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IDENTIFICATION OF THE RED FLAGS OF CORPORATE FRAUD AND LEGISLATIVE OMISSION IN COMPANIES ACT 2013

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ABSTRACT

In several cases, it is found that the medium of the company is used to commit fraud by the people in management and obtain undue benefits in the name of the company. All over the world, in the recent past, the financial market has faced several high-profile scandals, management misconduct, fraud and scams which was primarily due to fraudulent financial reporting and audit failure that hugely impacted the economy and lowered the confidence of the investors. The object of the paper is to explore the red flags as indicators of fraud commission in a holistic manner that encompasses the conspicuous factors sufficient to arouse suspicion of fraud to a man of ordinary prudence and understanding so that shareholders activism is promoted in India. The paper identifies the significance of the responsibility of the Chief Executive Officer (CEO) and the Board of Directors (BoD) to build 'ethical top' which is an important criterion for determining the ethical work culture in the company.

In the exercise of power, the management indulges in corporate fraud and each fraud discloses red flags that are the warning signs of any impending danger of fraud. The paper categorizes red flags of corporate fraud in terms of financial performance, operation, behavior and structure that help in disclosing evidence of financial and non-financial information of the company. Furthermore, the paper identifies that the activism of the stakeholders of the company may arouse suspicion relating to the existing irregularity before the problem aggravates causing huge damage to all the stakeholders and the company as well. The paper argues that it is not the auditors only to analyze the red flags and perform the audit functions, but all the stakeholders of the company especially the investors must take these indicative factors into consideration for determining the values of their

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stake in the company. The paper analyses section 143 of the Companies Act 2013 that imposes a duty on the auditors to examine and seek for explanation from the officers of the company and the Securities and Exchange Board of India (Listing Obligation and Disclosure Requirement) Regulation 2015 that has introduced a significant change in the disclosure policies of all listed companies. The paper ends with the suggestion to improve the law relating to the identification and disclosure of red flags of corporate fraud.

Keywords: Fraud, Red flags, Auditors, Companies Act 2013

INTRODUCTION

In several cases it is found that the medium of the company is used to commit fraud by the people in management and obtain undue benefits in the name of the company. Persons in authority having an opportunity to commit fraudulent acts intends to exploit their position taking advantage in a diverse manner (Fama and Jensen 1983[2]; Davis et al. 1997[3]). The commission of such corporate fraud is instigated by the opportunity being taken by the management to priorities their interest over and above the interest of the company.

Mostly due to false financial reporting and subsequent audit failure, the financial market has recently seen several high-profile frauds. Around the world, corporate deviant behavior was noticed that hugely impacted the economy and decreased the investors' confidence. In this backdrop, it is obligatory for the stakeholders of the company to be vigilant regarding the conduct of the managerial responsibilities legally imposed on the management of the company. More prominent responsibility is imposed on the statutory auditors concerning the identification of any material misstatement that is hidden in the documents that the company preserves relating to the financial information accessible to the auditors during audit. This hidden information acts as a red flag of corporate fraud.

Red flags are "conditions or events that have some situational opportunities and pressures or personal traits that motivate the management to commit fraud"[4]. Association of Certified Fraud Examiners (ACFE) defined red flags as the "indicators of the possibility of the fraud existing with unique characteristics associated with specific fraud schemes. Red flags are the fingerprints in fraud"[5]. "These warning signs can be in the form of personal information or financial information".[6] The ACFE reported that 92 % of 1483 occupational frauds exhibited warning signals. The worldwide examination of fraud reflects that there are red flags in corporate fraud. The presence of the red flags makes the auditors more sensitive to the clients' business and promote better understanding[7]. The Indian corporate law is silent on the definition and the scope of red flags.

The object of the paper is to identify the red flags as indicators of fraud in a holistic manner that encompasses the conspicuous factors sufficient to arouse suspicion of fraud to a man of ordinary prudence and understanding. Consequently, the shareholders of the company having a stake ought to

2. Fama, Eugene F., and Michael C. Jensen. "Separation of Ownership and Control." Journal of Law and Economics, vol. 26 (June):301-325.(1983)
3. Davis, J. H., Schoorman, F. D., & Donaldson, L., "Toward a stewardship theory of management". Academy of Management review, 22(1), 20–47. (1997).
4. Gullkvist, B., & Jokipii, A. "Perceived importance of red flags across fraud types. Critical Perspectives on Accounting," 24(1), 44-61. doi: http://dx.doi.org.proxy1.ncu.edu/10.1016/j.cpa.2012.01.004, (2013).
5. Singelton, T., Singelton, J., "Fraud Auditing and Forensic Accounting". Hooboken, New Jersey, John Wiley & Sons, Inc., p. 95 (2010.)
6. Coenen, T. L., Essentials of Corporate Fraud. Hooboken, New Jersey, John Wiley & Sons,Inc., p. 30. (2008.)
7. Hassink, H., Meuwissen, R., & Bollen, L. "Fraud detection, redress and reporting by auditors". Managerial Auditing Journal, 25 (9), 861-881. (2010).

consider the factors and confront the management promoting shareholders' activism. The paper further considers the recent corporate fraud and indicative red flags that the auditors ought to consider during the verification and authentication of the financial statements and preparation of the audit report. The paper ends with the suggestion to improve the law relating to the identification and disclosure of red flags of corporate fraud.

RED FLAGS OF CORPORATE FRAUD: CLASSIFICATION AND DENTIFICATION

The red flags are indicative of the possible commission of fraud in the company. The 'Statement of Auditing 99' and 'Standards of Auditing 240' illustrate "fraud risk factors as events where incentive, pressure and opportunities are present to commit fraud that rationalizes or justifies the commission". Continuous growth of the company with 'abnormal profitability and complex business transactions with ineffective accounting system' is found to be good predictors of fraud (Deloitte 2012[8]). ACFE (2014) classified red flags as related to "fictitious revenue, improper revenue recognition, improper asset valuation, concealed liabilities or expenses and improper disclosures". The AICPA[9] developed the list of such symptoms that helps in detection of fraud which are as follows-

- Highly dominating senior management with the ineffective board of directors or compensation not commensurate to performance.
- Deterioration of the earning quality like the decline in sales volume or the senior management with earning alternatives on earning per share.
- Business conditions create unusual pressure like earning pressure, huge investment in volatile industry, debt restrictions with little flexibility.

Red flags are the warning signs that do not necessarily give a suggestion of the actuality of fraud but those are indicators of caution which needs to be investigated. Based on existing facts, the red flags can be classified in the following manner-

1. Financial red flags- Financial ratio examines the relationship between two or more different but relevant and meaningful items of the financial statement identifying the trend whether positive or negative, to detect the performance of the company and consequently prediction can be drawn of the business failure risk and the possible distress. Any unreasonable association like the growth of revenue with diminishing inventory or inventory increasing faster than revenue is an indication of fraud. Similarly, with augmented revenue and diminished accounts receivables or accounts receivables escalating more than the revenue is the red flag of fraud. Fraud sales generate uncollectable income which decreases account receivables turnover. "Disproportionate increase in account receivables relative to sale is an indication of fraud caused by inflated earning"[10]. "The profitability and generating cash flow is the indicator of the company's performance"[11]

8. Deloitte (2012), Indian banking fraud survey-2012 navigating the challenging environment. Deloitte Touche Tohmastu India Private Limited. Retrieved May13, 2014, from http://www.indiafinancebrief.com/best practices/industry/186534/india-banking-fraud-survey-2012-navigating-the-challenging-environment.
9. AICPA. Statement on auditing standards (SAS) no. 99: Consideration of fraud in a financial statement audit. Durham: American Institute of Certified Public Accountants. (2002).
10. Beneish, M. D. "Detecting GAAP violation: Implications for assessing earnings management among firms with extreme financial performance". Journal of Accounting and Public Policy Journal of Accounting and Public Policy, 16(3), 271- 309. (1997).
11. Lee, C. C., Li, K. K., & Ran, Z. Shell Games: The long-term performance of chinese reverse-merger firms. Accounting Review, 90(4), 1547-1589. doi:10.2308/accr-50960, (2015).

Profitability includes how well the company spends its funds to produce value and profits with the cash flow which is essential to meet the outstanding short-term obligations. "The financial ratios of gross operating profit to net income and operating cash flow to sales are common measures of profitability"[12]. SAS considers company's threatened profitability conditions, rapid growth and undue profitability as risk factors for managers to engage in fraudulent financial reporting. Additionally pressure and expectation to meet the financial target are the factors that affect the fraud. Managers are motivated to report conditions that show the sound financial conditions of the company. "Companies that are unable to achieve similar results as compared to the past performance tend to engage in fraud to maintain their financial performance trend and expectation"[13]. "The sales growth and profit growth also serve as an important indicator of earning quality and better performance. The unusual rapid company growth may be an indicator of the financial statement fraud"[14]. A disproportionate increase in the day's sales is an indicator of manipulation of the financial statement. Similarly, the declined gross margin is the negative indicator of the business prospect and the red flag for impending earning manipulation. "Companies indulging in fraud adjust their net income to exceed operating cash flow that may be a signal of fraud"[15]. "Decreased cash flow and return on assets are warning signs of misstatement as the managers prefer to report growth in earnings"[16]. "The ratio of working capital to total assets, current assets to current liabilities are the measures of motivation for fraud; the higher the ratios the lower is the chance of fraud"[17]. It also discloses the "stronger ability of the company to pay the dues"[18]. Additionally despite a severe fall in the share prices certain members of the board and the executives appropriating a huge amount of money in the form of salary, bonus and any other incentive or any unwise investment or merger, or outstanding result of the company wherein the industry is suffering downfall, or unusual financial ratios as compared to others, or persistent cash flow problems when the company has received profits, or regular audit adjustments are red flags of fraud detection. The above-mentioned indicators are based on the financial information that is disclosed by the company and easily accessible to the auditors during verification and authentication of the financial statements.

2. Operational red flags include all that within the scope of which the administration of the company falls. Fraudulent activities in the company is reflected if the employees do whatever they want and whenever they want

12. Albrecht, W. S. Fraud examination. Mason, Ohio: South-Western Cengage Learning, (2012).
13. Song, X., Hu, Z., Du, J., & Sheng, Z. "Application of machine learning methods to risk assessment of financial statement fraud: Evidence from china". Journal of Forecasting, 33(8), 611-626. doi:10.1002/for.2294, (2014).
14. Association of Certified Fraud Examiners. Fraud examiners manual. Austin, Texas. ACFE, (2014).
15. Lee, T. A., Ingram, R. W., & Howard, T. P. "The Difference between earnings and operating cash flow as an indicator of financial reporting fraud". Contemporary Accounting Research, 16(4), 749-786. (1999).
16. Dechow, P. M., Ge, W., Larson, C. R., & Sloan, R. G. "Predicting material accounting misstatements". Contemporary Accounting Research, 28(1), 1-16. (2011).
17. Kanapickienė, R., & Grundienė, Ž. "The model of fraud detection in financial statements by means of financial ratios". Procedia - Social and Behavioral Sciences, 213, 321-327 doi:10.1016/j.sbspro.2015.11.545 (2015).
18. Ravisankar, P., Ravi, V., Rao, G. R., & Bose, I. "Detection of financial statement fraud and feature selection using data-mining techniques". Decision Support Systems, 50(2), 491-500. doi:10.1016/j.dss.2010.11.006, (2011)

within the scope of their employment without supervision, or experience a very close relationship with the supplier and the third party[19] or vendors, or inadequate number of meetings of the department[20], or have few Audit Committee meetings and lesser internal audit support[21], or poor segregation of duties or unwillingness to share duties and inadequate record keeping[22]. Poor internal control is a contributing factor of fraud (ACFE, 2012). When the internal control is weak with ineffective supervision or review of the management, the commission of fraud becomes easy.

3. Behavioral red flags are the behavior pattern of the employees, or the persons associated in the various levels of administration that indicates the commission of fraud and serves as red flags for fraud detection. If the persons in management of the company live beyond their means with conspicuous and sudden extravagant changes in lifestyle which is significant and clearly visible within a very short span of time, or indulges in insider trading, or there is an increased turnover of the internal auditors or senior management, or Chief Executive Officer[23], then it reflects some irregularity in the company administration. The attitude of the key managerial personnel towards the company and its business also provides a significant indication of possible fraudulent activity in the company. Red flags indicate situations when the focus on short term performance goals is made, or independence problems with the company's auditors is noticed, or nonexistence or weak execution of the code of ethics, and violations of the law and the regulations. Last minute adjustments that significantly affect the financial results, employees having access to the system and records that they do not require, any conflicting or missing evidence, any problematic or unusual relationship between the management and the auditor which can be reflected by the denial of access to records and facilitates from which auditor sought for evidence are significant red flags of fraud. The possibility of fraud also increase with the lack of cooperativeness with the auditors, high turnover of the top management[24] or ineffective internal audit department, the hostile attitude of the management toward the regulatory bodies[25] or the lack of the management cooperation with the auditors.[26] Additionally, undue time pressure imposed by the management to solve complex issues, complaint regarding the management intimidation, unwillingness

19. Gullkvist, B., & Jokipii, A. "Perceived importance of red flags across fraud types". Critical Perspectives on Accountisng, 24, 44-61. (2013).
20. Hegazy, M. A., & Kassem, R. Fraudulent financial reporting: Do red flags really help? Journal of Economics and Engineering, 4, 69-79. (2010),
21. Beasley, M.S., Joseph V. Carcello, Dan R. Hermanson, and Paul D. Lapides. "Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms." Accounting Horizons, vol. 14, no. 4 (December) (2000)
22. Jessup, C. M., & Noblet, I. N. "Fraud insight derived from stories of auditors' of financial institutions". Journal of Forensic and Investigative Accounting, 4 (2), 206-243. (2012),
23. Waibach 1988 Weisbach, M.S. "Outside Directors and CEO Turnover." Journal of Financial Econiomics, vol. 20, nos. 1-2 (January-March): 431-460.(1988)
24. Smith, M., Omar, N. H., ZulkarnainIdris, S. I., & Baharuddin, I." Auditors' perception of fraud risk indicators Malaysian evidence". Managerial Auditing Journal, 20 (1), 73-85. (2005).
25. Hegazy, M. A., & Kassem, R. "Fraudulent financial reporting: Do red flags really help?". Journal of Economics and Engineering, 4, 69-79. (2010),
26. *Ibid* at 71

to add or revise disclosure of information are red flags of fraud detection.

4. Structural red flags are related to the ways a company has set and framed the policies creating the business environment that promotes or prevents corporate fraud. "If the company is being controlled by a small group of people there is an increased chance of fraud"[27]. The top senior executives may get involved in the fraud secretly. Beasley 1996[28] finds that the "inclusion of the larger proportions of the outside directors in the board significantly reduces the likelihood of reporting fraud." A weak system of management control is relevant when the insiders like the managers have a majority control on the board of directors with the CEO having a powerful position in the company and not comfortable with criticism. Furthermore, the red flags of fraud that exist in the company indulging in fraud are the absence of the rotation of the duties, lack of written polices of administration, frequent related party transactions, senior management turnover, weak insider stock, non-existence of the code of ethics, investment problems with the company's' bankers, dubious corporate approaches with impervious disclosures.

These are the evidence that comprise of non-financial information of the company and the executives which any person of ordinary prudence may comprehend and therefore the activism of the stakeholders of the company may arouse suspicion relating to the existing irregularity before the problem aggravates causing a huge damage to all the stakeholders and the company as well. It is the responsibility of the auditors to analyze the red flags while performing the audit functions, nevertheless, all the stakeholders of the company especially the investors must take these indicative factors into consideration before their participation in the Annual General Meeting. Hence, it would enable them to confront the management promoting shareholders' activism. The red flags of corporate fraud can be regarding the financial aspect; relationship of the auditor with the company and the administration; role of the board of directors which is summarized herein from the abovementioned:

Firstly, in regard to the financial aspect, the indicative red flag of fraud is reflected in the related party transactions, highly complex and unusual transactions with many adjusting entries, immediate high or low profitability, asset overstatement and understatement of liabilities, low or poor cash flow with high profits. If the report of the auditors further reflects accounting irregularities or financial distress or threat that may lead to insolvency of the company or insider trading that is not permitted by the laws is also a red flag. If the stakeholders find that the growth of the company discloses significant variation from the immediate past which may be unusually high or low; the pressure to meet the targets, the probability of the commission of fraud in the company can be assumed.

Secondly, the relationship that the managerial personnel may have with the auditors of the company may be indicative of fraud commission. If the facts indicate that the management having a strained relationship with auditors or close relationship with internal and external auditor or lack of independence of the external auditors, there may be a possibility of the commission of the fraud with connivance or in collusion with the auditor. The stakeholders may also question the appointment of the auditor and restrain the company from appointing the said auditor if the auditor's past conduct revealed dishonesty. The auditor himself

27. Majid, A., Gul, F. A., & Tsui, J. S "An analysis of Hong Kong auditors' perceptions of the importance of selected red flag factors in risk assessment". Journal of Business Ethics, 32, 263-274. . (2001)

28. Beasley, M.S. "An Empirical Investigation of the Relation between Board of Director Composition and Financial Statement Fraud." Accountinig Review, vol. 71, no. 4 (October) 1996)

may raise a doubt during audit, if there is an attempt to exercise influence by the management or withholding information from the external auditor.

Thirdly, regarding the administration of the company and the role of the directors, the vigilant stakeholders may be in a state to identify the possible commission of fraud in the company by the management. If the facts reflect companies with complex structure and lack of segregation of responsibilities, poor or weak internal control with the autocratic management overriding the control or dominant top management or poor strategy formulation or weak board and inefficient audit committee or lack of management oversight. If the company has few independent directors in the board or there is a frequent change of the directors or any senior management or managers hold significant interest in the company or no rotation of key managerial personnel or inexperienced person in key position, then also doubt can be raised regarding the administration of the company and the role of the directors.

In regard to the administration of the company, the Chief Executive Officer (CEO) is responsible for having a strong management with the responsibility of the Board of Directors (BoD) to oversee its function. The way in which the CEO or the BoD perceive the responsibilities in the organization acts as a significant factor. Therefore, the personal values of the executive in the management have a prominent influence in regard to the control environment of the work culture. All those who deal with the company look up to the management to determine the work environment of the company. They look up to the CEO for his guidance in the administration of the company. Hambrick 2007[29] stated that if a person wants to consider the reason and the intention of the company, they must consider the bases and the dispositions of the 'powerful actions of the top executives. Khanna et al 2015[30] also identifies "top management as the key antecedents of corporate frauds". When the corporate board lacks independence or financial and accounting experts then the possibility of corporate frauds increases. (Deschow, e al 1996[31] and Agarwala and Chadha 2005[32]).

The source of managerial misconduct, management perception and exercise of power is inter-related to one another. Power has also become a motivating factor that leads to organizational deviance and managerial misconduct. Therefore, the exercise of power ethically and with proper check and balance will also reduce the commission of corporate fraud. Appropriate measures for capturing intention, attitude and rationalization of the fraud is necessary to be framed for determining any corporate deviant behavior.

COMPANIES ACT 2013 AND RED FLAGS FOR AUDITORS: AN OVERVIEW

Section 143 states that the auditors have "the right to access the books of accounts of the company" and the vouchers and consequently the law imposes a duty on them to "examine and seek for explanation from the officers of the company and inquire-

a. whether loans and advances made by the company based on security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members.

29. Hambrick, D. C. "Upper echelons theory: An update". Academy of Management Review, 32: 334-343 (2007)
30. Khanna, V., Kim, E. H., & Lu, Y. CEO "Connectedness and corporate fraud". The Journal of Finance, 70(3), 1203-1252. (2015).
31. DeChow, P. M., R. G. Sloan and A. P. Sweeney 'Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC', Contemporary Accounting Research 13(1), 1-36. (1996)
32. Agrawal, A., and S. Chadha. "Corporate Governance and Accounting Scandals," 48 Journal of Law and Economics 371— (2005.)

b. whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company.

c. where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.

d. whether loans and advances made by the company have been shown as deposits.

e. whether personal expenses have been charged to revenue account.

f. where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading: Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries and associate companies insofar as it relates to the consolidation of its financial statements with that of its subsidiaries and associate companies."

The section further states that

"The auditor's report shall also state—

a. whether he has sought and obtained all the information and explanations which is to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements.

b. whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him.

c. whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the way he has dealt with it in preparing his report.

d. whether the company's balance sheet and profit and loss account dealt with in the report agree with the books of account and returns.

e. whether, in his opinion, the financial statements comply with the accounting standards.

f. the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company.

g. whether any director is disqualified from being appointed as a director under sub-section (2) of Section 164.

h. any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith.

i. whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls; (j) such other matters as may be prescribed".

Additionally, section 143 (4) specifies that "where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons therefor."

The section discloses the intricate financial information of the company that the auditors need to be vigilant at the time of audit functions. However, it is beyond the understanding of the common

man to comprehend the complex transactions. The auditors are supposed to check and examine the above-mentioned information as disclosed in various documents and accounts of the company and any deviation of the same raises a red flag towards the commission of the fraud.

The law ought to enumerate mandatory provisions concerning the shareholders exceeding a certain reasonable amount of shareholding to ventilate their grievances by activate participation, relating to any variations in the company's strategy or its administration. The management misconduct and commission of fraud can be prohibited to some extent. Additionally, it can create a pressure on the management to eradicate the pitfalls and inefficiencies that would affect the company's performance. In this manner, shareholders' activism can also be secured in India. However, isolated instances of shareholder's activism having a huge impact on the corporate and its investors is noticeable. When Cyrus Mistry was removed as the chairman of Tata Sons on grounds of alleged irregularities in the management of the company, shareholders activism was very prominently reflected.

Analysis of compulsory disclosure of information of the company as red flag

The Securities and Exchange Board of India (Listing Obligation and Disclosure Requirement) Regulation 2015 has introduced a significant change in the disclosure policies of all listed entities so that the governance of such entities become transparent. As per section 3, the regulation is applicable to "all listed entities which has been listed on SME Exchange or Innovators Growth Platform; non-convertible securities; Indian depository receipts; securitised debt instruments; security receipts; units issued by mutual funds."

The regulation provides some principles that are to be followed for disclosures. Firstly, the prescribed accounting standards have to be followed and the annual audit has to be done by independent and qualified auditors; secondly, the listing entity shall prevent any falsification and guarantee that no misleading data is given to the stock exchange and the investors. Moreover, the information must be timely and adequate; thirdly, the channel of communication must provide equal, timely and cost-effective access to the information.

The regulation further enumerates the rights of the shareholders which includes the right to be informed sufficiently of the corporate with any of the changes made, the opportunity to confront the board, participate in the Annual General Meeting, and the exercise of the shareholders 'right with mechanism to ventilate the grievances of the shareholders, It also empowers the stakeholders by giving them opportunity to redress their grievances, have sufficient, relevant and reliable information relating to the corporate governance process, and establishes a responsibility on the corporate to have a 'vigil mechanism and the whistle blower policy'. Disclosure and transparency have been identified to be the underlying principle that governs the administration of the corporate. It is their responsibility to have a timely and substantial disclosure of all material information governing the corporate which includes the "financial situation, ownership and performance". Schedule III of the Regulation specifies the material events that is necessary for the corporate to disclose. The Regulation further specifies the responsibility of the corporate to disclose information to the stock exchange within a specified time frame or provide sufficient explanation for the delay. Additionally, the information given to the stock exchange has to be put up on the website of the corporate as well. Therefore, this acts as an indication of the possible material irregularity or fraud existing in the company, hence source of identification of the red flags of fraud.

Instances of corporate fraud and reflection of red flags

The world has witnessed several infamous corporate frauds that shook the confidence of the investors in the financial market and the regulatory

mechanism of the country. Each of the fraud indicated some warning signals much prior to the commission. In Satyam Computers, the chairman himself got involved in falsification of the accounts and financial statement. The profits were inflated, and the debts suppressed to convey a false impression relating to the financial aspect of the company. A close association of the auditors with the management was found, that destroyed the independence. Similarly in 2003 in HealthSouth Corporation a massive accounting scandal came to light wherein the company's financial reporting process was manipulated to overstate earnings and inflate its financial performance. They recorded revenue from non-existent services, inflated the revenue from legitimate services to overstate the company's financial performance, manipulated its assets on the balance sheet by inflating their values or recording fictitious assets. HealthSouth's financial statements lacked transparency and were made intentionally complex, causing it difficult for investors and analysts to identify the fraudulent activities. The fraud was noticed by the auditors during verification and authentication of the financial statements. In Enron, the CEO and the CFO were involved to boost the performance and hide the liabilities like that of Satyam and Health South. Enron had certain off-balance sheet entries that were not consolidated in Enron's financial statements, which made the company's financial position appear stronger than it was. This accounting method allowed Enron to recognize anticipated future profits immediately, even before the actual cash flow materialized leading to inflated revenue figures that misled investors about the company's profitability and further overestimation of revenues. Enron's financial reporting was intentionally made complex and convoluted, making it difficult for investors to decipher. The external auditors have failed to perform as per the required norms. Similarly, in Worldcom, accounting fraud was noticed. The CEO manipulated the financial statements, inflated the earnings and mislead the investors. WorldCom treated normal operating expenses as capital expenditures. By capitalizing these expenses, they inflated their assets, booked revenue from non-existent source or inflated sales, essentially fabricating financial performance. WorldCom understated its liabilities to present a healthier financial position. The revenue was further inflated by fictitious accounting entries that created a good reputation of the company, consequently increased the share price. WorldCom's financial statements were difficult to understand due to their complexity and lack of transparency. External auditor, Arthur Andersen, failed to identify and report the fraudulent practices at WorldCom. In Parmalat also the there was a significant cash balance on offshore account that was non- existing and all fictitious revenue. Parmalat reported having significant cash balances in offshore accounts that did not exist. To support the false cash balances, Parmalat employees forged bank statements from reputable financial institutions, overvalued its assets, recorded fictitious revenue from non-existent sales and transactions. Like other corporate scandals, Parmalat used off-balance sheet entities to hide debt and losses, providing a distorted view of its financial condition. Parmalat had an intricate web of subsidiary companies in various countries, making it challenging for investors and auditors to grasp the company's true financial position. Parmalat's external auditors also failed to detect the fraudulent activities and relied heavily on the company's representations. In Vivendi, it was noticed that many subsidiaries were formed to make complex transactions. Complex transactions were found in PNB as well. The inflated revenues gave a false impression of the company's growth and profitability. The company was criticized for overvaluing its assets. Overstating asset values gave the illusion of higher net worth and financial strength concealed significant levels of debt, leading to an understatement of its liabilities, Vivendi used off-balance sheet entities to move debt and losses off its books. Vivendi had a complex corporate structure involving numerous subsidiaries and joint ventures, which made it difficult for investors

and regulators to fully understand the company's financial situation. Hence, it can be inferred that all the corporate frauds taken up for the study disclosed manipulation of the financial statements and irregular accounting by false entries which ought to have been discovered by the statutory auditor. Furthermore, issues like the form of the internal control techniques and the internal control environment remained significant in all the cases. The relationship of the CEO and the company has been found collusive. The control mechanism of the company also failed because the people in management having the responsibility of putting the said control mechanism in order has failed to enforce it. In this circumstance, it is imperative for the stakeholders to discover the underlying irregularity that would exist in the company and hence the red flags become significant to them.

CONCLUSION

A company runs with the money of the investors and the creditors along with the resources of the stakeholders. Verification and authentication of the financial statements lies with the auditors, but it is the responsibility of all concerned to be vigilant on the administration of the company. The management which is entrusted with the responsibility of creating an ethical work culture gets involved in fraud for their ulterior motive. Therefore, the red flags of corporate fraud, if discovered comprehensively, may give a warning signal before the commission of the said fraud or soon after. The Companies Act 2013 as well as the LODR regulation of the SEBI does not portray the said indicative factors holistically. Although the auditor's report and the annual returns of the companies reflect some of the information, nevertheless those are outside the reach of the common man as they do not explore the intricate information that is specified in those voluminous documents. It is necessary to have a mandatory legal provision of disclosure in a simplified manner to be filed with the competent authority as well as it needs to be put up on the company's website for any stakeholders to identify the impending danger that the company may have to face. This will promote shareholders activism in India as well.