concession arrangements (IFRIC 12) |
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- Share-based payments (IFRS 2)
- Taxation (IAS 12 – Income Taxes)

Important standards to be knowledgeable of as a CFE (besides revenue recognition) include: Stock options, interim reporting (for timing differences) and valuation standards for inventories, PP&E and investment property, and IAS 37 for the proper reporting of liabilities. Reporting tools for financial instruments (for financial service companies, banks, and insurance companies) are still being developed further to be integrated into a full set of IFRSs.

As we know, most financial reporting fraud occurs in revenue (sales) recognition. A new revenue recognition standard, being jointly developed over the last several years by the U.S. Financial Accounting Standards Board (FASB, [www.fasb.org/home](http://www.fasb.org/home)) and the IASB should provide for more clarity and transparency in this area. International valuation standards are now more promoted by the International Valuation Standards Council (IVSC) and should add sophistication to this field.

International Public Sector Accounting Standards (IPSAS), which are used by governments (e.g., the EU administration) to do their accounting and reporting are based on IFRS and should make the integration and comparison easier in the long run.

For further information on resources about IFRS see the separate hand-out provided to you or download from [http://issuu.com/accountantme/docs/accountant_july-aug_2013_low_res_fo](http://issuu.com/accountantme/docs/accountant_july-aug_2013_low_res_fo) pages 58–61.

The large accounting firms publish Disclosure Checklists and Model Financial Statements to assist in the compilation of data.
**eXtensible Business Reporting Language and Technology**

In fact the Model Financial Statements were used to create the first IFRS XBRL taxonomy. eXtensible Business Reporting Language (XBRL) is a free software tool that provides the means by which financial information can be collected, collated, transmitted, and analysed with remarkable rapidity and accuracy.

XBRL is a XML language. It is a means of modelling business information in a form understandable by computer applications.

XBRL is rapidly becoming the mandated reporting language for publicly listed companies in many countries. A fundamental element by which XBRL and IFRS garner continued and accelerating success lies in the application and creation of the taxonomy. In general, taxonomy means a catalogue or a set of rules for classification. In other words, taxonomies are dictionaries of XBRL elements used to tag information in XBRL applications. For example the IFRS XBRL taxonomy contains financial statement elements. Besides common elements the user can extend or add tag elements to the taxonomy to provide further detailed information (e.g., a taxonomy travel expenses could be broken down into hotel expenses and airline tickets).

*Link bases* (also called layers) are the components of a taxonomy that provide information about relationships among elements and link them with specified external resources.

1. The *label link base* provides human-readable strings. A real bonus is for IFRS, since different languages can easily be compared: German versus English labels.
2. The *reference link base* associates connections with concepts (e.g. IFRS standards).
3. The *calculation link base* associates concepts with other concepts so that the values appearing in an instance document (e.g., balance sheet) can be checked for consistency.
4. The *definition link base* associates concepts with other concepts using a variety of arc roles and is very technical.
5. The *presentation link base* associates concepts with other concepts for rendering or visualization. Inline XBRL (iXBRL) is used to preserve a human and machine readable presentation. It is used for block tagging (often used HTML tags) as the tags are embedded in the soft copy.

The U.S. Securities and Exchange Commission (SEC) requires XBRL tagging of quarterly and annual reports on Forms 10-Q and 10-K, and certain other filings. This requirement was phased in over three years, and the phase-in period ended in June 2012. The rule also provided a temporary limitation of liability for XBRL filings, which has now expired for virtually all companies. The most challenging aspects of XBRL reporting continue to be in the final review process, the validation, and the mapping and tag selection process. Source: “SEC reporting and the impact of XBRL” and “Data Mining with XBRL”, both from FEI, November, December, 2013.

It is important that international codes are developed for object identification and tracking. Each XML document contains one or more elements, usually marked by a start and end tag (<…> and </…>). Tags basically describe the data. Examples are the IBAN code for banking transactions and the legal entity identifier (LEI) promoted by the European Central Bank. In fact, in Europe, the banking
sector and tax authorities are more active in developing XBRL than the securities regulators. In December 2013, the European Banking Authority (EBA) published its XBRL taxonomy to be used for remittance of data under the Implementing Technical Standards (ITS) on supervisory reporting. The UK tax authority, HM Revenue & Customs, has made it compulsory for companies to send their company tax returns online using iXBRL (inline XBRL, as discussed before).

XBRL will be an important tool to compare financial reports presented in different languages and make them available to a larger audience, increasing transparency. As a requirement for the adoption by the European Union, the IFRS Foundation started early to translate the standards into various languages. IFRS are now available in nearly 50 languages and the XBRL IFRS taxonomy is published in the major languages. IFRS and XBRL implementation complement each other and will provide impetus for the further standardization of financial reporting. In contrast to IFRS, XBRL reaches into areas such as common business reporting, taxation, and technology development. The automation of the valuation and reporting supply chain should enhance the data quality and assist in their assurance. These globalization efforts in standard setting (IFRS), technology (XBRL), and the force of the global assurance and consulting practices should help in preventing (or reducing) fraudulent financial reporting and are tools for CFEs to become familiar with. XBRL reduces the amount of data mapping and the pain of the so called spreadsheet hell.

**Payroll and Expense Reporting Systems**

Two further examples how globalization and technology will have a dramatic effect on reducing fraud are the developments to provide services (including cloud
computing) and manage people-related areas on a world scale—global payroll services and global expense reporting.

The global payroll landscape has continued to change dramatically over the last ten years. New providers, technology, vendor-service delivery models, and global capabilities have made payroll administration possible, at least conceptually, across complex global organizations.

Payroll is, and will continue to be, one of the most frequently outsourced business processes. With second-generation business process outsourcing (BPO) providers maturing in their offerings, global payroll services are becoming an important tool to fight corruption and fraud. Source: “Global payroll survey”, EY, 2013.

Larger corporations are increasingly improving their global expense reporting and management systems, integrating them with online booking and activity reporting (time sheets). Better and faster data analytics identify violations to quickly take corrective action. Again, complex legislative rules—such as VAT reclaim, income tax deduction rules, mobile capabilities, and receipt imaging—are incentives for companies to use common systems. Source: BTN’s Expense Manager Survey, 2013, www.businesstravelnews.com.

The Way Forward
Despite these helpful tools to combat fraud, new challenges are laying ahead: Will reporting fraud shift from financial reporting fraud to business reporting fraud? With more global standards and global industry comparisons in place, stock and share option prices are less and less affected by financial numbers alone. Investors prefer to invest in transparent enterprises and seek other information besides
physical and financial assets such as human capital risk management, brand management, carbon exposure, innovation, etc.

In Europe we see already a greater emphasis on sustainability reporting and discussions are forming around integrated reporting on a global scale. The leader in setting standards for sustainability reporting is the Global Reporting Initiative, based here in Amsterdam. GRI has pioneered and developed a comprehensive Sustainability Reporting Framework that is widely used around the world. A sustainability report is a report published by a company or organization about the economic, environmental, and social impacts caused by its everyday activities. A sustainability report also presents the organization’s value and governance model, and demonstrates the link between its strategy and its commitment to a sustainable global economy. G4, just published in 2013, is the latest version of GRI’s Sustainability Guidelines—the core document in its Reporting Framework (www.globalreporting.org).

A similar initiative has been started in the United States with the formation of the Sustainability Accounting Standards Board (SASB). They have a strong industry- or sector-specific reporting focus. The SASB’s Conceptual Framework sets out the basic concepts and definitions behind SASB’s sustainability accounting standards and serves as additional guidance for the adoption of the standards by corporations and the use of material sustainability information by investors. SASB’s work is more aligned to the U.S. legal requirements and environment. www.sasb.org

On December 17, 2013, the SASB signed a Memorandum of Understanding (MoU) with the International Integrated Reporting Council (IIRC) to more closely collaborate to
advance the evolution of corporate disclosure and communicate value to investors.

The IIRC, based in London, is a global coalition of regulators, investors, companies, standard setters, the accounting profession, and NGOs. Together, this coalition shares the view that communication about businesses’ value creation should be the next step in the evolution of corporate reporting. The IIRC released a framework based on worldwide input on December 09, 2013 (www.theiirc.org). For further information see the hand-out “Integrated Reporting and Intellectual Capital”.

Summary
Potential “rewards” for fraudulent reporting are high, and it is the most costly form of occupational fraud. In the past, litigation for financial reporting fraud has been pursued over-proportionally in the United States. Reasons include an incentivized management remuneration system based on stock options and bonuses, governance structures, and sophisticated reporting rules and standards as a base for tailored legal actions.

International reporting standards and technologies, such as IFRS and XBRL are now applied on a global basis to provide a level playing field. Despite the 24 official languages spoken in the 28 different countries in the EU, progress has been made to implement a better infrastructure to increase investor protection and communication.

The newly gained transparency should reduce occupational fraud in this area and with “integrated thinking”. In combining financial numbers and sustainability, corporate disclosure and the communication value for investors should improve. With greater transparency, plus global standards and speedy technology, we will hopefully see
financial reporting lose its costly first place in future *Reports to the Nations*.

**Two Hand-outs (Supplementary Materials)**