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Research paper

An Epistemology of Fraudulent Financial Reporting: a Business Model Canvas Adoption

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Abstract

As an emerging trends of business, new development of epistemology is necessary. In the field of forensic accounting and fraud examination, numerous model on how fraud could happen have been evolving innovatively. On the other hand, fraudulent financial reporting scheme has never been explained in an epistemological manner. As business process is growing more sophisticated and complicated these days, an epistemology development must be done grounded on a representative business framework in which, this research employs business model canvas (BMC) by Alexander Osterwalder due to its adaptability and flexibility. This research interprets the elements contained in BMC in the context of fraudulent reporting in stock market through sequential explanation presented in the model.

Keywords: *Business Model Canvas, Fraudulent Financial Reporting, Stock Market Fraud*.

1. Introduction

This Fraud has been an emerging topic in accounting field which triggers researchers to introduce it from many perspectives. Sutherland's [1] invention evokes thought through "different association" theory, discussing from its provenance. It is argued that humans' early character establishment would likely define their notion towards irregularity which is embedded on the subconscious [1]. This is further interpreted by Cressey's fraud triangle as a rationalization of fraud which is one of the most uncontrollable factors amongst pressure and opportunity [2]. In another perspective, Cohen and Felson (1979) explain "routine activity" theory meaning sudden economic growth might turn social structure which open more doors for fraudulent activities [3].

Amongst all, fraud triangle gets more attentions in several ground researches in 20th century focusing on the modification of fraud theory. Fraud diamond puts a capability component as an accentuation on corporate scandals [4]. Another model in a regional context (Nigeria) by embedding national value system, personal integrity, and MICE (Money, Ideology, Coercion, Ego) aspects as determinant for governance practices [5]. All these are done in a broad context of fraud which indicates an absence of particular discussion of fraud schemes theoretical construction.

Occupational fraud scheme consists of corruption, fraudulent statement, and assets misappropriations [6, 7]. Further, in fact, fraudulent reporting has caused the biggest losses during the year 1999 to 2000 [8], and statistically has the biggest proportion of losses in smallest amount of doing, then it is an appropriateness to consider this as a body of knowledge for which a representative framework explicating its epistemology, and a proper adoption from contemporary framework describing business process are required. Therefore, this research provides new thoughts for fraudulent statement schemes through the adaption of business model canvas by Alex Osterwalder.

2. Methods

This research employs qualitative method through comprehensive search of literature review. Through information obtained, researchers understand the BMC's methodology of thought and interpret that in the context of fraudulent financial reporting. This interpretation is presented on a new model of fraudulent financial reporting.

3. Literature Review

3.1. Another Si de of Business Model Canvas

Fundamentally, business sustainability relies upon resources i.e. funds, labor forces, goods, services, and experts. According to Osterwalder [10], BMC provides business insights from internal, external, and resources to pursue the objectives embracing management process, stakeholders' engagement, and financing plan. These must adhere the value of propositions set by an organization. The value of proposition is company's objective, which is achieved through internal strategies to engage with external stakeholders with a direct purpose of funding. In other words, this model offers systematic methodology to understand business strategy in terms of external stakeholders' engagement [10].

In many cases, BMC is shown to be adaptable in terms of business complexity, trends, or structure coverage. Several studies show the examples i.e. (1) start-up enterprises usually vary in internal key activities and resources [11] while go-public enterprises brainstorm on financing [12] and customer aspects [13], (2) health care business' volatility occurs on customer engagement [15] and key activities [15], (3) hospitality business tends complicate the revenue stream through innovations [16] with less dynamic on key internal activities [17], and (4) in airline business line, where all

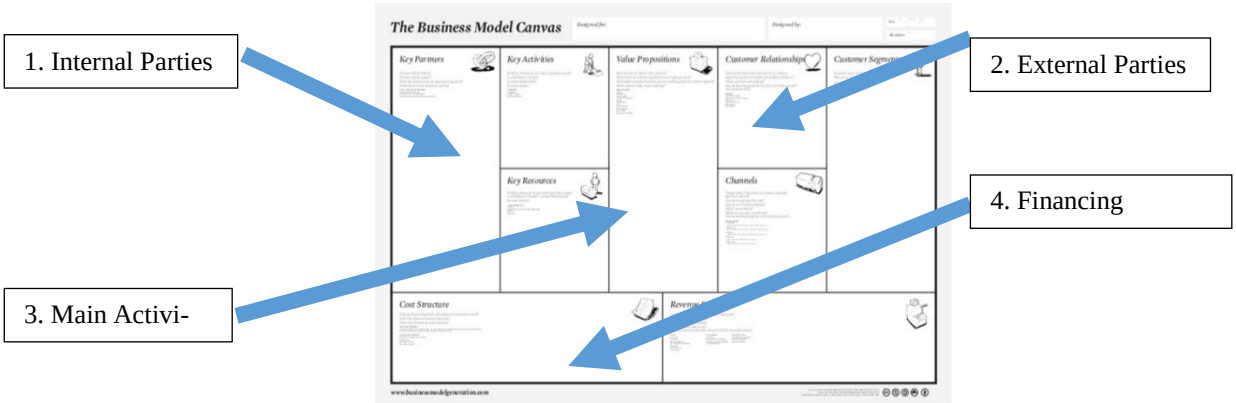
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factors are nearly similar, those are differed by value proportions (pricing policies) based on selected market share [18, 19].
As its adaptability, this model is assumed to be representative for any circumstances for business topic including corporate accountability cycle. According to Beasley *et al*. [20]. One of the issues of financial accountability in the last two decades is fraudulent reporting. It is a form of corporate public deception in which, an enterprise must engage outside stakeholders which may harm those engaged parties [20]. Furthermore, Schilit & Perler [21] state that stakeholders through financial performance and credibility through a mirror called corporate financial reporting. This fact opens several risks lurking outside stakeholders [21]. Based on this circumstance, researchers are convinced to build an epistemology grounded on BMC's elements.

3.2. How it is codified

Researchers view the model built to be an epistemology of business process meaning that, an organization may conduct business practices when engagement done in commercial purposes. The categorization of this model is grounded on discussions of good corporate governance and managerial best practices. According to Plessis et al. (2012), corporate governance theory comprises elements in a way that business process could run sustainably and harmoniously. The answer is by eliminating undisclosed agency problem between directors, management, auditors, regulators, creditors, and investors [22]. Matching this theory to BMC ontology, there are four groups: (1) internal strategies including partners, activities, and resources, (2) external stakeholders (customers) relationship, segments, and networking (3) fund availability from either or both creditors or/and investors, and (4) all these aspects must support the enterprise's value of prepositions.
In accordance with those codification, translation can be made in the context of forensic accounting. Internal parties are those who exercise power in the company in terms of either strategic or tactical decision making [22]. According to Davis *et al*. (1997), stewardship theory explains that the directors and managers who have legal rights to conduct day-to-day operations must decide all policies in a good faith for the sake of stockholders' protection. This theory emphasizes on directors' requirements which is to exercise all duties in a degree of care and good faith In other words, policies made must both adhere to investors' aspirations and regulators' requirements so the owners would be corporately and legally secured [23].

An enterprise may gain profit mainly from commodity trading activity which targets particular groups of customers. The right company's decision may affect holistically to profit, due to right marketing strategies and customer relationship regarding to customer segments could provoke many of them to consider the products [15, 16]. When customers are considered as external stakeholders, so as auditors and regulators in which, companies' maximum performance is one of their concerns. Studies also suggest how important companies for those parties i.e. (1) a company might be a lea of both ordinary and extraordinary income [24], (2) a good performance is an indicator for companies' involvement in governmental projects through public-private partnership (PPP) [25], and (3) it is more secure for audit firm to safeguard such companies which benefits the auditors' marketing [7].
Furthermore, strategies are implemented with the circumspection of revenue and cost calculation. Osterwalder [10] explains that financing sources are located on the bottom of BMC indicating that, all internal and external strategies which support the company's value of prepositions are grounded firmly on the company's financing goals. The trading revenue goal is one of the ways for company to have a financial wealth-look which pinpoints another sources of money: creditors and investors [10]. Weaver [26] argues that some companies boost their income right after go-public decision which triggers investment which indirectly guarantees creditors in long-term loan due to availability of funds. There are at least three areas to which investors and creditors have concern with i.e. (1) future cash flow indicating funds availability, (2) ratios of margin indicating operational (trade) efficiency, and (3) composition of leverage indicating solvability [26].
Value of propositions is at the center of BMC, as it is the main purpose of a company supported by internal key activities, external key engagements, and financing sources [10]. In other words, value of proposition can be meant as a specific value or methodology that drives the internal decision making and external relationships on the basis of funding [27]. In a general term, value of proposition implicitly contains all corporate schemes employed to gain funds efficiently. Discussion of "the schemes" has been emerging since the occurrence of corporate scandals. Several researches suggest some of common schemes employed i.e. (1) undisclosed third-party relationship long prior go-public commencement [28, 29], (2) wrongful revenue recognition at the go-public period [30, 31], and (3) income smoothing in a long-run when listed [32, 33].



Picture 1: Alex Osterwalder's Business Model Canvas and Its Codification

4 Results and Discussion

According to the discussion of BMC, researchers build an epistemology of fraudulent financial reporting through elements and essence of BMC. The epistemological construct consists of three different parties explained by BMC as business' stakeholders who are centered to one scheme of fraud (value of preposition). Based on these interpretation, there are three phases explaining how stock market deception could occur via fraudulent reporting.
As the BMC's fundamental is built on the basis of involvement between stakeholders of business so as fraudulent reporting epistemology. This research attempts translating BMC's elements into the context of corporate scandals which begun with the board directors' con. Studies find that corporate financial distress are

ussually started by incompetent directors and managers in assessing risks [34]. While their failure put them in pressure towards investors and creditors expectation, creative accounting techniques utilized to cover the failure. Further, such deceptive information must pass through the assurance service providers before gets into investors eyes [7].

The problem occurs when auditors fail to fulfil their duties based on Statement of Auditing Standards (SAS) i.e. (1) risk assessment on both financial analysis and internal control [35] and fraud and misstatement (American Institute of Certified Public Accountants, 2002), (2) audit sampling [36], and (3) going concern analysis and opinion [37]. In a more sever condition, some studies find that audit fees and other incentives could affect on bias audit opinion in which, favorable terms reached between board of directors and accounting firms [38]. At this point, undisclosed relationship between auditors and companies' executives might indicate conflict of interests named as conspiracy stage.

Furthermore, as intrigues of directors and auditors go along the way, investors and creditors making use of such financial information are reassured by stock exchanges regarding to its reliability [20]. This stage is called as engagement stage. The next step in the market is the decision stage which depends upon public perception towards the company. Based on that perception, financial analysis and forcasts are done for the purpose of decicions making regarding to the proportion of investment, loan interest burden, and portfolio analysis [21]. Facing this phenomenon, creditors and investors are expected to be more analytical and skeptical towards information. Learning from previous scandals, some new-listed companies might be questioned for a sudden keen-look of financial circumstance [20, 44], while stable companies might also be doubtful for their stable growth in a period of crisis [40].

Furthermore, variables such as auditors rotation[7], audit delays [41], undisclosed third party transactions [42], negative associaion between sales and expenses [7], peculiar increments [31], large extraordinary gains [41], and inept capitalization and acquisition [43] must be cofirmed by considered as questionable items. If such irregularities pass through investors and creditors without any investigation, the model explains that the cycle will be recomenced from the board of directors involvement with auditors as their partners in crime in order to assure creditors and investors regarding to company's credibility through accounting reports which triggers other investments.

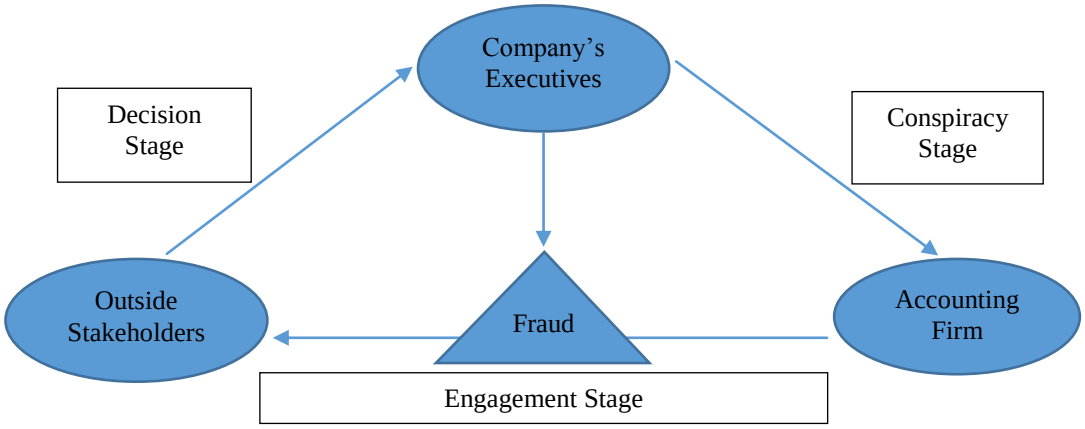


Chart 1: Epistemology of Fraudulent Financial Reporting

5. Conclusion

This epistemology emphasized on the involvement of auditors as a first-line of defense which prevents losses occuring on all stakeholders. Furthermore, it is important for creditors and investors to conduct critical assessment on numerous factors regarding to the cicrumstances of companies they are about to invest. This epistemology is limited at a moment when congeries of debts and stakeholders' losses can no longer be covered and anticipated through deception due to company's inability to generate fund as the reports depiction. The framework only discusses how fraudulent financial reporting occurs in the stock market.

Acknowledgement

This research contributes on a new framework of fraud aiming specifically to fraudulent financial reporting scheme which ends up in stock market deception. As this model explains the emerging business circumstances, then BMC is employed as a brainstorming tool. The researchers would like to acknowledge Alex Osterwalders' contribution to the world of economics as his proficiency shown by his intellection in business ontology.

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