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THE DETECTION OF FALSE FINANCIAL STATEMENTS USING ACCOUNTING RATIOS: AN EMPIRICAL INVESTIGATION

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ABSTRACT

The issue of corporate frauds has been brought into the limelight, after the most important financial scandals that began to appear from late 2000.

Frauds threaten the integrity of the company's assets and generate negative consequences for all stakeholders who are interested in corporate organization. These phenomena increase the interest to develop a method to identify and avoid corporate failures. However, it is not easy to predict this kind of scandals due to several variables that affect frauds.

Previous literature tested different analytical procedures (e.g. analysis of trends and ratios) to identify signals of fraud. Examining a sample of US firms, some researchers find that financial ratios show a limited ability to detect and predict fraudulent financial reporting (Kaminski et al., 2004). However, there is a paucity of evidence in the European context.

The goal of this paper is to understand whether accounting ratios are able to detect an accounting fraud. Specifically, we aim to investigate whether accounting ratios of fraudulent firms differ from those of non-fraudulent firms. To this end, we select a sample of companies listed in the European stock exchange and we classified them in two categories: fraudulent firms and non-fraudulent firms.

We consider "fraudulent firms" those that engage in ascertained behaviours aimed to manipulate financial statements, while "non fraudulent firms" are the others. The sample selection of "non fraudulent firms" is based on firm size, time period and industry of "fraudulent firms".

The exploratory study will be conducted for a eight-year period, between 2000 and 2008.

Keywords: Financial statement, Corporate fraud, Europe, Financial ratios, Accounting, Management performance

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