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Aspects of Management Control Philosophy that Contribute to Fraudulent Financial Reporting

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This paper examines the association between management control philosophy and the releasing of false financial statements. It identifies four factors that contribute to poor management control philosophy and how they influence financial statement reporting. Using a sample of 113 firms that were convicted of fraudulent financial reporting, drawn from the five-year period 1992 to 1996, the results show that fraud is more likely to occur when the firm has a poor management control philosophy, weak control structures, and a strong motive for engaging in a financial statement fraud. Indicators of a poor management control philosophy are a large number of related party transactions, the continuing presence of the firm's founders, and the absence of a long-term institutional investor. The findings suggest that auditors should be sensitive to both the firm's management control philosophy as well as its control structures.

INTRODUCTION

Recently, the media has been reporting a number of accounting scandals and bankruptcies involving companies such as Sunbeam Corp., Kmart Corporation, Enron Corp., and Global Crossing Ltd. Consequently, both investors and the Securities and Exchange Commission are raising questions about the quality and integrity of the financial reporting process (Browning 2002). The profession (Committee of Sponsoring Organizations (COSO) of the Treadway Commission 1992; Public Oversight Board (POB) 1993) has recommended that one means of improving the quality of the financial information released by firms is to enhance the level of control over the reporting process. This paper investigates an under-explored aspect of financial statement control, namely, management's control philosophy, and it tests the relationship between a control philosophy and fraudulent financial reporting.

Firms introduce control systems in order to achieve their objectives. These objectives include ensuring that operations are effective and efficient, maintaining a reliable internal and external financial reporting process, and complying with applicable laws, regulations, policies and procedures (SAS No. 78, AICPA 1995). Strong internal controls help firms to