iJETRM
International Journal of Engineering Technology Research & Management
(IJETRM)
https://ijetrm.com/

CAUSES AND MOTIVES OF FINANCIAL STATEMENTS FRAUD

Prof. Janka Dimitrova, Ph.D.
Full professor in Accounting and Audit, Faculty of Economics,
University Goce Delcev, Stip
janka.dimitrova@ugd.edu.mk

Eftimija Dimitrova, MSc
eftimijadimitrova@yahoo.com

ABSTRACT
Reliable financial reporting is the basis for economic decision-making by investors, creditors, regulators and other stakeholders. Financial statements should provide a true and objective presentation of the financial position, performance and cash flows of business entities. However, numerous corporate scandals in recent decades have shown that financial statements can be deliberately distorted in order to mislead users of financial information.
Fraud in financial statements poses a serious threat to the reliability of financial reporting and to the confidence of investors, creditors and other stakeholders. Fraud in financial statements, although less common than other forms of corporate fraud, has far-reaching consequences. They can lead to significant financial losses, erosion of confidence in financial markets, and serious legal and reputational consequences for companies and individuals. The identification and analysis of the causes and motives of such fraud is of particular importance for the accounting and auditing profession. Therefore, scientific and professional interest in the causes and motives of such fraud is constantly present. The aim of this paper is to analyze the main causes and motives for fraud in financial statements by applying relevant theoretical models and empirical knowledge from the literature, as well as to consider the implications for the audit profession.

Keywords:
fraud, financial reporting, economic decisions, audit risk, corporate controls

INTRODUCTION

Misrepresentations in financial statements may result from fraud or errors. The factor that separates fraud from error is whether the underlying action that results in the mispresentation of financial statements is intentional or unintentional.
The term "error" refers to inadvertent misrepresentations in financial statements, including the omission of a given amount or disclosure.
The term "fraud" refers to a deliberate act by one or more individuals of management, those in charge with governance (management fraud), employees (employee fraud), or third parties that involve the use of fraud to gain an unfair or unlawful advantage.
Fraud is a broad legal concept, but the auditor's main concern is with respect to fraud that causes material misrepresentations in the financial statements. It differs from error, which occurs when material misrepresentation is caused by error, for example, in the application of accounting policies. In particular, there are two types of fraud that cause material misrepresentations in financial statements:

- Financial reporting that contains fraud.
- Unauthorized misappropriation of assets.

Fraudulent financial statements include intentional misrepresentations, including omissions of amounts or disclosures in financial statements to mislead users of financial statements. Fraudulent financial reporting can be achieved by:

- manipulating, falsifying, or tampering with accounting records/supporting documentation;
- Misrepresentation (or omission) of events or transactions in financial statements;

iJETRM
International Journal of Engineering Technology Research & Management
(IJETRM)
https://ijetrm.com/

- Intentional misapplication of accounting principles.

Such fraud may be committed by circumventing controls that would otherwise have been shown to work effectively, for example, by recording fictitious transactions in the general ledger or by improper corrections to assumptions or estimates used in financial reporting. The pursuit of higher earnings is an ongoing issue and, in the extreme case of aggressiveness, financial disclosure containing fraud may occur.

Unauthorized misappropriation of assets constitutes theft of an entity's assets (e.g., cash, inventory). Employees may be involved in such fraud in small and intangible amounts, however, it may also be carried out by management for larger items that may then conceal the unauthorized appropriation, for example through:

- embezzlement of bills (e.g., by diverting them to private bank accounts);
- Theft of physical assets or intellectual property (e.g., theft of inventories for personal use or sale, theft of leftovers for resale, conspiring with a competitor by disclosing technological data in return for payment);
- Inducing the company to pay for goods that are not received (e.g., payment to fictitious suppliers, bribes paid by suppliers to merchants for the entity's procurement in return for inflated prices, payment to fictitious employees); and
- Use of the entity's assets for personal use (e.g., using the entity's assets as collateral for a personal loan or a loan to a related party).

Fraud in financial statements is defined as the intentional misrepresentation or omission of information in financial statements in order to mislead users (ACFE, 2022). It is most often carried out through the manipulation of income, expenses, assets, or liabilities and is usually initiated by management.

Unlike errors, which are unintentional, fraud is characterized by the existence of intent and a conscious decision to violate accounting principles and legal regulation. This intent makes fraud more difficult to detect and significantly increases the audit risk.

LITERATURE REVIEW

The scientific literature on fraud in financial statements begins with the sociological research of Cressey (1953), who first formulated the concept of the Fraud Triangle. This model lays the foundation for understanding fraud as a result of a combination of individual and organizational factors and remains the dominant theoretical framework in contemporary audit research.

Later research has expanded on this concept in order to better explain complex corporate fraud. Wolfe and Hermanson (2004) develop the Quadrilateral (Diamond) model of fraud, emphasizing the role of ability as a critical factor in the realization of fraud, especially in senior management.

The empirical literature identifies a number of determinants associated with fraudulent financial reporting. Beasley (1996) establishes a strong negative correlation between board independence and the occurrence of financial fraud. Dechow et al. (2011) further suggest that companies involved in fraud are often characterized by poor financial performance, aggressive growth, and complex transactions.

Earnings management research has shown that flexibility in accounting standards can be used as a means of manipulation, which in certain situations turns into fraud (Healy & Wahlen, 1999).

A significant part of the literature is devoted to the impact of International Financial Reporting Standards (IFRS) on the quality of financial reporting. Ball (2006) points out that the principled nature of IFRS increases transparency, but at the same time increases the importance of professional judgment, which may pose a potential risk of manipulation.

From a regulatory perspective, the introduction of stricter corporate governance and audit oversight mechanisms, such as the Sarbanes–Oxley Act, is seen as a direct response to major corporate scandals and has had a significant impact on reducing fraud risk (Healy and Palepu, 2003).

RESEARCH METHODOLOGY

The methodological part of this paper aims to systematically examine the causes and motives of fraud in financial statements and their relationship to audit risk. Based on the literature review, the following research questions are formulated:

1. What factors are most commonly associated with the occurrence of fraud in financial statements?
2. What is the role of corporate governance and internal controls in fraud prevention?
3. How are auditors adjusting their procedures in response to the increased risk of fraud?

iJETRM
International Journal of Engineering Technology Research & Management
(IJETRM)
https://ijetrm.com/

Research is based on a qualitative and quantitative secondary research approach. Qualitative analysis is conducted through a systematic review of relevant academic literature, professional reports, and regulatory documents. The quantitative aspect relies on the analysis of existing empirical studies and secondary data published by relevant institutions.
Data are collected through the analysis of scientific papers published in reputable journals in the field of accounting and auditing, as well as through reports from the International Federation of Accountants (IFAC), the Association of Certified Fraud Examiners (ACFE) and regulatory bodies. The analysis is carried out using a comparative method and synthesis of findings in order to identify common patterns and trends.
As with any research based on secondary data, there are certain limitations, especially with regard to the generalization of findings and their applicability in different institutional contexts. These limitations form the basis for future research with primary data.

FRAUD IN FINANCIAL STATEMENTS

Fraud in financial statements is one of the most serious and complex problems in the field of financial reporting and auditing, as it directly impairs the reliability of financial information and compromises users' confidence in financial information. In a substantive sense, fraud implies a deliberate act or omission, committed in order to mislead the user of the financial statements, whereby the perpetrator derives a particular benefit or avoids adverse consequences. (Wells, 2017).
Unlike unintentional errors, fraud is characterized by deliberate intent, planning, and concealment, which greatly increases their complexity and makes it difficult to detect them in a timely manner.
In the context of auditing, fraud in financial statements is most often associated with activities undertaken by management or people involved in management, which have the potential to affect financial reporting.
These activities may manifest themselves through manipulation, falsification or alteration of accounting records and supporting documentation, intentional omission or misrepresentation of transactions and events, and misapplication of accounting policies. Particularly risky are situations in which management has discretion in applying assessments and judgments, as they allow room for subjectivity and potential abuse.
In terms of classification, fraud in financial statements can be grouped into two main categories (Dorminey et al., 2012).
- The first category includes fraud related to *false financial statements*; whereby financial statements are intentionally misrepresented to show a better financial condition or performance of the entity. These frauds often include overestimation of income, underestimation of expenses, unreasonable capitalization of expenses, manipulation of reservations and impairments, and misclassification of items in financial statements. These frauds are particularly serious because they directly mislead investors and creditors in their decision-making.
- The second category of fraud refers to *the misuse or misappropriation* of legal entity's assets. These frauds are most often committed by employees or managers and may include theft of cash, misuse of inventories, fictitious payments, or unauthorized use of the entity's property. Their cumulative impact can be significant, especially when it comes to long periods of time and weak internal controls.

Fraud Triangle

The causes of fraud in financial statements are complex and interrelated, and in audit theory they are most often explained in terms of the concept of the "*fraud triangle*" (Nelson, 2009).
The fraud triangle, originally formulated by Cressey (1953), provides a basic theoretical framework for understanding the causes of deceptive behavior. According to this model, fraud occurs as a result of the simultaneous existence of three factors: pressure, opportunity, and rationalization.

International Journal of Engineering Technology Research & Management
(IJETRM)
https://ijetrm.com/

Figure 2 Fraud Triangle

This concept encompasses three key factors that contribute to the commission of fraud: *pressure, opportunity,* and *rationalization.*

Pressure is a motivating factor that pushes an individual toward fraud. In a corporate context, this pressure most often stems from financial problems, the need to meet market expectations, or management's personal financial obligations.
Common sources of pressure:

- Financial difficulties (losses, liquidity problems)
- Need to meet targets (profit, EBITDA, revenue)
- Pressure from investors, banks or owners
- Personal financial problems (loans, gambling, luxury lifestyle)
- Fear of losing your job or position

The opportunity of fraud arises when there are weaknesses in the internal control system, insufficient division of duties, or ineffective oversight. The opportunity arises when there are weaknesses in internal control systems and corporate governance that allow fraud to be committed and concealed without significant risk of detection.
Fraud occurs when there is an opportunity – weaknesses in the system that allow manipulation without detection.
Key factors:

- Weak or dysfunctional system of internal controls
- Concentration of Power in Management
- Lack of oversight by a board or audit committee
- Complex accounting estimates (reservations, valuations, depreciation)
- Inadequate or formal audit

Rationalization is the psychological mechanism by which the perpetrator justifies fraud as an acceptable, temporary, or necessary procedure.
Typical justifications:

- "I'm just borrowing it; I'll pay it back later"
- "Everybody does it"
- "The company owes me"
- "This is for the good of the company"
- "There is no real harm"

iJETRM
International Journal of Engineering Technology Research & Management
(IJETRM)
https://ijetrm.com/

Fraud Diamond

Wolfe & Hermanson (2004) extend the model by adding the fourth element, capability. This element emphasizes the role of the perpetrator's individual skills, position, and authority, which enable him to successfully commit and conceal the fraud.

Figure 2 Fraud Diamond
Source: Wolfe & Hermanson (2004)

The Fraud Diamond expands on the classic Fraud Triangle by adding the element of capability, emphasizing that fraud depends not only on pressure, opportunity, and rationalization, but also on the individual knowledge, position, authority, and ability of the perpetrator to commit and conceal the deception.

MAIN CAUSES AND MOTIVES FOR FRAUD IN FINANCIAL STATEMENTS

Pressure to Deliver Better Financial Results

One of the most significant motives for fraud in financial statements is the pressure to show steady growth and profitability. Research shows that companies facing financial difficulties are more likely to resort to manipulation (Dechow et al., 2011) such as:

- Displaying Higher Profits
- Reducing or concealing losses
- Revenue and Expenditure

Examples:

- Early Recognition of Income
- Deferral of expenses
- Unrealistic accounting estimates
- Fictitious income
- Overvalued assets
- Undervalued liabilities
- Reservation manipulation
- „Creative accounting“

Fulfillment of contractual obligations and covenants

iJETRM
International Journal of Engineering Technology Research & Management
(IJETRM)
https://ijetrm.com/

Loan agreements often contain financial covenants that require the maintenance of certain financial indicators. Failure to meet these conditions may result in a withdrawal of funding, which creates a strong incentive for fraud. The reasons for the fraud would be:

- Fulfillment of banking covenants
- Getting New Loans
- Credit Rating Improvement

Impact on company valuation

Manipulation of financial statements may be aimed at increasing the value of a company in situations of merger, takeover, or listing. In such cases, financial reporting becomes a means of strategic influence on investors due to:

- Attracting investors
- Sale of the company
- Initial Public Offering (IPO)

Personal benefit of management

Reward systems linked to financial performance create potential conflicts of interest. Research suggests that a high proportion of profit-based bonuses increases the likelihood of fraudulent financial reporting (Healy & Wahlen, 1999). Here are some of the key takeaways:

- Bonuses related to results
- Stock options
- Retention of the Governing Position

Tax motives

Although tax evasion is often considered separately, in practice it is closely related to fraud in financial statements, particularly through the deliberate reduction of reported gains due to:

- Reducing the tax liability
- Showing less gain

Weak corporate governance and dysfunctional internal controls are significant factors that increase the likelihood of fraud. Boards of directors, audit committees, and internal audit have a key role to play in fraud prevention and detection.

IMPLICATIONS OF FRAUD ON AUDITS

Understanding the causes and motives of fraud is directly related to the assessment of inherent and control risk within the broader audit risk model.

The following tabular overview summarizes the relationship between the key causes and motives of fraud in financial statements, their consequences and typical audit responses, in accordance with International Standard on Auditing (ISA) 240 and relevant scientific literature.

Cause	Motive	Consequence	Audit Response
Financial pressures and weak liquidity	Displaying higher profits	Overvalued revenues and funds	Enhanced Analytical Procedures and Revenue Tests (IFAC, 2022)
Weak internal controls	Personal benefit of management	Manipulation of costs and reservations	Testing controls and increasing the scope of substantive tests (ACFE, 2022)
Pressure from investors and creditors	Fulfillment of covenants	Skewed financial indicators	Third-party confirmations and contract analysis (Dechow et al., 2011)

iJETRM
International Journal of Engineering Technology Research & Management
(IJETRM)
https://ijetrm.com/

Principled application of IFRS	Manipulation through professional judgment	Unrealistic valuations and fair values	Rethinking accounting estimates and expert opinions (Ball, 2006)
Poor oversight by the board	Retention of a Managerial Position	Long-Term Material Misrepresentations	Communication with the audit committee and increased professional skepticism (Beasley, 1996)

ISA 240 emphasizes the responsibility of auditors to consider the risks of fraud when planning and executing an audit. Understanding the motives and causes of fraud allows for a more effective risk assessment and the application of appropriate audit procedures.
International financial reporting standards aim to increase the transparency and comparability of financial statements. The application of IFRS, particularly standards related to the recognition of income, financial instruments and disclosure, can significantly reduce the scope for fraud through clearly defined rules and disclosure requirements.
However, IFRS are largely principle-oriented standards, which implies significant use of professional judgment. This creates a potential risk of manipulation, especially in areas such as fair value assessments, asset depreciation, and reservations (Ball, 2006).
Auditors have a key role to play in ensuring that management's professional judgment is reasonable and based on relevant evidence. In this context, the implementation of ISA 240 and increased professional skepticism are essential.

EMPIRICAL RESEARCH ON FRAUD IN FINANCIAL STATEMENTS

Empirical research on fraud in financial statements provides significant evidence of factors that increase the likelihood of fraud. A number of studies have used financial indicators, corporate governance characteristics, and market behavior data to identify patterns associated with fraudulent financial reporting. Dechow et al. (2011) show that companies involved in material accounting misrepresentations often have poor profitability, high revenue growth, and significant dependence on external funding.
Other research suggests that the concentration of power in executive management and the weak role of independent directors are strongly associated with fraud (Beasley, 1996). These findings confirm the importance of effective corporate governance as a prevention mechanism.
Various models for early detection of fraud have been developed in the literature, the most famous of which is the Beneish M-score model. Beneish (1999) shows that a combination of financial ratios can identify companies with increased risk of profit manipulation with relative accuracy. These models have significant practical applications as an additional tool for auditors and regulators.

CONCLUSION

Analysis of the causes and motives of fraud in financial statements provides a key theoretical and practical basis for understanding fraud risk. The integration of theoretical models, empirical research, and analysis of famous corporate scandals allows for a comprehensive approach to this complex phenomenon. The tabular overview further highlights the link between the motives for fraud and specific audit responses, which is essential for advancing audit practice and the regulatory framework.
Fraud in financial statements is the result of a complex interaction of individual motives and organizational weaknesses. Theoretical models such as the Fraud Triangle and the Fraud Diamond provide a useful framework for understanding this phenomenon and for developing more effective prevention and detection mechanisms.

REFERENCES

[1] ACFE. (2022). *Report to the Nations: Global Study on Occupational Fraud and Abuse*. Association of Certified Fraud Examiners.
[2] Cressey, D. R. (1953). *Other people's money: A study in the social psychology of embezzlement*. Free Press.
[3] Dechow, P. M., Ge, W., Larson, C. R., & Sloan, R. G. (2011). Predicting material accounting misstatements. *Contemporary Accounting Research, 28*(1), 17–82.

iJETRM
International Journal of Engineering Technology Research & Management
(IJETRM)
https://ijetrm.com/

[4] Healy, P. M., & Wahlen, J. M. (1999). A review of the earnings management literature and its implications for standard setting. *Accounting Horizons, 13*(4), 365–383.
[5] IFAC. (2022). *International Standard on Auditing 240: The Auditor's Responsibilities Relating to Fraud*. International Federation of Accountants.
[6] Wolfe, D. T., & Hermanson, D. R. (2004). The fraud diamond: Considering the four elements of fraud. *The CPA Journal, 74*(12), 38–42.
[7] Ball, R. (2006). International Financial Reporting Standards (IFRS): Pros and cons for investors. *Accounting and Business Research, 36*(sup1), 5–27.
[8] Beasley, M. S. (1996). An empirical analysis of the relation between the board of director composition and financial statement fraud. *The Accounting Review, 71*(4), 443–465.
[9] Beneish, M. D. (1999). The detection of earnings manipulation. *Financial Analysts Journal, 55*(5), 24–36.
[10] Healy, P. M., & Palepu, K. G. (2003). The fall of Enron. *Journal of Economic Perspectives, 17*(2), 3–26.
[11] Turner, L. E. (2002). Learnings from WorldCom's accounting scandal. *Accounting Horizons, 16*(4), 347–356.