

Earnings Management Environment

With the case of Troms Kraft

By

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PREFACE

This paper is a part of my master in Economics and Business Administration and also marks the end of my five years of study at The Norwegian School of Economics. In this paper I study the concepts of earnings management and fraud, and the circumstances under which it occurs, taking a case approach. I focus on the recent accounting scandal in TROMS Kraft, and analyze the conditions in the environment that allowed the fraud to occur, and try to explain why the fraud was not uncovered at an earlier stage.

I find earnings management to be an interesting field and therefore decided to write about TROMS Kraft. I have been writing this paper while at the same time working as an auditor, which has been valuable, although stressful at times. Being a part of the audit team of a large Norwegian power company has helped me gain insight and knowledge to the business and environment, and I have also received feedback and inputs from more experienced auditors.

I would like to thank my colleagues and my supervisor, Frøystein Gjesdal, for valuable feedback and inputs to the paper.

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SUMMARY

In this paper I examine the topic of earnings management and use a case example. In the first part of the paper I review theory on two closely related topics - earnings management and fraud - and present and discuss incentives, methods, typical indications and frequency of earnings management in the financial statements. I continue to describe the frameworks and laws that apply to revenue recognition and how income is recognized in the power industry, as this is especially relevant for the case. Further, I describe the auditor's and the board of director's responsibilities to detect fraud according to the law.

The next part deals with one of the largest Nordic accounting scandals in recent years. In 2011 it was discovered that a subsidiary of Troms Kraft had recorded fictitious revenues of 1.5 billion over a period of 10 years. I examine the company's financial statements in the years before the fraud was uncovered to evaluate if there are any indications of misstatements. Moreover, I analyze the company's environment to identify factors that increased the risk of fraud, including motivations and opportunities of fraud. The aim of the analysis is to investigate how the company was able to record the fictitious revenues, by drawing upon established academic literature on earnings management and fraud.

In the last part I will analyze which control mechanisms the company had in place, mainly focusing on the composition and quality of the board of directors and the auditor. This way I try to answer whether they performed their duties to prevent and discover fraud. By both considering the company's specific risks and indications of earnings management, I will conclude on whether the control mechanisms were adequate and should have detected the fraud at an earlier point.

PART I - INTRODUCTION

1. Introduction

1.1 Problem identification

The annual report provides information on the company's activities and financial performance in a year. This is important as the owners, having limited information on the company's daily operations, base their decisions on this report. The management on the other hand, running the firm, has much more information. One problem with this separation of ownership and control is that the two parties might have different interests. While it is in the best interest of the owners to maximize firm value, management may focus on short term personal incentives, even though they have a fiduciary duty to act in the best interest of the owners.

When a firm performs poorly, managers can be tempted to use accounting as a way of improving business performance, for instance through exploiting the flexibility in the accounting rules. The manager can increase earnings by recording transactions too early or by postponing to record costs, even though this is not in accordance with the applicable accounting framework. There are many motives behind such actions, such as pressure to beat earnings expectations or incentives to maximize compensation. Moreover, as bonuses are often tied to performance, managers might feel tempted to maximize salary by managing earnings numbers.

Earnings management is when managers or others in charge of preparing the financial statement manage the earnings or report numbers in the company by either exploiting the flexibility in the accounting rules, or by breaking them. The academic interest for the topic has increased in recent years, due to the many accounting scandals around the world. Internationally, companies like World Com, Enron, and most recently Lehman Brothers, managed to perform EM on a large scale. In Norway, we have examples of EM from the cases of FAST, Sponsorservice, Tordenskjold, Finance Credit and most recently Troms Kraft. All these companies managed to fool the market, even though control mechanisms such as accounting rules and auditors were in place to prevent and detect EM. What characterizes all these cases is the lack of information or wrongful information, stretching of accounting rules and intentional falsification of accounts. In most cases the fraud also concerned revenue

recognition. The reason is that revenues have a great effect on profits, and also because it is a complex area - making it difficult for external users to detect misstatements.

The company's governance mechanisms are the policies and procedures in place to control and protect the interests of the stakeholders (Thomsen & Conyon, 2011). In other words the mechanisms that reduces the possibility that management behaves opportunistically. Such mechanisms include the regulative framework, internal control routines, the board of directors and the auditor, which are all designed to prevent and detect misstatements in the financial statement. The auditor's role and responsibility is to *add reliability* to the financial statements and to assure that they *have been prepared in accordance with law and regulations and in accordance with accounting standards, principles and practices* (Stuart, 2011). But as accounting rules are flexible, even within generally accepted practices, there are many opportunities to manage a company's performance numbers. What is more, the reliability and relevance of information in the financial reports depend largely on management competence and integrity, as many estimates depend on their discretion and judgment.

Since the board controls who is elected as top manager, they are responsible to judge the competence and integrity of this person. The board is also accountable that the financial statement is accurate and reflects the true financial position of the firm. In many accounting scandals, management was able to misstate financial statements over longer periods of time. In many cases, circumstances suggest that the board should have detected the fraud earlier. Some claim that board members generally are too busy, and do not have the necessary knowledge of the firm, while others argue they place too much trust in top management.

In response to the many scandals, regulatory bodies such as the government and stock exchanges have increased their efforts to improve accounting standards, laws and enforcement actions. The most acknowledged is probably the Sarbanes Oxley Act in the US, which was a result of the failure of Enron. The corporate failures in Norway and the rest of Europe have also resulted in increased regulation concerning board structure, independence and auditor work. However, this does not necessarily improve information in the financial statements or make it easier to detect misstatements as many items are based on management's good judgment. This opens opportunities to manage earnings, and as outsiders and auditors have limited information to judge and control whether these numbers are correct - this represents a problem.

1.2 Problem definition

The reason I find the case of Troms Kraft interesting, is the magnitude of earnings management – it is referred to as the largest fraud in Nordic history by the Swedish Economic Fraud Authority (Ekobrottsmyndigheten). Troms Kraft estimate that the misstatements that was uncovered in 2011, started already in 2002. The misstatements are estimated to amount to around 1.6 billion SEK, which the company had recorded as revenues. It is surprising that the management were able to deceive the owners for such a long time without anyone questioning the reliability of the numbers. To understand how the fraud could go on for such a long time, it is necessary to look at the company's environment, as there are certain conditions that need to be present in a company in order for fraud to occur. These conditions include the company's existing corporate governance mechanisms, pressures or incentives to meet earnings targets or a certain level of growth, and the values and integrity at the core of the company's culture. As the manipulation occurred over many years, and constituted a considerable amount of revenues, it is questionable whether the governance mechanisms surrounding the company were effective. Consequently, the research question can be derived;

Which conditions where present in the company that made the fraud possible?

In order to answer this research question, I will analyze if available information could indicate misstatements or the possibility of misstatements. To see if there were any indications of fraud, I will analyze the trends and reasonableness of the numbers in the company's financial statement. Hence, the first sub research question is;

Are there any indications of misstatements in the financial statement numbers?

After having analyzed the financial statement and environment in Kraft & Kultur I will investigate specifically how earnings were manipulated. This relates to the specific accrual and accounting methods used for earnings management. The next sub research question is therefore;

What was the method or methods used for earnings management?

If there were any indications or irregularities in the financial statements, then the auditors and the board of directors had a responsibility to investigate these risk factors. As the board and auditor have certain responsibilities and obligations to prevent and detect misstatements, one

can question why they did not uncover the fraud at an earlier stage. The research question is therefore;

Should the auditor or board have detected the fraud earlier?

I will attempt to answer this question by looking at the circumstances and the information the auditor and board had available and take their responsibilities and duties according to the law into account.

1.3 Scope and demarcations

I use a case study approach when examining the topic of fraud and earnings management, and build on already established empirical results on the matter. Hence, the paper is empirical in nature, with a case approach. A lot of information concerning the power industry is based on knowledge from working as an auditor in a power company, conversations with experienced auditors as well as working papers. Thus, the amount of references is limited in chapter 5.

I focus on the case of Kraft & Kultur in Sweden, a subsidiary of Troms Kraft, and try to explain how management was able to misstate the financial statements over so many years. To accomplish this I will look at the environment surrounding the company, such as industry characteristics and existing corporate governance mechanisms and try to explain the incentives and opportunities for fraud that existed. I have limited the scope of the paper to focus at a few governance mechanisms, such as internal controls, auditors and the board. The accounting standards are only briefly discussed, but mainly to provide the reader with an understanding of the problem with recognizing revenues in the power industry, and to understand the method of earnings manipulation.

I will also analyze information in the financial statements to look for warning signs and try to understand the specific methods the company might have used when manipulating earnings. I will use this to evaluate if the board and auditors performed their job satisfactory. A drawback is that the available information is limited. The investigation of Kraft & Kultur and Troms Kraft is still ongoing, and the trial is not due until next year. Hence, the results and liabilities of the different parties will not be known until after this point. Most of the analyses and information presented in the paper is therefore based on the external investigation performed by Ernst & Young and publicly available information such as financial statements from Troms Kraft and Kraft & Kultur, and newspaper articles. Consequently, my conclusions and

results might be biased. Moreover, I assume that the information from Troms Kraft concerning the corrected financial statements and the fraud allegations is truthful and that it is the former Chief Executive Officer (CEO) in Kraft & Kultur who is the main responsible. The external investigation also confirms this fact. As the external investigation does not analyze the accuracy of the financial statement numbers, evaluations of the accuracy and methods of earnings management will be based on my own assessments.

1.5 Structure of the paper

Part I is an introduction to the paper, the problem and research question and overview of methods and research performed.

Part II provides the theoretical background of the paper, including theory on corporate governance, earnings management and fraud. In particular, I focus on the incentives and methods of earnings management and fraud and the specific circumstances that allow fraud to happen in a firm.

Part III reviews the financial reporting frameworks, including the basic accounting principles and standards that apply when recording revenues and costs, and more specifically the challenges when recording revenues in the power industry and the risk of fraud.

Part IV is the main part of the paper, dealing with the case of Troms Kraft. This part includes an introduction to the company and the fraud, an analysis of the financial statement and environment, and finally a discussion of the work of the board and auditor.

PART II – THEORETICAL BACKGROUND

2. Theory on earnings management and fraud

2.1 Definition of earnings management and fraud

There are numerous definitions of earnings management (EM) in the literature. I chose to take a broad view of the topic, including not only management *of earnings* but all information in financial reporting as this information also has the potential to mislead external decision makers and affect the stock price. Consequently, I find the following definition by Healy and Wahlen to be of most relevance;

Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some shareholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy & Wahlen, 1999, p. 368).

As EM only deals with *external* reporting it is restricted to financial reports (financial statements, quarterly reports etc), where the firm presents numbers and information on the current financial situation (Kinserdal, 2006). EM also incorporates situations when important information concerning the financial position and profitability of the company is omitted. EM is typically done by top management, but can also be performed by the board, accounting committees and even general assembly or others (ibid). However, it must be someone in charge of preparing or signing the external financial statements.

A term closely relating to EM is fraud. The Association of Certified Fraud Examiners (ACFE) defined financial fraud as *the intentional, deliberate misstatement or omission of material facts, or accounting data which is misleading, and, when considered with all the information made available, would cause the reader to change or alter his or hers judgment or decision* (1993). In other words, fraud is the action of manipulating financial results to deceive the user in order to get an unjust or illegal advantage. Hence, fraud and EM are both dealing with *deliberate* adjustments of the financial information to obtain some sort of *personal benefit*. While EM can be said to deal with managing numbers both inside and outside the limits of the law, fraud *clearly* concerns alterations outside the law. EM rather deals with to what degree

financial information is unbiased, faithful, relevant, and complete (in accordance with the conceptual framework described below).

Fraud clearly violates Generally Accepted Accounting Principles (GAAP), as the financial statement is altered and does not reflect the true economic performance of the firm. As there is a range of degrees to which a company can manage their earnings, it might be helpful to think of EM as a continuum to better understand the concept. The continuum can be seen underneath (Figure 1). At one end of the spectrum we find conservative accounting with few nonrecurring or unusual items, and a close approximation of the economic reality. Moving to the right we find an increasing level of aggressive accounting until we find outright fraudulent financial reporting in the other end (Giroux, 2004). The difference between fraud and creative accounting is essentially that fraud is clearly illegal while creative accounting, although outside the borders of GAAP, is harder to prove or find evidence to support.

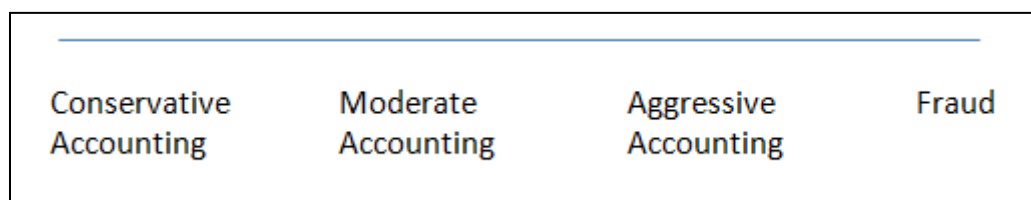


Figure 1: The earnings management continuum (Giroux, 2004)

Moreover, it is necessary to distinguish between errors and EM and fraud. While errors or misjudgments can occur due to lack of information or insight, EM and fraud are *deliberate* deviation from best estimates with the intention to mislead someone (Healy & Wahlen, 1999) (Stuart, 2011). The motive for EM and fraud is not necessarily management benefits, but could also be in the interest of the firm, employees, shareholders or creditors.

To conclude, EM and fraud is most fundamentally about altering or omitting information in financial reports to mislead external users and decision makers about the underlying economic performance of the firm. The reasons why people manage earnings are usually one or a combination of three factors, first of all because it is easy, secondly because it involves some sort of reward and thirdly because the probability of getting caught is low (Schilit, 2002). In the next section some common incentives and methods of EM is described, and also the circumstances under which EM is most likely to occur.

2.2 Earnings management incentives

Incentives for EM can generally be divided into two; (1) to maximize shareholder value (both short term and long term) and (2) to maximize personal gain (Giroux, 2004). Maximizing shareholder value could be done either through increasing profit or by beating earnings estimates, with the intention to increase share price. The motivation to increase share price can come both from internal and external pressure. External pressure mainly stem from the capital markets and their expectations of the company's performance (Burgstahler & Eames, 2006). As financial analysts and investors use financial information to value stocks, this gives an incentive to manage earnings to influence the short term performance of the stock. Management also faces internal pressure, for instance from the board, as the board is responsible to design performance targets and rewards for top management. This way management has incentives to meet certain financial targets and growth levels. In addition, management behavior is affected by the fact that the board has the power to hire and fire top management which provides incentives to show growth in firm value or other performance measures. This also includes avoiding negative results and a desire to maintain steady earnings growth. Maximizing shareholder value could also be from reducing profits with the intention to obtain lower tax rates, less competition, reduce pressure for salary increase or in order to stabilize results to be perceived less risky (income smoothing).

Managing earnings to maximize personal gain is usually performed by management and is achieved either by increasing results, lowering results or stabilizing results. The motive to increase results or beat earnings estimates could be to maximize bonuses, avoid violation of debt covenants, to be perceived as a good manager or to improve job security. As compensation is often directly or indirectly based on performance targets, management has incentives to manage earnings to reach these. The reasons for wanting to reduce results could be to reduce pressure for salary increases or as a way to reduce the pressure on future year's results (to save for a rainy day). The incentive to stabilize results is led by the desire to show stable and predictable earnings as investors dislike variance, in addition to the reasons mentioned above.

To summarize, there are many incentives to perform EM, from maximizing compensation and securing career development, to avoid breach of debt covenants or as a way of reducing taxes. The incentives are driven both from internal pressure to beat budget numbers, as well as

external pressure from analyst and creditors. As EM often simultaneously benefits both shareholders and management, it can be hard to isolate the primary motive of EM (Healy & Wahlen, 1999). Hence, it is difficult to conclude on the rationale. In the following I will describe some of the most frequently used methods of EM and fraud in order for the reader to gain a better understanding of how EM usually is performed.

2.3 Earnings Management methods

Revenues are considered the most important factor in determining a company's success, as it is an essential measure of a company's growth and potential. In addition, revenues have a large effect on the result in the financial statement. It is also an item associated with much uncertainty - which opens the opportunity of manipulation. Consequently, the highest occurrence of EM is found in the revenue recognition process.

One method of EM is *income smoothing*, which is a way of shifting current income to later periods or shifting future income to the current period by eliminating earning peaks and dips (Giroux, 2004). This way income appears to be smoother and steadily growing as movements in income are wiped out. The purpose of income smoothing is to avoid showing losses, to show low volatility in earnings and to show an upward income growth. The principal reason why listed companies misstate financial statements is to meet the expectations of investors and analysts, to avoid a fall in the company's stock price (Stuart, 2011).

If the company's earnings are below target the company could be tempted to report higher than true earnings, either through recording income prematurely or by recording fictitious revenue (Burgstahler & Dichev, 1997). An example of premature revenue recognition is to record revenue before the good is delivered or service rendered or when significant uncertainties still exists. Recognizing fictitious revenue will inflate financial statements now at the expense of future earnings. Companies that have improperly recognized revenue in one period, often continues to inflate revenue in later periods to cover up the previous improperly recorded revenue and losses. The result is that revenues are inflated at an increasing rate, and in many cases this ultimately leads to fraud.

For the same reasons, the company may want to defer revenue when actual revenue is above the targeted or budgeted revenue. This way the company creates a reserve for future periods, to be able to show growth or avoid losses when income is lower. Income smoothing is

typically done through using discretionary provisions (Peek, 2004) or by the use of accrual accounting (Kaznik, 1999).

Shifting expenses between periods is also a method of smoothing income. One method is to move expenses and losses into one single year that already has poor results (*big bath*). This way the company creates a buffer for the future, to be able to show growth and smooth income. This can be done by writing down assets from book value to a lower market value, by overstating restructuring expenses or other provisions (Peek, 2004). The company can also increase earnings by shifting expenses to later periods, for instance by improperly capitalizing costs or by depreciating assets at a too slow rate (Schilit, 2002).

These are just some of the methods of EM, and are not meant to be a complete list. The purpose is just to show some of the many methods that exist to manage the firm's earnings. Management and others responsible to prepare the financial statement are always finding new creative ways to manipulate financial statement numbers.

Red flags in Revenues

A red flag is a warning signal or an indication that something is wrong in the financial statement. If management is smoothing the company's earnings by recording fictitious sales or recording sales too early, this can be detected by looking at the cash flow from operations as the cash flow will not show the same growth as revenue. When the increase in cash from operations is less than the increase in reported results from a period to another, it can indicate that revenue is recorded too early. If the company is continuously manipulating their earnings year after year, an inconsistency between the income statement and cash flow will eventually reveal that something is wrong. Large accruals and hence large differences between earnings and cash flow is an indication of EM (Kaznik, 1999) (Dechow & Skinner, 2000). Moreover, this may be a sign that management is chasing growth at the expense of profitability. If increases in accrued income are larger than increases in accounts receivables, this can also suggest that revenue is recorded too early.

Another approach of spotting red flags in the financial statement is to analyze accounts receivables. Because accounts receivables usually follow sales, one should be aware if long term receivables increases significantly compared to sales as this could indicate fraud. It does not necessarily mean that the numbers are wrong, but it is definitely a warning sign. It might

imply that the company's accounts receivables department is falling behind in billing customers or that their customers are unwilling to pay. It can also be a consequence of changes in the company's payment terms, as the ratio increases if the company extends the credit time to customers. What is more, it can mean that customers are unable to pay, thus making it necessary to increase the bad loss provision and the corresponding cost. The two latter are the more serious. However, it is important to remember that an analysis cannot reveal fraud, but will just give indications that something is wrong.

2.4 The environment

Several factors influence the frequency and magnitude of EM and many studies suggest that EM and fraud is more likely to occur if the responsible person has an incentive or face some sort of pressure. An opportunity to perform EM also needs to be present. Moreover, the behavior needs to be rationalized. Pressure, opportunity and rationalization are three circumstances that usually are present in some degree when fraud occurs. This is commonly known as the fraud triangle (Stuart, 2011). In the following the framework will be presented, to understand the circumstances under which EM and fraud occur.

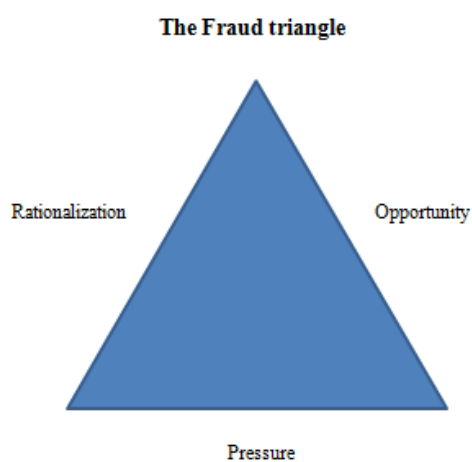


Figure 2: The Fraud Triangle (Stuart, 2011)

Pressure

The frequency of EM is closely related to the incentives or pressures that management or others in the company face from the external and the internal environment. Pressure is the motivation for the person who commits the fraud, and can stem from both internal and external sources. External pressure can stem from society, media, owners, analysts or other stakeholders. For instance, managers may try to show that revenue has increased, even if it has not, because outsiders, particularly owners, expect a certain level of growth (Giroux,

2004). Failing to meet targets could result in a fall in the company's stock price, lower salary, failure to meet debt covenants etc. Hence, management is facing pressure or incentive to misstate financial statements. The source of the pressure depends on the ownership structure and size of the company. As larger, public companies usually are in the public eye, management faces pressure to show positive results and growth to potential investors and analysts. As a result, one would expect a higher frequency of EM and fraud among these companies. However, as the firm grows so does transparency, which reduces the possibility of performing EM. Nonetheless, a higher earnings pressure will increase the tendency of EM. Ownership structure also affects the frequency of EM (Thomsen & Conyon, 2011). As large owners have more control over management, they may pressure management to perform EM.

Pressure from the firm's creditors can also affect the tendency of EM. When the firm is under financial distress or approaching its debt covenants, the occurrence of EM and fraud is higher (Healy & Wahlen, 1999). If the company violates its covenant ratios, they may face difficulties refinancing their debt and also run the risk of high fines. These two circumstances are interconnected as covenants often include minimum requirements for solvency ratios. Listed Norwegian firms report solvency ratios based on balance sheet numbers, and a frequent covenant requirement is book equity ratio. Consequently, management has strong incentives to manage company book values and earnings numbers to meet requirements and avoid fines.

Pressure for fraud might also be due to personal reasons. Personal financial problems or addictions may motivate someone to commit fraud and misappropriation of assets. A person's desire for material goods may also be a strong motivation for fraud. The criminologist Cressey found that the great majority of those who had committed fraud did it to meet their financial obligations (1973). Moreover, the tendency increase around events such as IPOs, mergers and takeovers, loan renewals, changes of management or auditors and changes in regulations (Kinserdal, 2006). On these occasions, management motivation is to obtain a favorable stock price, offer price (acquisition), better loan terms etc.

Opportunity

Opportunity is the possibility or ability to commit fraud in a company and hence a necessary attribute of fraud. In addition to motive, the person committing EM or fraud must believe that there is an opportunity to commit and conceal their actions, as he or she does not wish to be caught. A weak or lacking control system increases the opportunity and risk of fraud, as it is

easier for employees to exploit access rights to assets and records. Moreover, a lacking oversight by management and owners offers the opportunity to both commit and conceal fraud. This also applies to external control mechanisms, such as the quality and level of regulations and the quality and independence of the board and auditor. Hence, the quality of internal and external control mechanisms greatly influences the possibility to detect and avoid EM (Stuart, 2011).

However, most controls can be overridden and circumvented by people with sufficient motivation or control. As administrators of the firm, management is in a unique position to commit fraud. They have the power and necessary skills to manipulate accounting records. Persons with technical competence like the CEO or CFO, knows how to exploit control weaknesses in the company, and has the skills to deceive analysts, auditors and board members (Wolfe & Hermanson, 2004). This risk is present in most firms, even if controls are well designed and effective. Management can also seek assistance from subordinates as their authority and position in the company can facilitate the involvement of additional employees. However, owners and the board of directors have a certain control over this aspect. By hiring the appropriate management, encouraging high ethical standards and implementing appropriate controls the board can limit this opportunity to a great degree.

As the firm grows and becomes more complex, it is increasingly time consuming and difficult for outsiders to understand the company's business. These also increase the possibility and opportunity of EM (Giroux, 2004). Moreover, the existence of complex accounting rules and discretionary estimates provides opportunities to perform of EM, as estimates are usually based on the subjectivity and discretion of management. When estimates relates to uncertain future conditions, management can choose the most beneficial accounting rules and assumptions to portray the firm or themselves in a beneficial way. Because of the information asymmetry between management and outsiders, investors and auditors have difficulties to judge the appropriateness of the estimates.

Rationalization

Even though opportunity and pressure to perform EM and fraud exist, a person's ethical standards and honesty usually prevent such actions. The personal characteristics of management and others, such as morality, wealth and ambition, greatly influence the willingness to perform EM. Rationalization is the last condition that is present when fraud

occurs, and is the attitude or thought process where the person justifies their actions to themselves or others (moral justification). According to research, a primary driver of fraud is the mindset and culture present in the company (Rockness & Rockness, 2005). This is further closely related to the attitude of top management, which has strong influence of the organization's ethical conduct and culture (Buchholz & Rosenthal, 1998) (AICPA, 2002).

A top manager or others with strong personalities can more easily commit fraud as they are more capable of convincing and persuading employees and others, such as auditors and board members. They can also more easily use their power to convince employees to manipulate earnings numbers.

When employees commit fraud, there are often other motivations and reasons. One explanation can be derived using equity theory, where the basic idea is that employees wish to maintain equity between their inputs in a job (effort) and the outcomes that they receive from it, against the perceived inputs and outcomes of others (Adams, 1965). As people constantly compare themselves to others, for instance their colleagues, they try to achieve and maintain fairness between their efforts compared to others. If an employee thinks he is not being adequately compensated for his or her work effort, he will try to balance this inequity and the more dissatisfied this person is, the harder he or she will work to balance the scales which might ultimately lead them to rationalize a criminal act.

To summarize, *pressure*, *opportunity* and *rationalization* are circumstances under which fraud is more likely to occur, and all three conditions are usually present to some degree when fraud occurs.

3. Corporate Governance mechanisms

Corporate governance deals with mechanisms that aim to direct and control the company, such as ownership, boards, incentive systems and corporate law (Thomsen, 2010). These mechanisms are important in regards to EM and fraud. Most fundamentally, corporate governance deals with the problems of separating ownership and control, which is the main theme in the principal agent theory. The principal employs an agent to manage the daily operations of the firm, and as the principal and agent might have different interests, there is a potential risk of the agent acting in his own interest at the principal's expense (ibid). The principal therefore need to monitor the agent, and find ways to ensure that their interests are

aligned. This aim is to avoid that the agent behaves opportunistically, by maximizing his own benefits and personal utility on the expense of the principal.

3.1 Regulation

One way of preventing that the agent acts in his own best interests, is to establish laws and regulations that have the ability to punish the agent if breached. The Norwegian Private Limited Liability Companies Act (Aksjeloven) regulated the responsibilities and duties of the general manager or CEO. According to chapter 6-14 the general manager is responsible for the day to day management and administration of the firm. This include to carry out the company's overall strategy, to design and implement relevant control activities, make sure that the financial reporting is correct, as well as the upper responsibility for finance and risk management. Moreover, the law states that the general manager is subordinate to the board of directors and their instructions, meaning that the board can intervene in decisions that originally belong to the general manager's area of responsibility. The law also affirms that the CEO shall make sure that financial accounts are prepared according to laws and regulations and that the company's assets are administered in an acceptable way. Consequently, the manager has the upper responsibility that the financial statement is free of misstatements.

The general manager is also responsible to ensure that the boards of directors are getting the necessary information they need to fulfill their duties. As the board needs to be informed of the company's activities and financial position in order to perform their control duties, the general manager is obliged to provide the board of directors with information on the company's business, position and profit/loss development (chapter 6-15). These laws place a great responsibility in terms of fraud and EM prevention and detection with management. In part three of the paper I will describe the laws governing recognition of revenues.

3.2 The board of directors

According to Monks and Minow (2004) the aim of the board is to govern the firm and to ensure that the company is run in accordance with the best interests of the owners. This is known as the board's fiduciary duty. The board members are appointed by the shareholders to perform monitoring duties on their behalf. Hence, the board acts as an intermediary between the owners and top management. The board has decision making rights over the firm's assets and is responsible to support management in developing strategy, decide on executive

compensation and to sanction managers, ensure the law is being followed and to evaluate the company's finances (Thomsen & Conyon, 2011). Consequently, the board plays an important role in corporate governance.

The role and duties of the board are regulated in chapter 6 of the Norwegian Private Limited Liability Companies Act. Paragraph 6-12 determines that the board has the upper responsibility concerning the administration of the firm, thus placing the final authority of all major decisions with the board. Moreover, the board shall make sure that the business is properly organized (chapter 6-12.1) and is responsible to keep itself informed on the firm's financial position. It is also accountable to control the company's accounts, activities and capital management (chapter 6-12.3). The law also places a responsibility that financial statement is accurate and reflects the real financial position of the firm with the board.

The board has certain advantages concerning prevention and detection of misstatements compared to other stakeholders. First of all, they can more easily monitor management as they have greater access to information compared to owners and creditors. This also makes them better equipped to analyze the financial state of the firm. If there are any indications of misstatement due to errors or fraud in the financial statement, the board is in a unique position as they can examine the balance or income account down to the specific accounting entries. They also have a duty to investigate such matters. Second of all, the board exercises a strong power over management as they ratify all major company decisions and have the ability to sanction management if necessary. However, the board depends on management to provide them with the necessary information. If management withholds or is hesitant to share information, the board will not be able to perform their monitoring duties efficiently or have valuable contributions to decisions.

According to chapter 17-1, both the general manager and the board can be held liable for damages if they by intention or neglect cause loss to the company. As the law also states the duties of the different parties, which help clarify who is liable for the damage. Furthermore, the board is responsible to get the information they need in a manner they understand, to be able to act appropriately. This is important, as it implies that the board can be held liable for damages in a bankruptcy if they had information on the financial position of the company - even though they did not understand or were not able to analyze the numbers.

To summarize, the law places a large responsibility on the board to communicate correct information to the users of the financial statement. The board has a duty to keep itself informed on the financial position of the firm and has a duty to act and investigate issues they find appropriate. If a misstatement in the financial statement is uncovered, the board can be held responsible if they did not show the necessary attention to issues and indications.

As the directors are elected by the shareholders, the quality of the board depends on the election process and the shareholder's ability to elect a competent and diverse board. Board members should be nominated according to an optimal composition of competence and necessary level of monitoring. This way management and board can cooperate to maximize the value of the company. In the following I will introduce some important board characteristics.

Board Independence and Diversity

Board independence is the most discussed aspect of board structure. It is believed that independent board members are more objective and better at monitoring management as they don't have any ties to management. Board independence is measured as the composition of inside and outside board members. Outside board members can be further divided into independent and affiliated outside directors, who are somehow connected to the company. As dependent members are better informed on the company's activities and business processes, they are typically better suited to support management on decisions that affects profitability. Independent board members on the other hand, are usually are less committed to management, look at outside performance signals and are less occupied by internal activities. Consequently, they are more capable of monitoring the manager's actions and decisions. Thus, it is optimal to have a board made up of both independent and dependent members.

Lately the focus on board quality seems to have shifted from independence towards diversity, as a diverse board is assumed to increase quality of decision making and ultimately performance. Members with financial competence are especially valuable, as competence to analyze and understand financial statement numbers increase the monitoring ability of the board. In addition, it is optimal to have diversity in terms of both independent and dependent directors, as this is believed to increase the board's ability to monitor management and reduce groupthink. Moreover, directors with diverse competencies such as industry experience and financial literacy have the potential to increase the quality of decisions.

Board Size and Activity

Research suggests that large boards are less effective than smaller ones, due to free rider and communication problems. Hence, larger boards usually have a more symbolic purpose and are easier to control. When the board approves the manager's decisions without critical reflection, they are said to act as a *rubber stamp*. However, a company with many business areas needs more advice than a smaller one and consequently a small board is not always optimal. (Thomsen & Conyon, 2011). Nonetheless, the board depends on information and competent members to ensure the quality of important decisions.

Board activity is measured by the number of board meetings and is used as an estimate of the amount of board work. Board members should be involved in decisions and spend enough time on board work to avoid acting as *rubber stamps* and be able to monitor. On the other hand, as the board has less information than management, not delegating work to management can result in suboptimal decisions. Moreover, very active boards may reduce management flexibility and make them reluctant to share information. More involvement from the board can also lead to less objectivity and independence. Consequently, increasing board work and meetings is only optimal up to a certain point (Thomsen & Conyon, 2011).

Board Requirements

Duality is a situation where the CEO occupies the role as chairman of the board. From a governance perspective, this does not make much sense as this suggests that the CEO is monitoring his own actions. This extensive power of the CEO might facilitate the speed and efficiency of decision making, but might be a disaster with a bad CEO. Listed companies in Norway and Sweden are required to have a separation between the board and management, meaning these roles cannot be occupied by the same person. The board is also required to have at least 50% independent directors. The reasons for these requirements are that the board's degree of independence is expected to improve the company's corporate governance.

Other Control Mechanisms

In Scandinavia, social norms and welfare ambitions work as substitutes for laws and act as governance mechanisms. As the consensus principle is very strong, it is important to preserve harmony. Consequently, management strives to make decisions that receive a high degree of consent (Thomsen & Conyon, 2011). Other potential external control mechanisms are threat of takeover, labor market for managers, external analytics, creditors and competition. The

labor market for managers serves as a control mechanism as managers depend on a good reputation to find a new job outside the company or to develop in their career. Providing management with incentives is one way of aligning the interests of management and owners.

3.3 The auditor

The auditor is required to express an independent opinion on whether financial statements are prepared in accordance with applicable financial reporting frameworks (ISA 200.3). The aim is to increase the level of confidence in the financial statements and reduce the information asymmetry between the users and producers of the financial statement. Moreover, the auditor ensures that the statement gives a true and fair view of the company's performance and financial position. For these reasons, the auditor is another important governance mechanism. The responsibilities of the auditor are regulated in the International Standards of Auditing (ISA's)¹ and the Norwegian Audit law (Revisorloven). According to ISA 300, the auditor is responsible to identify and assess the risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and environment, including the existing internal controls. Hence, the auditor must obtain sufficient and appropriate evidence on whether material misstatements exist, through designing and implementing appropriate responses to identified risks. Consequently, the law places a responsibility on the auditor to prevent and detect fraud (Revisorloven §5-1.3). Similar to the board and CEO, the auditor can be held responsible for insufficient or fallacious information about the financial state of the company.

As discussed above, the risk of EM and fraud is especially high when financial statements include significant estimates based on management good judgment. The ISAs requires the auditor to review accounting estimates and evaluate if they contain any biases and judge whether the bias, under the circumstances, represent a risk of material misstatement due to fraud (ISA 240.32b). The auditor should also review *prior* financial statements for significant accounting estimates and assess the reasonableness of management judgments and assumptions. Moreover, the auditor ought to have a questioning mind and be alert to conditions which may indicate misstatements. Thus, it is key that the auditor has the necessary knowledge to be able to execute an audit with high quality. The next chapter introduces the frameworks that regulate financial reporting.

¹ International Standards on Auditing (ISAs) are professional standards regulating the auditor's responsibilities

PART III – FINANCIAL REPORTING

4. Financial reporting frameworks

4.1 The Accounting Act

The Accounting Act (Regnskapsloven) from 1998 regulates financial reporting in Norway. Most fundamentally, the company needs to comply with the basic accounting principles in the preparation of the financial statement. These principles are overall guidelines of accounting, and form the groundwork on which the more detailed accounting rules are based. These basic principles or guidelines can be found in chapter 4 of the Accounting Act (4-1 through 4-5). According to section 4-6 of the Accounting Act, the financial report should be prepared in accordance with good accounting practice, meaning in compliance with basic accounting principles, other provisions in the Accounting Act and other GAAP. In the following I will focus on the principles that are relevant for this paper.

The transaction principle

The transaction principle states that *transactions shall be recognized at the value of consideration at the time of transaction* (Accounting Act 4-1.1) According to the Accounting Act, a transaction involves the transfer of control of an economic resource, between two independent parties, in exchange for some sort of remuneration. Consequently, a transaction will alter the composition of the balance sheet in the relevant period and usually also affect the income statement (Johnsen & Kvaal, 1999). The transaction principle set guidelines on how goods or services should be recognized and valued in a transaction. According to the principle, the value of the good or service in the transaction is the value of the consideration. Transactions can be divided into sale- and purchase transactions, finance transactions and equity transactions.

It is important to distinguish between real and non real transactions. A *real transaction* is a transaction where the two parties are independent, in other words an arm's length transaction. Furthermore, the transaction must contain a real transfer of goods or services – the exchange or swap of identical goods or services is not regarded as a transaction that generates revenue. And finally, the transaction must involve a transfer of risk and control. The transaction time is identified as the time where both risk and control has been transferred between the buyer and

seller (Johnsen & Kvaal, 1999). For retail sales, the transfer of risk and rewards of ownership usually match with the shift of possession of the good to the buyer.

The Earned income principle

The earned income principle affirms that *income shall be recognized in the income statement when it is earned* (Accounting Act, 4-1.2). As revenue is not necessarily earned in the same period as the transaction takes place, the sale by itself is not sufficient for revenue recognition (Johnsen & Kvaal, 1999). Consequently, revenue recognition can be deferred or accrued in relation to the time of transaction. Income accrual is common when dealing with long term production contracts. Earned income can be divided into transaction based and value based income. In traditional historical cost accounting, income is recognized on the basis of a transaction. However, in cases where income is value based, it is inappropriate to recognize income this way, for instance for financial assets or foreign exchange where an efficient market exist.

Transaction based income can be further divided into income earned *on* the time of transaction, *after* the time of transaction and *before* the time of transaction. Normally, income is viewed as earned when the sale has taken place, meaning when goods are delivered or services rendered. The transaction is completed when all risks and rewards of ownership has been transferred to the buyer. The amount of revenue to be recognized is usually equal to the amount of cash the seller expects to receive, and this amount needs to be measured reliably. Moreover, the company cannot retain managerial involvement or effective control over the goods sold when they recognize revenue. Revenues should not be recognized before it is probable that economic benefits associated with the transactions pertains the company. In the case of deferred recognition of revenue, the transaction price is generally known, and the uncertainty relates to some other future component. In the case of accrued recognition, the uncertainty usually relates to the transaction price, which in this case needs to be estimated (Johnsen & Kvaal, 1999).

The matching concept

According to the Accounting Act *costs shall be expensed in the same period as related income* (4-1.3). The main aim of the financial statements is to measure the firm's performance in an accounting period, so that users are able to make informed decisions about the firm. The matching principle improves the measurement of results, as the disparity between when costs

are incurred and when revenue is realized is removed. With the periodic matching of costs to revenues, incurred expenses are offset with the related income on a cause-and-effect basis (Kvifte, 2006). This usually means that expenses are recorded when goods are transferred or services rendered. Moreover, when there is no direct association between revenues and expenses, matching become more discretionary. A document from the EC Accounting Advisory Forum explains that the matching principle is usually *understood as the practice of allocating expenditure to the related income* (2005, p. 19). Thus, allocating expenditure involves the deferral and accrual of costs. The size of accrued liabilities is usually uncertain and needs to be estimated based on subjectivity, which provides an opportunity for EM. Hence, the matching principle makes it easier to evaluate the firm's profitability and performance, but also enables management to manage earnings numbers as the principle is flexible,

Best estimate

The Accounting Act (4-2) requires the use of the best estimate in case of uncertainty, which implies considering all available information when the annual accounts are prepared. Hence, all foreseeable liabilities and potential losses that occurred during the accounting period or earlier should be recognized, even if they were discovered after the end of the accounting period. These items should be valued at expected value and be based on the latest available information in order to be unbiased. Because the expected value is unknown in many cases subjective judgment is necessary, which further provide opportunities for creative accounting.

Moreover, Section 3-2a requires the financial statement to give a true and fair view (rettviseende bilde) of the company's financial situation, and overrides the basic accounting principles and the other rules in Chapter 4,5,6,7 of the Accounting Act.

4.2 IASB Framework

The International Accounting Standards Board (IASB) is an independent, standard setting body of the International Financial Reporting Standards (IFRS). The foundation is responsible to write IFRS, formerly International Accounting Standards (IAS), and to promote the use and application of these standards. The IFRS and IAS is required or permitted to be used by more than 100 countries, including Norway and Sweden (Stuart, 2011). It is useful to be familiar with the framework, in order to understand the underlying prerequisites and fundamental principles of the financial statement (Kvifte, 2006).

Users of the financial statement

As the financial statement has many users, its quality depends on the user's interest in the firm. IASB and other standard setting organizations have identified the investor as the primary user of the financial statement (Kvifte, 2006). The aim of the financial statement is to communicate useful and valuable information to these decision makers to enable them to make informed decisions about the company. Thus, the quality of the financial statements depends on the ability to accurately reflect the underlying economic performance of the firm. To be useful, information need to be relevant and faithfully represent what it claims to represent (ibid). *Relevance* and *faithfully represent* are two fundamental qualitative characteristics in the IASB framework. The framework further has four enhancing qualitative attributes, namely *comparability*, *verifiability*, *timeliness* and *understandability*, which aim to improve the usefulness of financial information. These qualitative characteristics will be explained in the following.

Understandability

Information must be understandable for users with a reasonable knowledge of business and economics (IASB Framework, no 25) and is understandable if it is classified and presented in a clear and concise way. As relevance is more important than understandability, relevant information should be included even when it is hard to understand (Kvifte, 2006).

Relevance

Financial information is relevant if it affects a user's decision, or if it contains information on management performance (Kvifte, 2006). In addition, information needs to be timely to be relevant, in other words available in time to influence decisions. If information is late, it loses its value. Hence, *timeliness* is a prerequisite for relevance. Another related term is materiality, a firm specific feature of relevance that concern the nature or magnitude of items in the financial report. Only information that is material is regarded to be relevant by the IASB (Kvifte, 2006).

Comparability

Information in the financial statement needs to be comparable to similar firms (uniformity), and also with the same firm over time (consistency), in order for information to be useful in decision making. This way the user can see the firm's development in revenue or other line items and evaluate how the company is performing compared to its peers. Hence,

comparability facilitates the identification and understanding of similarities and differences between firms and within the same firm over time.

Reliability

According to the framework, information in the financial statements must *be neutral, that is, free from bias* in order to be *reliable*. This is closely related to the best estimate principle in the Accounting Act. Moreover, IASB states that reliable information must be valid, implying that the financial information faithfully represents what it is supposed to. This assures decision makers that information is neutral and accurate, and that the company's financial condition is represented truthfully. A problem is that information can be valid and reliable, even though it is not verifiable or objective. IASB emphasize that it is more important that information is valid than verifiable. This can be seen from the increase in the allowance of fair value accounting in IFRS, as fair value is in less verifiable than historical cost in most cases (Kvifte, 2006).

As companies often have to choose between relevance and reliability when preparing financial reports, these are seen as competing requirements. This relates to how the items in the financial statement are to be recognized and reported. In the next section, the different methods of measurement will be briefly discussed.

Measurement Methods

The Framework lists the following measurement methods; historical cost, current cost, net realizable (settlement) value, and present value (discounted). However, it does not state under which conditions or when different measurement principles should be used. A variety of these are used today and in combination. Historical cost is the most used measurement basis. Assets such as inventory, intangibles and equipment are carried on the balance sheet at acquisition cost adjusted for depreciation and impairment. Fair value is *the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction* (IAS 39.9). In recent years, IASB has taken tentative steps towards their long term goal of using fair market valuation as a measurement basis in IFRS instead of historical cost. Replacing historical cost basis with current cost system is argued to lead to more accurate financial reporting as values reflect the market's assessment instead of the historic acquisition price. This would give more relevant information for external users, and increase financial reporting transparency.

However, there are also many issues with fair value accounting. First of all, when financial instruments are not traded in active markets, fair value is difficult to measure and necessitates subjective estimations based on valuation models, which gives opportunity for EM. External users cannot easily judge if these estimates are reasonable or not. Secondly, a mixture of historical cost and fair value makes it hard to compare companies which can confuse readers and lead to misunderstandings. Thirdly, fair value accounting might give high variability in the value of assets and liabilities that translate directly into performance gains and losses, which results in increased volatility in the company's earnings and equity.

4.3 IAS 18 Revenue

International Accounting Standard (IAS) 18 is the applicable accounting standard used when recording revenue. The standard applies to accounting for revenue from the sale of goods, rendering of services and use by others of an entity's assets that give rise to interest, royalties or dividends. The standard defines revenue as increases in economic benefits in an accounting period that is linked to the firm's ordinary activities, that increases the firm's equity (IAS 18.7).

IAS 18 focus on the timing of revenue recognition, and lists certain conditions that need to be met in order to recognize revenue. First of all, revenue cannot be recognized until it is probable that the economic benefits associated with the transactions will go to the company. Secondly, both the amount of revenue and the costs incurred related to the transactions needs to be measured reliably. Thirdly, all significant risks and rewards of ownership need to be transferred to the buyer. This usually occurs when the legal title or control is passed to the buyer. Forth, the company cannot recognize revenue if they retain managerial involvement or effective control over the goods sold.

Usually, the time of transaction is when the risks and rewards of the product or service are transferred. Identifying the time of transaction is usually straightforward, but can be complicated, for instance when the sale includes guarantees or subsequent services. In this case, only the price of the good should be recognized at the time of transaction and the price of the service should be capitalized in the balance sheet, as deferred income and recognized as revenue over the whole period of the service obligation (IAS 18.13).

The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer. Revenue should be measured at fair value, meaning at the amount of cash the firm expects to receive. If the revenue is deferred the fair value may be less than the nominal amount of cash received or receivable. Then the fair value is determined by discounting the future cash flow using with an applicable interest rate. If revenue is based on an estimate, the standard states that the company and the other parties in the transaction should agree on the terms of the transaction, such as the compensation, the rights and obligations and the manner and terms of settlement before revenue is recorded. The standard also states the importance of an effective internal financial budgeting and reporting system.

4.4 IAS 10 Events after the Reporting Period

International Accounting Standard number 10 applies to events that occur after the reporting period, but before the issuance of the financial statements. The standard contains requirements for when such events should be taken into account in the financial statements. The standard separates between adjusting events and non-adjusting events. The adjusting events are events that exist at the end of the reporting period, which should be adjusted for in the financial statements. Non adjusting events on the other hand, arise after the reporting period, and are generally not disclosed in the financial statement (only when material). According to the standard, *a company should update disclosures that relate to conditions that existed at the end of the reporting period to reflect any new information that it receives after the reporting period about those conditions* (IAS 10.19)

Thus, the company ought to update disclosures that relate to conditions that existed at the end of the reporting period to reflect any new information that it receives after the reporting period about those conditions (ibid). For instance, a large estimate that has a large financial effect could be updated to account for new information. It also includes new information concerning the value of assets which indicates a fall in value that needs to be accounted for. Moreover, the company should also update the financial statement to conditions that arise after the reporting period, if these events are important, meaning they can affect the users decisions on the firm. This depends on the nature of the event and its financial effect.

4.5 Discussion

As financial reporting requires management discretion, it is particularly interesting in relation to EM. The accounting rules provides a great deal of flexibility to management and other preparers of the financial statement, and by exploiting this flexibility the company can increase revenues and stretch results. Even though this is not legal, it is difficult to find evidence or prove such accounting practices. Nevertheless, there is a tendency that aggressive accounting evolves and ultimately ends in more serious cases of fraud. Many efforts have been made to increase legislation and to improve accounting standards to avoid that the company exploits the accounting rules. However, according to Largay (2002), the mere existence of these rules is not the answer, as legislation will not prevent fraud from occurring. He claims that *the only answer is the rebirth of professional judgment in an environment characterized by incentives that make the prudent exercise of judgment the only viable alternative.*

The Norwegian accounting standards are principles based, as opposed to rules based. This means that preparers, auditors, audit committees and boards need to exercise professional judgment when reporting and auditing the financial statements. Even though principles based standards provides more flexibility in accounting, researchers and academics argue that they are more advantageous compared to rules based standards such as the IFRS. The reason is that an increasingly detailed regulatory framework cannot substitute good accounting practice anyway, so the auditor and preparer need to exercise professional judgment to make sure financial reports fairly represents the economic reality of the firm. They believe good practice is a dynamic concept that allows practice to develop at the same pace as the economic environment.

5. The power industry

To understand how revenue is generated and recognized in the power industry it is useful to give a short overview of the industry's value chain. The value chain includes generation, transmission, distribution and consumption of power. Figure 3 illustrates the value chain and key activities (Figure 3). In the following, I will focus on the two latter parts of the value chain, namely electricity distribution and consumption.

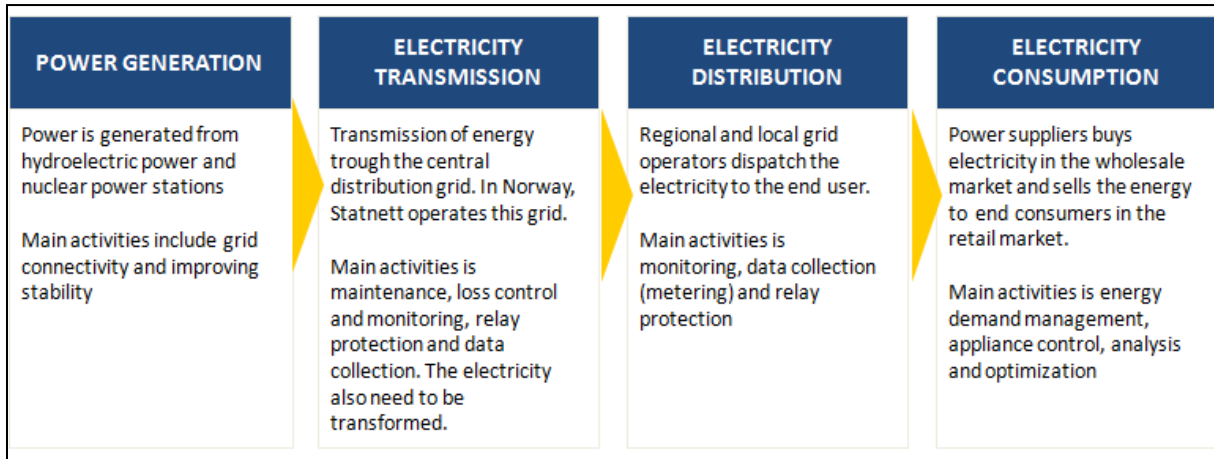


Figure 3: The value chain in the power industry (own illustration, 2012)

5.1 Electricity distribution

Electricity is distributed to the end users through a grid system, which is owned and operated by a local grid company. The grid company operates a part of the national distribution grid, where it owns the electricity meters and the electric power grids. As the grid company has a natural monopoly on electricity distribution services, it is obliged by law to deliver electricity to the end users in their area (Svensk Energi, 2012). The grid company is also responsible for maintaining a reliable and effective distribution grid. There are about 150 grid companies in Norway, where the majority is smaller companies with fewer than 10.000 customers (NVE, 2011). In Sweden, the market is dominated by a few large grid operators. The final customer pays for the distribution through a regulated network tariff, which is the basis of the grid company's revenue. In addition to the network tariff, the final customer has a contract with a power retailer for buying electricity. In Norway, constraints on the revenues of grid companies are strictly regulated by the Norwegian Water Resources and Energy Directorate (NVE).

NVE has placed the responsibility of data collection at the grid company, on consumption at both the customer level and more aggregated level if necessary. This means that the grid company has to transmit the data to all the power suppliers in their concession area and the person responsible to settle accounts (Regulation on metering, settlement etc. no 301). Moreover, they are responsible that this data is reliable. The grid company is also responsible to provide stipulated data that can be used in the settlement in cases where meter readings do not exist. Consequently, the grid company is the administrator of all consumer data in the value chain.

Meter readings

The contract between the consumer and the local grid supplier usually place the responsibility to read the meter with the consumer. The grid company is obliged to gather these data at certain intervals, depending in the customer's total consumption. In Sweden, household customers are required to read the meters on a monthly basis. However, the general rule is that all meters have to be collected *at least* once year, unless this causes unreasonable costs or inconvenience to the grid company (Nettavtalen 5-2). The number of customers that fail to read their meter once a year is quite large and it is accepted it takes some time before the grid companies carries out the meter reading. There are many examples of customer complaints, where the customer has not read the meter over longer periods (5-10 years) where the main responsibility is placed at the customer, and not with the grid company (Elklagenemda, 2012).

When the customer has read his meter and registered this with the grid company, the grid supplier forwards this information to the power supplier for invoicing. If the customer does not register his meter reading in time, for instance before the 15th of January, the grid company will usually wait a certain time period to allow the customer some time to still register. Depending on the grid company, this could mean everything from a week to a month, before the grid company eventually stipulates the customer's consumption. After the grid company has received the meter reading, or alternatively made a stipulation, they are obliged to supply this data to the power supplier within three weeks. However, it is not unusual that these data arrive late.

Some customers have installed automated meter reading (AMR) devices that automatically measure the customer's utilization of energy and transfers these data to the grid company on an hourly basis. In Norway, companies with a yearly consumption over 100 000 kWh are required to have installed such devices (Olje- og energi departementet, 2007). This is about five times the consumption of an average household, hence only applying for a small amount of the customer base - mainly commercial and industrial customers. The introduction of such measuring instruments provides a better basis for correct settlements, compared to today's system with manually read meters and stipulations.

Customer profiles

When reading the meter on a periodical basis, there is no possibility to determine how consumption is spread throughout the period. To estimate this, the grid company constructs

customer profiles, so called adjusted input profiles (justert innmatningsprofil JIP), which is a standard customer profile. They use this profile to estimate how consumption is spread throughout the day and between the different geographical areas. Thus, assume that all end users in an area have the same consumption pattern. The customer profile is calculated based on the difference between total physical delivered volume (less network losses), the actual delivered volume to the AMR devices and the number of other customers. Grid companies are required to make such profiles, and to use this profile when settling the accounts with the power companies.

The grid company knows the total delivered volume (kWh) on the day after delivery. This information is supplied from Statnett². However, as there are many different power suppliers operating in their concession area, they do not know how the split of volume between these suppliers. What they do know, is the amount of customers the different suppliers have in their concession area. Hence, they calculate a preliminary volume to the supplier based on the share of total customers the power supplier has. They use a macro calculation to distribute the volume on suppliers, based on the customer profile for the particular area. Consequently, there will be deviations between this preliminary volume and the actual total consumption for a specific power supplier. One problem with this volume distribution is that the grid operator has no incentives to make this estimation as accurate as possible, as they receive their revenues directly from the customers irrespectively. This deviation between the preliminary and actual volume is settled internally between the grid operator and the power supplier in arrears, after the actual consumption is known. In other words, the grid operator has to send out invoices and credit notes to all the suppliers operating in his distribution grid – which may take some time.

5.2 Electricity consumption

The last part of the value chain is the retail market, where power suppliers buy electricity in the market and sells it to the end consumer. Typically, the power supplier usually do not own or operate generation, transmission, or distribution facilities. The final customer can freely choose between all the power retailers participating in the power market and currently there are around 200 such retailers in Sweden (Proff, 2012). As users of electric power normally

² Statnett is the national main grid owner and operator in Norway, equivalent to Svenska Kraftnät in Sweden (<http://www.energifakta.no>).

either cannot or do not differentiate on whether power is generated from renewable sources, competition mainly focuses on price and the pressure on margins in the industry are high.

Price of power

The Nordic markets for electricity is integrated, and most trading happens through the Nordic power exchange Nordpool, where power suppliers buys electricity at spot price. The spot price of power is set according to total available electricity and size of demand (market clearing price), and is influenced by factors such as weather and temperature. As hydroelectric power and nuclear power represents 90% of total power production in Sweden, the price is heavily influenced by amount of available water in reservoirs, and production at nuclear power plants. If the availability or production is reduced at a reservoir or nuclear power plant - the price increases. The same happens when the outside temperature drops, as demand increases when consumers need more electricity for heating (Nord Pool, 2012). This makes demand and hence price extremely volatile throughout the year and between seasons. Even within hours, price can change dramatically. The price also varies between geographical areas, as the price is set in the equilibrium of an area's demand and production. Price variations represent a risk for power suppliers, as it heavily influences revenue and profit. The power companies usually mitigate this risk by securing the price in advance.

Hedging

Margins from fixed price contracts are secured through financial energy contracts, either through buying futures contracts or options. The futures contract is a standardized contract between two parties to buy or sell an asset, in this case power, at a predetermined price and during a specified future time period (McDonald, 2006). The time period of the future reflect the time period of the power contract. The option is a contract which gives the owner the right, but not the obligation, to buy or sell an underlying asset or instrument at a specified strike price on, or before, a specified date. This way the company secures against price movements above the fixed price level they offer their customers and reduce the possibility of substantial losses. This is called hedging (ibid).

Power retailers usually hedge electricity prices on fixed price contracts, based on the company's total forecasted volume from these contracts (Kraft & Kultur, 2011). As a result, the company reduces their exposure to price variations. Customers with market price contracts, pays the spot price with a markup. This makes hedging unnecessary as the risk of

price variations lies with the customer. When a customer enters into a fixed price contract, the power company turns around and buys the amount of electricity the customer is expected to use during the contract's time period. This is done by buying futures contracts or options at Nasdaq OMX Commodities. As the price can fluctuate a lot in a short period of time, the hedging should be done as soon as possible, preferably during a couple of minutes from the time the customer has agreed to a fixed price contract. Otherwise, the company has the risk that the price might increase, which makes the company vulnerable to losses. If a power company fails to secure the price, the company is exposed to price risk. If the price increases the company loses the difference between the price they pay in the spot market and the price in the contract. Similarly, they make a profit if the price increases. Because it is not possible to perfectly forecast demand, the company cannot safeguard against all price risk. Hence, there will always be some losses or gains due to price movements in a power company, but these are usually relatively small.

If the company does not secure the price, they have a so called short forward position, meaning an obligation to sell power at a fixed price. If an investor has a short position, he has an expectation that the value of the asset will drop (McDonald, 2006). Consequently, the power supplier is speculating on a fall in the price of electricity if he does not hedge. In theory, there is no limitation on the maximum loss of such a short position (ibid).

Contract price

The price charged to customers can generally be divided into either market or fixed price. Contracts with market price are based on the daily spot price at Nordpool plus a markup. This contract can either apply for a set time period or be terminated at any time. Fixed price contracts guarantees the customer a certain price, and usually apply for a predetermined time period. The price is based on expected future prices (derived from futures prices) and is set somewhere between the cost price and what the market allows.

5.3 Revenue recognition

According to GAAP, revenue should be recognized when goods are transferred or services rendered, which for a power supplier is when the electricity is delivered to the customer. In theory, this implies that the power companies need to recognize revenue continuously, as electricity is constantly utilized. The result is that a portion of earnings needs to be estimated at all times because of the natural delay in meter readings. In the following, I will go through

the information the power supplier use when calculating revenue, as well as how they estimate revenue at year end and the associated risk. I will start with the invoicing process.

Invoicing

The power supplier is free to choose the method of invoicing, as opposed to the grid company (Olje- og energi departementet, 2007). Thus, invoicing routines varies between suppliers, both in terms of frequency and method (before or after consumption). The frequency of meter readings and invoicing also varies between customer groups, but mainly occur on a monthly, quarterly or yearly basis. The most common invoicing method is to invoice *after* delivery, although some companies invoice *before* delivery. When invoices are sent after delivery, the invoiced amount is based on actual consumption derived from the of periodic cycle meter reading for the period or stipulated consumption. As payment takes place after delivery, the sale is on credit.

When invoicing the end user, the power company use the customer profiles (constructed by the grid company) to decide how the total consumption is distributed throughout the period, and then use the applicable price to calculate the total invoicing amount. If the customer does not read his meter, the power supplier use the total stipulated amount obtained from the grid company and the same customer profile to calculate the total invoicing amount. It is a relatively large number of customers that are invoiced based on stipulated consumption, thus a large fraction of earnings are based on stipulations. If actual consumption differs much from this number, earnings will vary over time. Conclusively, invoiced amounts will rarely be aligned with the actual running consumption, as power companies have different supply contracts (many grid operators, yearly settlement, invoice based on stipulated values etc).

Accounts receivables

The invoiced amounts, whether accurate or not, is recorded as accounts receivables on the balance sheet. Accounts receivables are current assets on the balance sheet and should be valued at the amount of cash the client expects to collect the following year. Consequently, it should be recognized in the balance sheet after deducting a provision of estimated loss. Estimated loss for uncollectible accounts is recorded in the same period as the related revenues, with an offsetting credit to the allowance for uncollectible accounts. The change in the accounts receivable balance from one year to the next is reported as an increase or decrease to cash from operations.

If consumption is stipulated, any errors in consumption will be corrected the next time the customer reads his meter. It is both the power supplier and the end user that bears the risk and cost if the stipulated value is wrong. So, if the invoiced consumption is higher than actual consumption the end user bears the loss, while the supplier bears the loss the other way around. Because of the large size of stipulated consumption, the risk of recognizing revenue in the wrong accounting period is high.

5.4 Revenue Estimation

Because of the delay in meter readings, actual consumption and earnings are not known with certainty until after the accounting period for a part of the customer base. Consequently, revenue earned from the last meter read date through the last day of the accounting period needs to be estimated. To assure the accuracy and completeness of revenues, suppliers of power is required to use their *best estimate* in consistence with the Accounting Act (section 4-2) when estimating income. As the forecast and estimates of consumption and earnings usually involves several different products and prices it is a complex calculation.

Accrued income

The earned but not yet invoiced revenue is recognized as accrued income in the balance sheet and recorded as income in the income statement. When income is earned but not yet invoiced, the receivable amount is added (debited) to the accrued income account in the balance sheet, and an equal amount is credited in an income account. Accrued income represents the amount of income earned or accrued that is applicable to current or prior periods that has not yet been invoiced or collected. Eventually, when this consumption is invoiced, it is deducted (credited) from the accrued income account and added (debited) to accounts receivables on the balance sheet. When funds are collected, the cash account (or an equivalent) is debited, and the receivable account is credited. Accrued income is an interim account, meaning that it is a short-term asset, and since customers are invoiced at least once a year, the bulk of this account at year end should relate to sales that occurred throughout the year.

Total delivered volume in the year minus already invoiced consumption is the basis of the income estimate. Consequently, the power supplier needs to obtain both volume and decide how this volume is distributed to contracts, in order to use the right prices.

Obtaining volume

The power supplier have no overview of delivered consumption, but rather rely on the grid companies to supply this data, both on preliminary consumption as well as actual meter readings and stipulated consumption. When the company buys volume it states the preliminary consumption received from the grid supplier, and hence pays for the estimated volume. What complicates this is the fact that the power supplier is likely to operate in different local grids, hence need to rely on *estimations* from multiple grid companies. There are also other sources of errors, such as reading errors, reading delays, errors in the exchange of information to the power supplier as well as errors in stipulated data. In addition, data can arrive late, as information handling and processing is time consuming and complex due to the large size of data. The grid companies also have different data systems, which result in varying quality in data and estimations.

A period's accrued income is calculated based on the sum of preliminary total volumes from the meter read date to the end of the period, obtained from the different grid companies. Since the preliminary volume is the same as the volume reported and bought at Nordpool, the company can easily reconcile purchased volume to delivered volume obtained from grid companies. Nordpool sends out monthly invoices specifying the total volume bought each week. Moreover, the actual physical delivered volume should not differ too much from the sum of the already invoiced volume and the estimated volume used in the income calculation (alternatively minus prepayments). This way the company gets a reliable and fairly good estimate of earnings at the closing of accounts.

Depending on the size of the company, they might have customers all across the country which implies they could need up to 150 different grid companies to provide them with preliminary volumes. As the preliminary volumes are only rough estimates, the total delivered volume used in the revenue estimate will in reality be the sum of 150 different estimates. Consequently, total volume used in the accrued income estimate might be inaccurate.

Deciding the price

Having now an estimate on total volume, the company needs to evaluate how volume is divided between the different contracts. This is important to get the best possible estimate, as prices differ between contracts (spot, fixed price etc.). If the volume distribution deviates much from the truth, the accruals and income would be wrongfully stated in the financial

statement. For instance, if the company completely misses the volume of spot price contracts, the estimate is inaccurate as the margins on spot price contracts and fixed price contracts can be significantly different. It is therefore crucial to use the best estimate when distributing volume. By using historical customer data already available in the company's databases, an advanced excel model can help distribute volume based on the customer profile's share of the total forecasted yearly volume. This consumption can then be used in the revenue estimate. Moreover, it is important that the calculation has the right and updated prices in order to give the best estimation of revenue. This might seem simple, but as prices can be manually transferred or changed in a manual earnings estimate –there is risk that price is not updated or incorrect. In addition, the company probably has a range of different prices in the fixed price contracts, depending on when the customer signed the agreement. This might make it hard to decide the average price. The accuracy of the price depends on the quality of the customer database (updated and correct data).

After deciding the volume split, the revenue estimate can be calculated using the appropriate prices. When determining revenue from spot contracts, the company first decides daily consumption of these customers and then multiplies this with the applicable daily prices taking the fixed number of customers/installations into account. They determine the daily utilization of electricity from the customer profile received from the grid companies. For fixed price contracts, the company uses an average price of these contracts multiplied with the total volume. There are many sources of errors in this calculation, and this is where the main risks in the revenue estimation lies.

Sources of error

There are many sources of errors and misstatements in the accrued income estimate. First of all, the power supplier does not control any data on delivered volume - as it is the grid supplier that distributes the electricity to the end user. As mentioned earlier, the power supplier receives this data from the grid supplier. Since the grid supplier only has data on the *total* actual physical delivered electricity for a period, he does not know the volume split between the different power suppliers in his concession area. Thus, there is a risk that the preliminary volumes might be wrong. The settlement between the preliminary and actual volumes is not done until after the reporting period, there is a risk that the total volume used in earnings estimate is wrong. However, as most grid companies are fairly good at estimating

volumes the risk of using wrong total volume is not significant. The relationship between the power supplier and the grid company is illustrated in Figure 4.

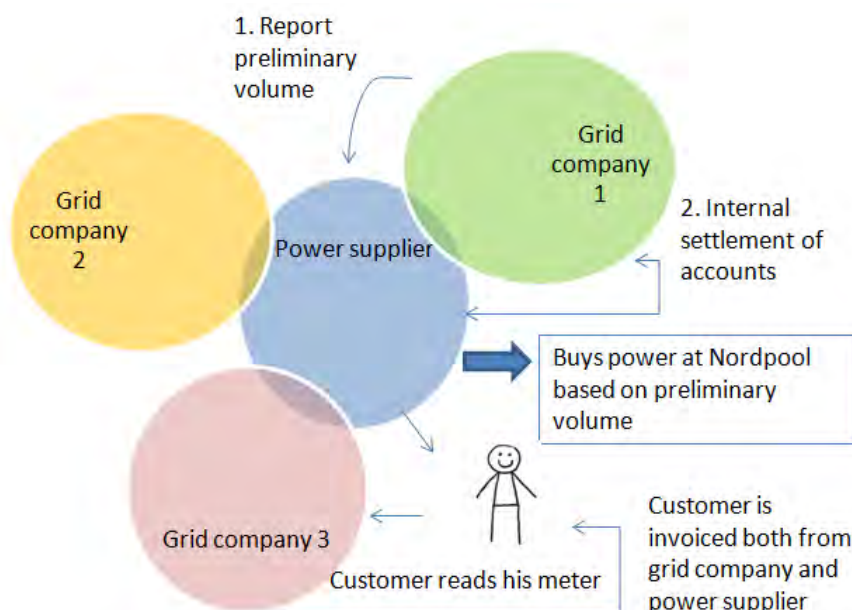


Figure 4: The grid supplier and power supplier (Own illustration, 2012)

The largest source of error in the accrued income estimate relates to the *volume split* between the different contracts. As prices differ between contracts, the revenue estimate can be correct concerning total volume – but still be over or over or understated if volume is incorrectly divided between contracts. Since this volume split can be difficult to know in advance, there is typically a deviation between *estimated* accrued income in the balance sheet and the *actual* earned income. The size of the deviation depends on the quality of data concerning historical consumption of customers, whether the company is growing or in steady state, the number of contracts, grid companies, quality of data at the grid company, quality of meter readings etc.

To illustrate, if the company is in steady state, the distribution of volume can be an unproblematic exercise. In this case, the customer base is more or less constant with only a limited numbers of customers rotating. Then, it is important that information in the customer database is valid and updated. If the company has high quality data on their customer's consumption pattern, they will also have a good idea on how volume should be distributed to the different price contracts. On the other hand, if the company is growing it lacks historical customer data. What is more, the quality of the customer database might be poor. Consequently, the revenue calculation can be a challenge and might not give valid and reliable results.

The precision of calculations of consumption and accrued revenues will also vary as certain interim periods are generally subject to more estimation variability than others e.g. due to seasonal variations. Hence, the different customer profile's share of total consumption will vary and cause some variability in the accuracy of estimations. It is therefore also necessary that the firm reviews and revises the revenue estimate if necessary and that the auditor reconciles the actual invoiced revenue to the estimate in the following year.

Conclusion

As it takes time to collect and update consumption data from for the different grid suppliers, it can take months before the actual consumption is known after delivery. This might take as long as 3-6 months, depending on when the meter is read and stipulated and when the power supplier gets the final settlement of accounts from the grid companies. Figure 5 sums this up in a simplified timeline. Thus, revenue relating to the last period in the year needs to be estimated in the financial statement. After the financial statement is issued, the power supplier will know the size of actual earned income, and can see if the estimate was accurate or not. In a large Norwegian power company, these deviations have historically varied between +/- 80 MNOK (Hafslund ASA, 2011), thus affecting the profit both positively and negatively. The deviation stems mainly from incorrectly distributing total volume to contract types, but there are also some deviation from using incorrect volumes. Even though this deviation seems very high, it equals less than one per cent of total earnings, thus relatively immaterial. It amounts to 15% of accrued income at year end.

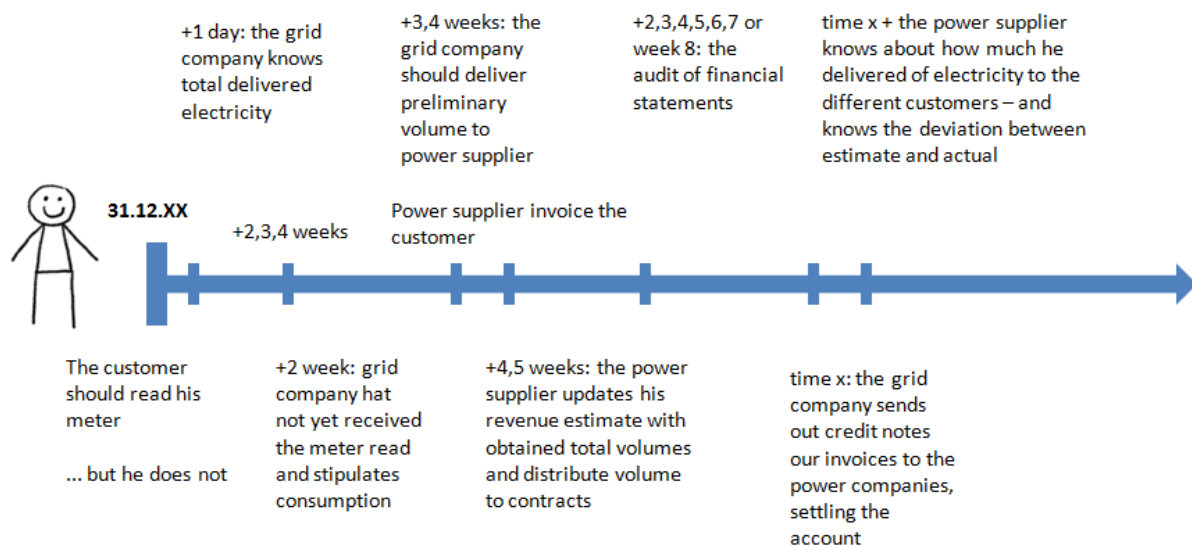


Figure 5: Timeline (Own illustration, 2012)

To sum up, the revenue estimate is based on preliminary volume from the grid company, after subtracting already invoiced volume for the period, distributed to customer profiles based on

the forecasted share of the profile's total demand. The deviation between estimated and actual income can be quite large, as this is a complex calculation. What is more, the deviation can be both positive and negative as this depends on if volume is overstated on contracts with high margins or low margins.

5.6 Risk of fraud

The accrual method of accounting aims to provide a more accurate picture of the company's economic performance in a period (FASB, 1985), but also increases the risk of misstatement in the financial statement. As revenues have a large effect on the company profit, there is an inherent risk of fraud in the revenue recognition process, mainly due to fraudulent financial reporting, as management or others have an incentive to manage earnings. As accrued income is an estimate it is susceptible to misstatement both due to errors and fraud. This stems from the fact that the estimate necessitates subjective estimations, which provides flexibility and opportunity to manage earnings. There is a risk that revenue is recognized in the wrong accounting period, or that accrued earnings are estimated to high or low. As both consumption and price are uncertain variables, the risk that management overstates earnings increase. Moreover, small adjustments in the underlying assumptions on the volume distribution may result in very different outcomes. Thus, both the reliability and relevance of the estimate can be questioned. Another issue is the fact that inputs and formulas in the valuation models are not publicly available. Hence, external users cannot easily judge if the estimates are reasonable or not. This increases the probability of EM in the industry.

As revenues at year end usually include a considerable estimate, there is an inherent risk of EM and fraud in the business. Moreover, the risk increases because of the high volatility in earnings in this industry. This emphasizes the importance of reliable internal control systems to prevent and detect misstatements in the revenue recognition process. However, there is always the risk that management might override such controls (AICPA, 2002). The board and auditor also have a responsibility to analyze the company's calculations and estimations and assess the reasonableness of these calculations. However, as management has more knowledge on the variables in the calculation it is hard to question the estimate for the auditor, or another external stakeholder with less knowledge.

PART IV – TROMS KRAFT

In this part of the paper I will use the theory presented in the first part on the case of Troms Kraft (TK). First, the company and facts of the fraud is presented. Then, the company's financial statements are analyzed to look for indications of EM. Then, plausible methods used in the manipulation are discussed. Afterwards, I discuss whether the Board and auditor fulfilled their duties, based on the information they had available. The aim of this is to evaluate if the fraud could have been discovered earlier.

8. Introduction to the company

Troms Kraft AS is a vertically integrated energy group which generates, distributes and delivers electric power and offer fiber optic communications services in Norway, Sweden and Finland (Bloomberg, 2012). The company is headquartered in Northern Norway, where it operates twelve hydroelectric power plants, and has concession to distribute power in 15 of the 25 municipalities in Troms, making it the leading energy company in the area (Troms Kraft AS, 2012). With consolidated revenues of 3 billion NOK in 2011, it is also a large player in the Nordic market. Their power plants produce about 1.9 terawatt hours yearly, supplying more than 100 000 retail customers. The company is state owned and employs about 450 people.

TK operates in other business areas as well, providing telecommunications services, efficiency consulting services and outdoor lighting facilities. Moreover, it develops and maintains a power grid, supervises and inspects electrical installations in businesses and private homes and manufacture and supply district heating for universities, schools, and sports centers. It also engages in trading electricity. In 2000, TK expanded its geographical scope with the establishment of the subsidiary Kraft & Kultur in Sweden.

Kraft & Kultur

Kraft & Kultur was founded with the vision to supply renewable energy to people that care about the environment, society and culture. Boris Benulis was one of the company's founders in 2000, and had the position of CEO from this point until November 2011. The company experienced an incredible growth from the start and is currently Sweden's sixth largest power retailer. In 2010, the company contributed with more than 50% of the group's total revenues.

The company sell renewable energy to more than 60 000 households, 5 000 companies and half of Sweden's municipalities (190 municipalities). The strong growth is illustrated in the table below.

| Year | Employees | Volume (GWh) | Increase in volume | Total sales (MSEK) | Increase in sales |
|------|-----------|--------------|--------------------|--------------------|-------------------|
| 2003 | 13 | 1692 | | 568 | |
| 2004 | 13 | 1977 | 17 % | 671 | 18 % |
| 2005 | 14 | 1934 | -2 % | 728 | 8 % |
| 2006 | 18 | 2122 | 10 % | 850 | 17 % |
| 2007 | 18 | 1995 | -6 % | 1 000 | 18 % |
| 2008 | 30 | 2132 | 7 % | 1 298 | 30 % |
| 2009 | 49 | 2315 | 9 % | 1 514 | 17 % |
| 2010 | 91 | 3234 | 40 % | 2 630 | 74 % |

Table 1: Growth in Kraft & Kultur 2003 - 2010 (extracted and altered from K&K's financial statements)

Kraft & Kultur is the largest supplier of energy to Swedish municipalities, making municipalities an important source of revenue for the company – contributing with almost 85% of total income in 2010. The company is one of the few suppliers that only provide its customers with green energy. In addition to their core strategy as an energy supplier, the company offers a broad selection of cultural products and services to differentiate themselves (Kraft & Kultur, 2012).

8.1 Corporate Fraud

In November 2011, during internal control routines and follow up, employees in TK discovered accounting abnormalities in the financial reports of Kraft & Kultur. A press release stated that the company had found strong indications that income, and hence profits, was overstated as a result of many years of manipulations (Troms Kraft, 2011). The company estimated that the misstatements had accumulated since 2002 and amounted to 1.8 billion SEK in overstated revenues. The findings were reported to The Swedish Economic Crime Authority, and the CEO, Boris Benulic, was pointed out as the main suspect in the case. Benulic and two other former central members of management were remanded to custody in April this year, suspected and charged with multiple felonies relating to fraudulent financial reporting. Benulic was held five weeks in custody, accused of serious violations of the book keeping act as well as serious economic misconduct. The other suspects are Pierre Sjöö, the former chief financial officer (CFO) and Erik Helmenius, who was involved in the company's investments in ventilation and energy recovery. They are both face charges of fraud and complicity to fraud. Kraft & Kultur is still under investigation by the Swedish Economic

Crime Authority and the trial is due next year. The CEO on the other hand, claims his innocence. According to him, the board is trying to cover up losses resulting from price speculations by framing him for manipulation. Benulic therefore pressed charges against the former CEO in TK, Oddbjørn Schei (Jensen, 2011), who also were the chair of the board in Kraft & Kultur at the time of the fraud revelations. According to Benulic, it is not revenues that are overstated but rather costs of purchased power that is understated.

An external investigation by the auditing firm Ernst & Young (2012), has also found strong indications that revenues is overstated as a result of many years of manipulations. The report by Ernst & Young also indicates that the CEO is the main responsible for the fraudulent financial reporting, with the help of other central members of management. Ernst & Young found no indications that members of TK or the auditor were involved in the fraud or that they were familiar with the misstatements. Nevertheless, managers in TK were members on the board in Kraft & Kultur (Ernst & Young AB, 2012), meaning they had responsibilities and duties to prevent and discover the fraud. The auditor also has duties to detect fraud in the financial statement.

8.2 Business Strategy

K&K buys power in the wholesale market and sells it to the customer with a fixed price or a market price plus mark up. K&K's goal is to be the leading supplier of electricity in Sweden, by offering products and services within the cultural sector as a way of differentiating themselves. The CEO had an ambitious competitive strategy, and had visions of growth into new markets and countries. As the company core strategy is to only supply green energy, they buy renewable electricity certificates in addition to the normal spot price of electricity. Moreover, they offered reduced prices on cultural products as well as free subscriptions on a monthly magazine to all their customers. Hence, it is reasonable to expect that the company's prices include a small premium to cover these extra costs compared to competitors that do not offer renewable energy and these services. K&K also claimed their customer was willing to pay for this. According to the company, their customers chose them because of the competitive prices and their eco friendly services and products (Troms Kraft, 2011).

However, the revenue contributions from the activities in culture only constituted 3.4% of total income in 2010, representing an insignificant amount. As the industry is characterized by price competition it also seems peculiar to invest significant amounts in culture. Moreover, it

also sounds like a bad investment, considering that 70% of the customer base is municipal enterprises that typically only base their decision on price. Moreover, the prices did not reflect that they offered such services. This is also evident after the fraud was uncovered, as it appears numbers of the culture segment were manipulated to show positive results (Ernst & Young AB, 2012). Recently, the company also decided to phase out the products and services relating to culture (Troms Kraft, 2012). The company's strategy was not to be the price leader, but in reality the companies offered very competitive prices, and often lower than what their competitor offered. This was the reason the company won many auctions at Kundkraft.³ Because of their extremely low prices, they won many fixed price contracts with municipalities. Consequently, it seems as the company followed a price leadership strategy.

To conclude, the business strategy of K&K was not reasonable, given the limited ability of customers to differentiate electricity, and the fact that competition is based on price. First of all, providing customers with culture seems to be very inefficient – as they seemingly cannot charge their customers with higher prices anyway. Second of all, as margins on electricity typically is low, a high volume is essential to cover other costs and to make a decent profit in the industry. The company was able to reach a high growth in volume, by offering extremely low prices. This might be a sign that the company offered too low prices, meaning that they actually were losing money on the contracts. What is more, their prices did not reflect the fact that they were offering additional services and renewable energy.

8.3 Financial Statement Analysis

The financial statements in K&K for the years of 2002 to 2010 had not been representative and failed to represent a true and fair picture of the financial position of the company. The company had recorded fictitious revenues of 1.5 billion NOK over the years. In the following, the company's financial information is analyzed with the intention to find overall trends, and red flags that could indicate EM.

8.3.1 Income statement

To easier see the development over time, the ratio to operating income is showed for each single line item in the income statement. This also facilitates comparison to industry peers in a

³ Kundkraft is a Swedish company that hosts auctions for suppliers of electricity. The supplier with the lowest bid wins the contracts.

meaningful way. The peer companies used in the comparison⁴ include Modity trading AB, Storuman Energi AB, Telge Energi AB, Fortum and Godel. The yearly growth is shown for operating income.

| INCOME STATEMENT | 2007 | | 2008 | | 2009 | | 2010 | | Average | Trend Peer |
|-----------------------------|-----------------|-------------|-------------------|-------------|-------------------|-------------|-------------------|-------------|-------------|-----------------|
| <i>in 1000 SEK</i> | | | | | | | | | | |
| Operating income | 1 000 167 | 18 % | 1 297 722 | 30 % | 1 513 623 | 17 % | 2 629 304 | 74 % | 34 % | ↗ |
| Cost of purchased goods | -884 819 | 88 % | -1 139 615 | 88 % | -1 317 495 | 87 % | -2 285 471 | 87 % | 88 % | ➡ 97,4 % |
| Other external costs | -41 770 | 4 % | -56 802 | 4 % | -75 386 | 5 % | -120 945 | 5 % | 5 % | |
| Wages and salaries | -13 747 | 1 % | -16 651 | 1 % | -26 390 | 2 % | -39 486 | 2 % | 1 % | |
| Depreciation | -263 | 0 % | -2 810 | 0 % | -3 504 | 0 % | -5 081 | 0 % | 0 % | |
| Other operating expenses | 0 | 0 % | 0 | 0 % | 0 | 0 % | -3 078 | 0 % | 0 % | |
| Total | -940 599 | 94 % | -1 215 878 | 94 % | -1 422 775 | 94 % | -2 454 061 | 93 % | 94 % | |
| Operating profit | 59 568 | 6 % | 81 844 | 6 % | 90 848 | 6 % | 175 243 | 7 % | 6 % | 0,3 % |
| Financial income | 1 305 | 0 % | 3 016 | 0 % | 642 | 0 % | 436 | 0 % | 0 % | |
| Financial expenditure | -24 484 | -2 % | -34 866 | -3 % | -24 562 | -2 % | -32 648 | -1 % | -2 % | |
| Interest paid | -4 505 | 0 % | -5 756 | 0 % | -800 | 0 % | 0 | 0 % | 0 % | |
| Financial items, net | -27 684 | -3 % | -37 606 | -3 % | -24 720 | -2 % | -32 212 | -1 % | -2 % | ➡ |
| Profit before taxes | 31 884 | 3 % | 44 238 | 3 % | 66 128 | 4 % | 143 031 | 5 % | 4 % | ↗ 0,1 % |
| Amortisation | -1 196 | 0 % | -12 061 | -1 % | -17 689 | -1 % | 1 115 | 0 % | -1 % | |
| Taxes | -9 158 | -1 % | -10 093 | -1 % | -13 413 | -1 % | -38 275 | -1 % | -1 % | |
| Annual profit | 21 530 | 2 % | 22 084 | 2 % | 35 026 | 2 % | 105 871 | 4 % | 3 % | ↗ -0,1 % |

Table 2: Income statement Kraft & Kultur 2007 – 2010 (Extracted and amended from the annual report)

Operating income

The first thing to notice when looking at the income statement, is that growth in operating income has accelerated from a high growth of 18% in 2008, to an unbelievable increase of 74% in 2010. The average yearly growth is 34%. It is quite unusual to see such high growth numbers in an industry characterized by high competition and price pressure. Thus, these growth numbers represent a red flag as such high growth levels are not sustainable in the long run. In order to analyze the cause of the growth, it is necessary to look at the size of delivered volume. The delivered volume can be seen in Table 2 below.

⁴ The peer percentages is based on financial statement numbers for 2010 and are calculated based on the average percentage of income for the respective companies.

| Year | Volume (GWh) | Change | Total sales | | Total sales/ Volume |
|------|-----------------|--------|-------------|--------|------------------------|
| | | | MSEK | Change | |
| 2003 | 1692 | | 568 | | 0,34 |
| 2004 | 1977 | 17 % | 671 | 18 % | 0,34 |
| 2005 | 1934 | -2 % | 728 | 8 % | 0,36 |
| 2006 | 2122 | 10 % | 850 | 17 % | 0,38 |
| 2007 | 1995 | -6 % | 1 000 | 18 % | 0,49 |
| 2008 | 2132 | 7 % | 1 298 | 30 % | 0,59 |
| 2009 | 2315 | 9 % | 1 514 | 17 % | 0,60 |
| 2010 | 3234 | 40 % | 2 629 | 74 % | 0,68 |

Table 3: Development in key figures in K&K from unadjusted reported numbers (own illustration, 2012)

From 2009 to 2010, sales revenue grew from SEK 1.5 to 2.6 billion. In the same period delivered volume grew 40%, from 2315 to 3234 GWh which was the main driver behind the sales growth. An increase in prices also reinforced this development. A growth in volume of 40 % is quite high, especially if the market itself is not growing in size, meaning that the company is increasing its market share. The large volume increase might indicate that the company is increasing the market share at the expense of competitors, which in turn is a sign that the company is charging to low prices. increase in volume can be the result of either growth in market share (increased customer base) or increased consumption per customer (e.g. due to a cold winter).

When looking at average sales price (Total sales/revenue), revenue seem to increase proportionally with delivered volume until 2007. From 2007 to 2010, a price increase of 40 % (0.49 to 0.68 SEK/ kWh) also has a significant effect. What is striking is that average prices seem to continually increase in the period.

Operating margin

Operating margin is the difference between the price offered to consumers and the market price, and shows how much of income is left to cover fixed costs and profit. Normally this ratio is very stable, so large increases or decreases in the ratio can represent a red flag. As the ratio is constant throughout the years at 12%⁵, there is no reason to be suspicious. As the industry is characterized by high price pressure, the operating margin should be similar in the industry. What might make the ratio vary somewhat between players in the industry are differences in product mix. Nevertheless, when comparing to competitors the company has an unexpectedly high margin as competitors have a margin of only 3%⁵ in 2010.

⁵ Operating margin is derived from the income statement (1 – 88% = 12%) (1 – 97% = 3%)

8.3.2 Balance sheet

| BALANCE SHEET | 2007 | | 2008 | | 2009 | | 2010 | | Average | Trend | Peer |
|--|----------------|--------------|------------------|--------------|------------------|--------------|------------------|--------------|--------------|-------|------|
| <i>in 1000 SEK</i> | | | | | | | | | | | |
| ASSETS | | | | | | | | | | | |
| CURRENT ASSETS: | | | | | | | | | | | |
| Stock of goods for resale | 4 895 | 0 % | 8 636 | 1 % | 13 983 | 1 % | 17 431 | 1 % | 1 % | ↘ | |
| Advances to suppliers | 0 | 0 % | 0 | 0 % | 1 798 | 0 % | 0 | 0 % | 0 % | ↘ | |
| Accounts receivable from customers | 292 089 | 30 % | 380 716 | 30 % | 447 024 | 26 % | 691 611 | 27 % | 28 % | ↘ | |
| Earned, not invoiced operating income | 8 260 | 1 % | 8 260 | 1 % | 4 960 | 0 % | 0 | 0 % | 0 % | ↘ | |
| Receivables from group companies | 13 300 | 1 % | 7 590 | 1 % | 4 054 | 0 % | 43 471 | 2 % | 1 % | ↘ | |
| Deferred tax asset | 7 771 | 1 % | 7 018 | 1 % | 3 685 | 0 % | 1 289 | 0 % | 0 % | ↘ | |
| Other short-term receivables | 628 | 0 % | 1 745 | 0 % | 3 873 | 0 % | 16 924 | 1 % | 0 % | ↘ | |
| Accrued income | 509 924 | 52 % | 745 081 | 58 % | 991 847 | 57 % | 1 638 073 | 63 % | 57 % | ↘ | 13 % |
| Cash in hand, bank and giro account | 86 228 | 9 % | 53 013 | 4 % | 147 736 | 8 % | 66 599 | 3 % | 6 % | ↘ | |
| Total current assets | 923 095 | 94 % | 1 212 059 | 94 % | 1 618 960 | 93 % | 2 475 398 | 95 % | 94 % | ↘ | |
| FIXED ASSETS: | | | | | | | | | | | |
| Trademarks | 326 | 0 % | 523 | 0 % | 523 | 0 % | 923 | 0 % | 0 % | ↘ | |
| EI certificates | 51 023 | 5 % | 66 681 | 5 % | 97 422 | 6 % | 92 565 | 4 % | 5 % | ↘ | |
| Software | 5 300 | 1 % | 3 533 | 0 % | 0 | 0 % | 0 | 0 % | 0 % | ↘ | |
| Other intangible assets | 0 | 0 % | 0 | 0 % | 5 326 | 0 % | 3 024 | 0 % | 0 % | ↘ | |
| Total intangible assets | 56 649 | 6 % | 70 737 | 5 % | 103 271 | 6 % | 96 512 | 4 % | 5 % | ↘ | |
| Inventories | 4 627 | 0 % | 3 813 | 0 % | 4 500 | 0 % | 7 187 | 0 % | 0 % | ↘ | |
| Shares in subsidiaries | 125 | 0 % | 0 | 0 % | 10 000 | 1 % | 10 000 | 0 % | 0 % | ↘ | |
| Deposits | 2 000 | 0 % | 2 000 | 0 % | 2 000 | 0 % | 0 | 0 % | 0 % | ↘ | |
| Other financial assets | 0 | 0 % | 0 | 0 % | 0 | 0 % | 14 493 | 1 % | 0 % | ↘ | |
| Total fixed assets | 63 401 | 6 % | 76 550 | 6 % | 119 771 | 7 % | 128 192 | 5 % | 6 % | ↘ | |
| TOTAL ASSETS | 986 496 | 100 % | 1 288 609 | 100 % | 1 738 731 | 100 % | 2 603 590 | 100 % | 100 % | ↘ | |
| EQUITY | | | | | | | | | | | |
| Share capital | 40 000 | 4 % | 40 000 | 3 % | 50 400 | 3 % | 50 400 | 2 % | 3 % | ↘ | |
| Legal reserve fund | 27 000 | 3 % | 27 000 | 2 % | 27 000 | 2 % | 27 000 | 1 % | 2 % | ↘ | |
| Share premium account | 0 | 0 % | 0 | 0 % | 79 054 | 5 % | 79 054 | 3 % | 2 % | ↘ | |
| Revaluation reversal fund | 99 265 | 10 % | 120 795 | 9 % | 142 880 | 8 % | 167 083 | 6 % | 9 % | ↘ | |
| Distributable equity (-uncovered losses) | 21 530 | 2 % | 22 084 | 2 % | 35 026 | 2 % | 105 871 | 4 % | 2 % | ↘ | |
| Total equity | 187 795 | 19 % | 209 879 | 16 % | 334 360 | 19 % | 429 408 | 16 % | 18 % | ↘ | |
| SHORT TERM LIABILITIES | | | | | | | | | | | |
| Bank overdraft | 471 012 | 48 % | 719 632 | 56 % | 1 069 332 | 62 % | 1 695 556 | 65 % | 58 % | ↘ | |
| Accounts payable to suppliers | 32 438 | 3 % | 23 314 | 2 % | 27 339 | 2 % | 33 960 | 1 % | 2 % | ↘ | |
| Payable tax | 0 | 0 % | 0 | 0 % | 0 | 0 % | 15 343 | 1 % | 0 % | ↘ | |
| Payable to group companies | 0 | 0 % | 0 | 0 % | 10 481 | 1 % | 13 | 0 % | 0 % | ↘ | |
| Other short term debt | 131 897 | 13 % | 127 394 | 10 % | 122 213 | 7 % | 234 518 | 9 % | 10 % | ↘ | |
| Accrued costs and deferred income | 12 475 | 1 % | 8 363 | 1 % | 21 998 | 1 % | 23 004 | 1 % | 1 % | ↘ | |
| Provisions | 60 200 | 6 % | 97 287 | 8 % | 122 033 | 7 % | 141 900 | 5 % | 7 % | ↘ | |
| Total short term liabilities | 708 022 | 72 % | 975 990 | 76 % | 1 373 396 | 79 % | 2 144 294 | 82 % | 77 % | ↘ | |
| LONG TERM LIABILITIES | | | | | | | | | | | |
| Other long term liabilities | 90 679 | 9 % | 102 740 | 8 % | 30 875 | 2 % | 29888 | 1 % | 5 % | ↘ | |
| Total debt | 798 701 | 81 % | 1 078 730 | 84 % | 1 404 271 | 81 % | 2 174 182 | 84 % | 82 % | ↘ | |
| TOTAL EQUITY AND LIABILITIES | 986 496 | 100 % | 1 288 609 | 100 % | 1 738 631 | 100 % | 2 603 590 | 100 % | 100 % | ↘ | |

Table 4: Balance sheet Kraft & Kultur 2007 – 2010 (Extracted and altered from the annual reports) Note: Provisions are classified as long term liabilities.

The balance sheet is shown as a percentage balance sheet, meaning that each asset and liability is shown as a percentage of the total. This makes it easier to see alterations in the composition of assets or the methods of financing, when comparing numbers over the years. When looking at the balance sheet, the first thing to notice is that assets mainly consist of receivables and other current assets, while the share of fixed assets and inventory is low. This is one of the unique characteristics of the industry. The reason is that power cannot be stored and so power is produced and consumed at the same time. The most significant account on the balance sheet is accrued income, accounting for about 60% of total assets.

Accrued Income

A report written by the Group CFO in 2006 explains the process of calculating accrued income in Kraft & Kultur; *an employee requests lists on customer level. Then, the invoiced consumption (by customer profile) is reconciled to the total delivered volume in the period. The difference between delivered and invoiced electricity is then recorded as revenue through valuing the volume based on the average invoiced price in the time period. The price will include administrative markups as well as revenue from energy certificates (Earnst & Young AB, 2012).*

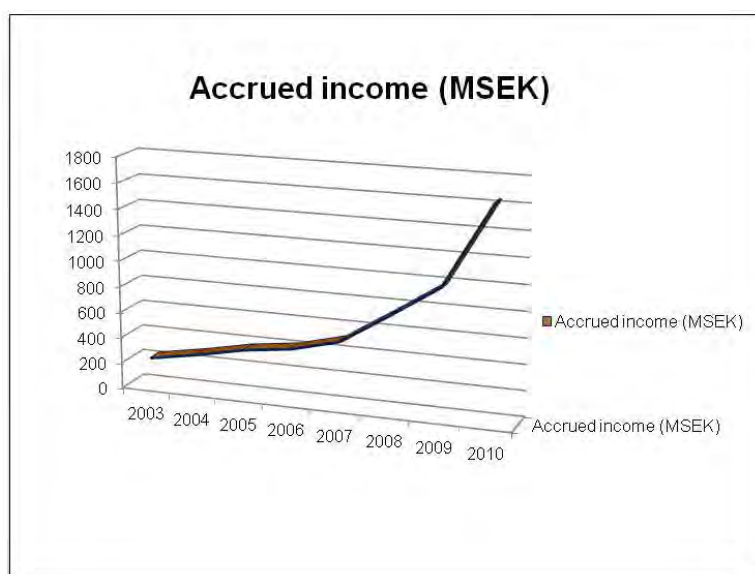


Figure 6: Yearly development in accrued income in Kraft& Kultur from 2003 -2010 (own illustration, 2012)

As seen in Figure 5, accrued income has steadily increased since the start of the company in 2001. The account had an average growth of 34% each year between 2003 and 2010. In 2009, the company reported earned, not invoiced operating income of 1 billion which reportedly grew to 1.6 billion in 2010, a growth of 600 MSEK or 65%. If we look at the balance sheet, the account's share of total assets is also increasing. The significant increase in the account is worrying, as it may be a sign of EM or point to problems in invoicing customers. The explanation can also be a steep increase in revenues, as accrued income is expected to grow proportionally to earnings. Consequently, it is necessary to compare it to total sales to see if the development is a cause for concern or not. The ratio to sales is shown in Table 5 below.

As receivables usually track sales, we expect the account to have the same ratio to income, assuming credit terms are unchanged. In 2003, accrued income amounted to 40% of total sales and grew steadily until it made up 74% of total sales in 2010. In other words, the

majority of the company's recorded income was not yet invoiced. This is alarming. From 2007 to 2008 and 2009 the ratio to sales increased with 14% and 19% respectively, hence indicating that the account might be inflated.

| Year | Total sales (MSEK) | Total receivables (MSEK) | Change | Receivables in % of sales | Accrued income (MSEK) | change | Accrued in % of sales |
|------|--------------------|--------------------------|--------|---------------------------|-----------------------|--------|-----------------------|
| 2003 | 568 | 300 | | | 225 | 188 % | 40 % |
| 2004 | 671 | 450 | 50 % | 67 % | 290 | 29 % | 44 % |
| 2005 | 728 | 490 | 9 % | 67 % | 366 | 26 % | 52 % |
| 2006 | 850 | 650 | 33 % | 76 % | 414 | 13 % | 52 % |
| 2007 | 1 000 | 811 | 25 % | 81 % | 509 | 23 % | 52 % |
| 2008 | 1 298 | 1136 | 40 % | 88 % | 745 | 46 % | 60 % |
| 2009 | 1 514 | 1448 | 27 % | 96 % | 990 | 33 % | 71 % |
| 2010 | 2 629 | 2347 | 62 % | 89 % | 1637 | 65 % | 74 % |

Table 5: Development in key figures from 2003 – 2010 (Own illustration, 2012)

Since accrued income is an interim account, most of the accrued earnings should relate to the current year and not lag from previous years. Moreover, we expect accrued income to relate to income earned at year end. If income and consumption is more or less distributed evenly throughout the year, with some seasonal variations, it is natural that accrued income makes up 10% to 50% of sales, depending on the frequency of invoicing. Looking at the ratio in 2008(60%), 2009(71%) and 2010(74%), it seems that the main share of income is earned around year end or alternatively that customers are invoiced less than twice a year. When accrued income amounts to such a large part of total income this is a warning signal and should be investigated. According to the board, the large size of accrued income is mainly due to the fact that the Swedish municipalities, which account for the main part of their customer base, is invoiced once a quarter in arrears (Ernst & Young AB, 2012). This means that income from the last quarter is not invoiced at year end. If this was true, accrued income should equal 25 % of total sales the same year, compared to the actual 74 %!

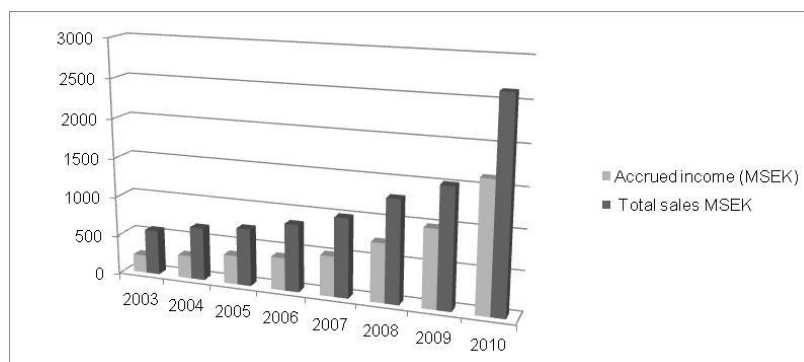


Figure 7: Comparison of Accrued income to Total sales 2003- 2010 (own illustration, 2012)

It is surprising that such a large share of consumption has not been invoiced when considering that the credit time of municipalities were four months. The company also explained that the estimate included additional revenues from customers that consume *more* than the maximum according to the contract and that these revenues were invoiced after year end (ibid). The company also claimed that the transition to AMR led to delays in invoicing as a large amount of customer data was incorrect. The sharp increase in the account from 2009 to 2010 was allegedly due to an unusual price increase together with increased number of customers. Although these reasons sound plausible, it does not justify the ratio of accrued income to sales of 74%. The increase in the accrual compared to sales definitely indicates that something is wrong.

When looking at the company's total receivables (including accrued income) these total 1.45 billion in 2009, equaling 96% of total income. The same ratio is 88% in 2008. In 2010, the size of total receivables is 2.35 billion SEK compared to 2.63 billion in total sales. This is a serious cause of concern. Accrued income on average constituted 70% of total receivables⁶.

Working capital

As the company grew, so did the need to invest in working capital due to the long credit time of customers. Working capital is a measure of the company's liquidity or the capital available to the daily operations. Working capital is defined as current assets less short term debt and can be seen in the table below. There are no indications of liquidity problems, as working capital is positive and slowly increasing. The reason is that short term liabilities are rising in the same ratio as accrued income in the time period. In 2010, Kraft & Kultur had a total debt of 2.2 billion, of which more than 90 % was classified as short term. The bank overdraft constitutes the main part of short term liabilities, amounting to 1.6 billion SEK. The financial statement reports increases in the bank overdraft from 471 MSEK in 2007 to 1 700 MSEK in 2010, equaling a yearly average increase of 50%. This is extremely high, even when considering the high growth the company experienced. The company reports positive results in the period, hence it does not make sense to increase bank overdraft with such a large amount.

⁶ Total receivables = Accounts receivable from customers + Accrued income + Other short-term receivables

| Liquidity | 2007 | 2008 | 2009 | 2010 |
|--|-------------|-------------|-------------|-------------|
| Current assets/ Short term liabilities | 1,30 | 1,24 | 1,18 | 1,15 |
| Working capital | 215 073 | 236 069 | 245 564 | 331 104 |

Table 6: Liquidity ratios (extracted from financial statements)

Another measure of a company's liquidity is the ratio of current assets to short term debt, which should be higher than 1.5, meaning that current assets should be 1.5 times higher than short term debt. Here, the ratio is below 1.5 and decreasing (Table 6), indicating that the company's ability to meet their short term commitments is declining. The main reason for this is that investments are increasingly being financed using short term debt. As the share of receivables is increasing, this also negatively affects the liquidity of the company.

8.3.3 Cash flow statement

It is always useful to analyze a company's cash flow, as it shows the discrete cash values of the company, hence is not subject to accounting assumptions. When looking at K&K's cash flow statement, it does not match very well with the income statement. The company reported positive earnings and earnings growth each year, while the cash flow reveal a negative trend. From 2008 to 2010 the company had recurring negative net cash flow from operations. This is a red flag, as it could be an indication that customers are not able to pay, or that the income statement is artificially inflated. As this red flag is accompanied by rising accounts receivables as a percentage of sales – there is an obvious risk that income is overstated.

When looking at the annual report in 2010, profit after tax is 106 MSEK, while cash from operations is 112 MSEK. But, when changes in current assets and debts are included, a negative result of 677 MSEK is derived. In 2009, the company appears to have incorrectly recorded an increase in the bank draft under cash from operations in the cash flow statement. Thus, cash from operations appear to be positive. When looking at the financial statement in 2010, the error is corrected (Table 5 applies the changed numbers). Here, cash from operations after including changes in current assets and short term debt shows a negative result of 235 MSEK. If this was on purpose or not is hard to say, but it made the cash flow from operations look positive in 2009, while it in 2010 appeared that the cash flow from operations had improved.

Normally a company that generates profits would also generate a positive cash flow from operations. However, if the company's numbers are manipulated to show growth in earnings,

it is obvious that the company will not receive any cash from this. Then, they need to finance their losses in other ways. The company's large deficit in cash from operations relative to net income is a red flag, and provides a strong indication that something is wrong.

| CASH FLOW STATEMENT | 2007 | 2008 | 2009 | 2010 |
|--|---------------|-----------------|-----------------|-----------------|
| <i>in SEK 1000</i> | | | | |
| CASH FROM OPERATIONS | | | | |
| Profit from operations | 59 568 | 81 844 | 90 834 | 175 243 |
| <i>Adjustments for non cash items;</i> | | | | |
| Depreciation | 263 | 2 810 | 3 504 | 5 081 |
| Provisions | 6 778 | 37 087 | 24 746 | 19 867 |
| Profits from operations after adjustments | 66 609 | 121 741 | 119 084 | 200 191 |
| Received interest | 1 305 | 3 016 | 642 | 436 |
| Paid interest | -25 546 | -39 081 | -25 362 | -32 648 |
| Paid income tax | -24 557 | -9 340 | -10 066 | -56 014 |
| Net cash flow from operations before change in WC | 17 811 | 76 336 | 84 298 | 111 965 |
| CASH FROM CHANGES IN WORKING CAPITAL | | | | |
| Decrease/increase(+/-) of inventories | -4 457 | -3 741 | -7 145 | -1 650 |
| Decrease/increase(+/-) of accounts receivables | -53 382 | -88 627 | -66 308 | -244 587 |
| Decrease/increase(+/-) of receivables | -86 108 | -246 222 | -269 743 | -672 542 |
| Decrease/increase(+/-) of accounts payable to supplier | 16 180 | -9 124 | 4 025 | 6 621 |
| Decrease/increase(+/-) of current debt | 158 954 | 238 464 | 18 936 | 122 734 |
| Net change working capital | 31 187 | -109 250 | -320 235 | -789 424 |
| Net cash flow from operations | 48 998 | -32 914 | -235 937 | -677 459 |
| INVESTING ACTIVITIES | | | | |
| Aquisition of subsidiary | 0 | 0 | -10 000 | 0 |
| Aquisition of intangible assets | -5 351 | -197 | -4 183 | -1 439 |
| Sale of financial assets | 0 | 125 | 0 | 0 |
| Aquisition of tangible assets | -4 503 | -229 | -1 801 | -4 436 |
| Net cash flow from investments | -9 854 | -301 | -15 984 | -5 875 |
| FINANCING ACTIVITIES | | | | |
| Lending(-)/payback of financial payables | 0 | 0 | 0 | -12 493 |
| Borrowing | 0 | 0 | 349 700 | 626 224 |
| Net cash flow from financing activities | - | - | 349 700 | 613 731 |
| NET INCREASE IN CASH | 39 144 | -33 215 | 97 779 | -69 603 |

Table 7: Cash flow statement Kraft & Kultur 2007 – 2010 (Extracted and changed from the annual report)

Other key figures

As the income statement might be manipulated to look normal it is suitable to also look at some key financial figures, as these might provide stronger indications if something is wrong.

| Key figures | 2007 | 2008 | 2009 | 2010 |
|----------------------------------|-------------|-------------|-------------|-------------|
| Return on total capital | 2 % | 2 % | 2 % | 5 % |
| Equity ratio | 19 % | 16 % | 19 % | 16 % |
| Debt ratio | 81 % | 84 % | 81 % | 84 % |
| Short term debt ratio | 89 % | 90 % | 98 % | 99 % |
| Credit time accounts receivables | - | 93 | 98 | 78 |
| Credit time total receivables | - | 268 | 306 | 259 |

Table 8: Other key figures from 2007 – 2010 (Own illustration, 2012)

Return on Total Capital = (Annual profit + Financial income)/Average Total Capital

The return on capital is on stable level, but increases in 2010. The ratio is low, indicating that the company's profitability is low.

Financial structure

The financial structure shows the company's mixture of debt and equity, which directly affects the risk and value of the business. The equity and debt ratio measures how much of the firm's assets that are funded by equity. The equity ratio shows a negative development, which could indicate that the company's financial health is worsening. In 2010, almost all assets were financed using short term debt, mainly consisting of the bank overdraft. An increasing debt ratio increases the company's exposure to interest rates and insolvency. The short term debt ratio also reveals that the size of short term debt relative to long term is increasing. The company's capital structure does not seem to be optimal.

Average credit time = Average receivables / (Total operating income / 360).

The average credit time measures of how many days it takes the company to receive cash from the invoiced receivables and includes the time of meter reading, invoice time and credit time. The municipalities, accounting for 70% of the customer base, were invoiced on a quarterly basis and had one month credit time in addition. Hence, around 120 days seems reasonable, considering that this equals quarterly invoicing and a month credit time. The company's high ratio is worrying. As this ratio is approaching 300 days, it means the company almost uses a year from income is earned to the company has received the cash.

The quality of financial statement

The overall quality of the company's financial statement depends on the usefulness of financial information for the users. First of all, the financial reports never include any basis of comparison (last year's numbers or budgeted numbers) before 2009, which made it hard for users to judge the performance of the company. Secondly, all reports lack supporting information on the financial situation and explanations on significant sizes. For instance, there is no explanation concerning the size of accrued income or how it is measured. Consequently, the estimate is difficult to understand and evaluate for an outsider. Thirdly, none of the reports include key statistics or figures of the company's financial position and development. Forth, as financial statements were issued late on many occasions, information loses its value and relevance.

The poor quality of the financial statement made it difficult to see the underlying development in earnings and the financial condition of the firm. The information should have been more detailed in order to be understandable for the users. Moreover, it is clear that the financial statement did not *faithfully represent* the company's financial position and that information was not reliable.

8.3.4 Conclusion

In 2010, accrued income grew by almost 70%! The large increases in the account and the fact that the relative size of the account was significantly higher compared to competitors represent a red flag. Moreover, as accrued income normally track sales, the high growth of account receivables compared to accrued income is alarming. This discrepancy indicates that something is seriously wrong, either with the reported numbers or with the company's ability to invoice customers. Moreover, there is an inconsistency between the cash flow and income statements as cash from operation are negative. This does not reflect the incredible growth and profitability shown in the income statement. This represents another red flag. This development can also be seen in the significant increase of bank overdraft, which seems to finance the negative cash flow. These facts should together have made the alarm go off with the board and auditor, as the income estimate was unrealistically high and inconsistent with the cash flow development.

8.4 Fraudulent financial reporting

In the following I provide my subjective interpretation of what happened in Kraft & Kultur, why management manipulated earnings and how. I base my evaluations on the financial statement, my knowledge of revenue recognition in the industry, EM theory and news paper articles from before and after the discovery of the fraud.

Changed financial statement numbers

The management in K&K allegedly managed to manipulate earnings over a long period, by recording fictitious earnings in the income statement by inflating the size of accrued income. By overstating revenues, the company's showed too high profits every year as well as an inflated balance sheet. In the financial statement of 2011, the company restated sales revenue and costs for 2010. Sales revenues were reduced to by 650MSEK or 25%, while costs relating to purchases of electricity were increased with 283 MSEK or 12% from the originally reported numbers (Kraft & Kultur, 2011). Moreover, the accrued income was reduced

significantly, by almost 1500 MSEK a total reduction of 90%. Figure 7 shows the accumulated income in K&K from 2001 to 2010, and the size of accumulated manipulated income from year to year.

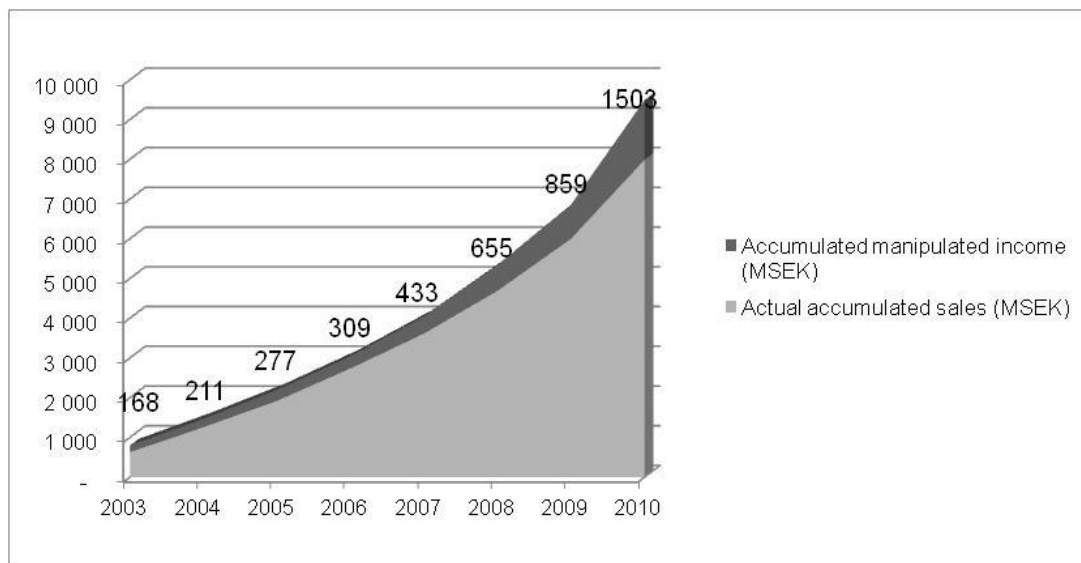


Figure 8: Accumulated manipulated income K&K 2001- 2010 (Troms Kraft, 2011)

As fictitious income needs to have a counter item in the balance sheet, Kraft & Kultur used the accrued income account to overstate their earnings year after year. Since the company never invoiced or received cash from these fictitious sales, the balance account only grew larger. Naturally, these sales will not increase cash flow from operations either and consequently the company had to increase their debt each year to finance the negative cash flow from operations. In other words, accrued income was the counter item for bank overdraft in the balance sheet, meaning that the bank overdraft financed accrued income.

Estimating Accrued income

As mentioned earlier, the main risk concerning the accrued income estimate is to precisely split the company's total delivered volume to the different contracts. There is also a risk that total volume is wrong, but this risk is lower due to the fact that the company receives these volumes from the grid company. If volume was incorrectly estimated in K&K, the settlement of accounts with grid companies afterwards would reveal this. Moreover, the grid companies are pretty good at approximating the power supplier's total volumes. It is therefore likely that the reported total volumes in K&K are accurate. A more reasonable explanation is that the company misstated earnings by using the wrong volume split in the revenue calculation so that the prices used in the calculation were wrong. Furthermore, management probably used incorrect prices on purpose when calculating the estimate to be able to show such high

revenue numbers. The revised financial statement numbers from 2010 shows the same delivered volume as previous years which confirm this theory.

Further, the accrued income account included large amounts of recorded revenue that related to previous accounting periods, meaning they should have been invoiced already. If this revenue was actually earned, the value of these revenues should have been questioned. In accordance with accounting standards the accrued income should be valued according to the amount of cash the company expects to receive. If the revenues were wrongly estimated, the accrued income should have been written down the following year. In addition, the estimate should have been modified in accordance with the updated assumptions.

To conclude, the company managed to record fictitious income by recording too high accrued income on the balance sheet. The management probably used incorrect prices on contracts to accomplish this.

Matching expenses

When customers enter a fixed price deal, employees in K&K should immediately secure the price by calling the risk management department in Tromsø (Affarsvarlden, 2011). However, the internal investigation uncovered violations of these internal rules (Troms Kraft, 2011). In February 2010, a cold temperature together with low levels in water reservoirs and many closed nuclear power plants, made the price of electricity reach historical high levels (Affarsvarlden, 2011). The price on Nordpool was on average 92 cents per kWh, almost three times as high as the current price. As employees failed to hedge electricity prices for fixed price contracts, the company had large open positions in the market and was exposed to large price risk. According to Benulic, the company had short position on about two billion kWh, or half the volume in 2010 and 2011. As K&K supplied electricity to their customers at 0.41 SEK per kWh, and employees failed to secure these positions, they lost whatever they paid above this price (Affarsvarlden, 2011).

We paid spotprices. Had short positions. It hurts me to say it, but it is how it is. (Benulic, 2011)

Benulic's explanation sounds plausible, assuming that the internal controls were missing in this area or that employees lacked common sense. Benulic blames low effectiveness and quality of internal controls for the error (ibid).

It sounds reasonable that the company failed to secure fixed price contracts, but there might be other causes of this failure than low effectiveness of internal controls. As revenues were inflated over many years, there was only a matter of time until the fraud was uncovered. In order to cover up previous inflated earnings the company might have deliberately speculated on a price fall to increase revenues or reach budgeted earnings growth. In other words, there is a possibility that employees were told not to secure the price. When the spot prices increased, the company was forced to buy expensive electricity in the spot market. Furthermore, the many activities within culture and environment had in reality generated large costs that had not been appropriately matched with revenues in the financial statement (Ernst & Young AB, 2012). To avoid showing these high costs and suffering a great loss, the company might have wrongfully activated these costs on the balance sheet under the accrued income account. As discussed above, capitalizing costs is one of the most used methods of earnings management.

To conclude, it seems that the company deliberately failed to accurately record expenses of buying electricity in accordance with the matching principle. Moreover, by increasingly estimating a higher accrued income each year the company managed to show a smooth growth in earnings and a positive development in equity from year to year. As the income statement did not show any numbers that were particularly suspicious the fraud was harder to discover. However, the development shown in the income statement and balance sheet were not consistent with the situation illustrated by the cash flow from operations as this was negative. By comparing the accrued income account to sales the auditor and board should have been suspicious as this indicates that revenues were inflated. After having established the method management used to manipulate the financial statement, the environment that made the fraud possible will be analyzed.

9. Environment

In this chapter I try to identify factors in the company's environment that increased the risk of fraud, such as the presence of incentives, weak internal controls and corporate culture. In other words, the circumstances that made EM and fraud possible in the company.

9.1 Pressure

Management and other employees have incentives or pressures to misstate the financial statement. The pressure to do *whatever it takes* to meet goals and the desire for personal gain are cited as the two most common reasons for fraud (Elder, et al., 2010).

Weak control

Benulic was one of the founders of K&K and was the CEO in the company from the start. He probably wanted to perform well in his job, considering that his reputation and career depended on the success of the company. As earnings and accrued income were overstated over many years, the misstatements probably started on a small scale, by stretching the rules. By preparing an aggressive estimate, the CEO was able to reach budgeted earnings – hoping that growth would increase revenues more than expected. When this did not happen, the company needed to continue to inflate earnings the next period to avoid showing a loss. This negative spiral then ended in fraud, although this probably was not the intention.

Moreover, the company obviously struggled with their invoicing routines, as many customers complained on lacking invoices, wrong prices on invoices or wrong consumption (Jensen, 2011). Early in 2011, the company was banned from Kundkraft, after topping the complaint list due to the lacking control of invoicing (Kjaergaard, 2010). This made the company lose about 30 000 customers (ibid). Moreover, the company's employees failed to follow routines set by TK concerning securing prices on fixed price contracts, indicating that important internal controls in this area were weak or not present, which is a significant deficiency. Moreover, the company was not appropriately staffed, as the growth in customers and earnings had outgrown the organizational development (Table 1). This resulted in a lack of control of the company's activities. The main reason why the CEO wanted to manage earnings might possibly be an attempt to cover up this lack of control.

Ambitious growth strategy

As mentioned earlier, the company had an ambitious growth strategy. The CEO had strong visionary objectives, risk willingness and a desire to show growth in order to expand the business into both new geographical markets and new products. In an interview, Benulic envisioned himself as the CEO of Kraft & Kultur in New York, illustrating his desire to grow the company and run a large organization. The motivation to grow is what usually makes a good CEO. Due to the high competitive pressure the company had to offer extremely low prices in order to grow and outbid competitors. K&K's competitors could not understand how the company was able to offer such low prices (DN, 2011). The CEO of Kundkraft says she could not understand how K&K were able to show above average profit numbers, considering that the company had problems invoicing their client and the fact that they offered low prices (Nordlys, 2011). Hence, management's desire to grow might have represented an incentive to overstate earnings and growth numbers to meet budgeted earning goals.

Expectations from parent company

The management also faced pressure to meet parent company's expectations. Press releases and annual reports from Toms Kraft were always overly optimistic and described Kraft & Kultur as a success story, due to the strong growth in revenues. Moreover, the parent company also supplied the company with a significant amount of capital over the years, and provided guarantees for their debt. This probably added to the pressure of covering up lack of control in the company and a desire to show above average performance. Management also faced pressures from other creditors, as the company had an excessive amount of short term debt. However, as the parent company was the guarantee of this debt, pressure from creditors were probably not as strong.

Personal financial gain

Another possible motive of earnings manipulation is the presence of performance based bonuses. The CEO's bonus could amount up to three months of salary, equaling a maximum bonus of about 350 TSEK in 2010 (Kraft & Kultur, 2010). Whether or not this is an incentive for the CEO to manipulate earnings is hard to say. However, a potential or expected salary increase might have provided an incentive to manipulate earnings as Benulic's total salary increased from SEK 970 000 to SEK 1.6 million when the company doubled their sales between 2008 and 2010 (Kraft & Kultur, 2011).

In summary, there are many possible causes and reasons why management misstated financial statements. As creditor pressure and financial incentives were low – it might seem as the main motive was the CEO's desire to grow the company and perform well on the job.

9.2 Opportunity of fraud

Significant accounting estimates

The presence of a significant earnings estimate provided an opportunity to manage earnings. As accrued income is based on uncertain variables, such as total consumption, the volume split between contracts, and price, it is difficult for outsiders and auditors to judge the accuracy and reasonableness of the estimate. Hence, it is difficult to detect an overstated revenue estimate, without inside information. Moreover, key statistics and information on prices and volume were also lacking in financial statements, making calculations hard to verify for an outsider. Thus, management had the flexibility to manage the accrued income number.

Moreover, as the organization grew and became increasingly complex the board faced an increasing challenge to understand and monitor the different business areas, including K&K's business model. This made it difficult to analyze financial numbers and to ask critical questions, especially relating to the culture segment. This gave management an opportunity to manipulate results, which evidently they did (Ernst & Young AB, 2012).

Internal controls

It is management's responsibility to design, implement and maintain internal controls over the accounting system. The objectives of an effective internal control system are usually operational effectiveness, reliability of financial reporting and compliance with laws and regulation (Elder, et al., 2010). Hence, having strong internal controls is important in preventing and detecting misstatements in the accounting system and financial statement. A key control procedure for the revenue process is segregation of duties (Stuart, 2011). In each business process the responsibilities concerning custody of assets, record keeping, authorization and reconciliation should be separated and handled by different employees. This way the company assures that transactions are valid, accurately reported, in compliance with rules and regulations, in accordance with the company's goals and objectives. An organization of K&K's size has normally good quality on internal control routines. However,

the auditor in K&K frequently reported that internal controls were weak from the start in 2002, and that delegation of responsibility in the organization (segregation of duty) was unclear (Ernst & Young AB, 2012). The CEO was in practice controlling a major portion of both the revenue and expenditure function and the one in charge of both the operational and record keeping responsibilities (ibid). Consequently, he had the power and opportunity to make inappropriate accounting entries. The CEO was the one who prepared the estimate, with the help of the CFO. Moreover, there company lacked controls concerning reconciling the estimate with total invoiced amounts and there were no approval of the estimate from the board or independent employees. The company never provided any statistics or numbers on the deviation of their estimate compared with actual invoiced amounts in the financial statement either. By doing this, the users could have assessed the historical accuracy of the estimate.

From internal inspections the company also uncovered deficiencies in routines relating to hedging of electricity prices and considerable deficits in the customer portfolio, as it seems the company have not known or managed the profitability of customer contracts. Even though these deficiencies is not especially important relating to manipulation of accrued income, they illustrate the lack of control in the company – both concerning the management’s control and understanding of business and the board’s control over management. Moreover, the poor routines are evidence of a lack of tidiness from the administration.

Competence and adequacy of employees

Accounting services were outsourced to external consultants, who took care of the company’s daily bookkeeping of transactions. The company also used different internal resources as a part of the financial function (Ernst & Young AB, 2012). One of the company’s external consultants was Pierre Sjöö, who apparently had a central financial function in the company. Until 2008 Sjöö functioned as the CFO, and was involved in discussions on accrued income together with Benulic. In 2008, Helena Ridderstråle replaced Sjöö. Ridderstråle was responsible of invoicing customers, but was not involved in involved in the accounting of accrued income and was never present in meetings with the auditor (Ernst & Young AB, 2012). Hiring a CFO at an earlier stage, would have been appropriate considering the aggressive growth strategy as well as for risk management purposes.

The finance function never had a strong position. Benulic had the upper responsibility for the economy and administration from the start in 2001. In 2003 the board decided that Benulic was accountable for the company's finances and the preparation of accounts. This responsibility was only supposed to last until the reporting routines were sufficiently working. However, in reality it lasted throughout the whole period. The board explained that this was due to a lack of potential candidates (Ernst & Young AB, 2012). The CEO he had a strong incentive not hire a CFO, as this would risk that the manipulation could be discovered. The financial competence and resources seem to be inadequate and limited until 2010 when a CFO was hired. However, Benulic continued to be involved in the preparation of accounts after 2010. In addition, all reporting and contact with the auditor happened via the CEO.

To sum up, the administration in K&K was dominated by the CEO, who was responsible to report financial statement numbers. The existence of a significant earnings estimate, together with inadequate controls over financial reporting provided the perfect conditions for fraud. With stronger internal controls in place, aimed at mitigating the risk of EM in the estimate the fraud could possibly have been prevented or detected at an earlier stage.

9.3 Rationalization

Management's integrity and attitude

The attitude and personal values of management affect both the culture in an organization and the likelihood that fraud occurs. Management integrity and ethical behavior is important to create a culture with honesty and ethical behavior, which in turn creates a good control environment. A dishonest manager with low morale on the other hand, can create an unwanted culture where EM and fraud are justified.

Benulic is a well known in Sweden, because of his career background as a journalist, news reporter, editor and his involvement in politics. He is a competent and intellectual person, and is good at debating. TK ascribed a great deal of the success and growth to the skills and leadership of Benulic, and described him as the *brains behind the operations* (Sæbbe, 2005). He was described as confident and strong personality by both people in the company and outsiders (ibid). When answering to the media on questions relating to the fraud, he is extremely calm and eloquent, which he also points out himself. He had a management style with strong drive and personal opinions. This can both be positive – as a leader who inspires

and sets high goals, and negative – as an authoritarian leader with bad cooperating skills and who is domineering. Benulic's authoritarian management style is illustrated in an incident when the Group auditor (PwC) addressed the size of accrued income where he answered in an aggressive and rude tone. He even accused the auditor of lacking competence and knowledge (Ernst & Young AB, 2012). The CEO exercised a great deal of power and influence in the company and was also the central decision maker in the fraud. His position and authority could also have facilitated the involvement of other employees, and emails from Benulic provided instructions to his accomplices on how to manipulate accounting numbers;

[..] Concerning culture – can you manipulate the numbers so that we end up with a positive result of 1.4 MSEK – for example by adding the amount to inventory or accrued income [...] Electricity income – take a sum that makes us end up at 16.1 MSEK in profit after taxes. (Ernst & Young AB, 2012, p. 10)

It also appears that the CEO had a great deal of power over the board, as they believed his explanations and did not question his integrity. Even though the CEO did not provide them with the information they requested, they never considered to fire him. It is clear that the CEO did not want any interference from the board, as the board's access to information was restricted, indicating that the CEO wanted to keep things hidden from the owners.

Conclusion

The company's management wanted to meet budgeted earnings and growth numbers, but lacked control of the company. Moreover, the company also faced pressure to perform from the outside and owners. The existence of a significant revenue estimate provided an opportunity to inflate earnings and receivables. Furthermore, the CEO exercised a strong control over company decisions which means he was in a unique position to manage earnings numbers. The company lacked controls that could compensate for this fact. Hence, both the opportunity and motive to commit fraud existed. The presences of these conditions are obvious risk factors of fraud, but ultimately, it was the CEO's personal values and attitude that made him commit fraud.

Both the auditor and the board of directors should have been aware that these risk factors existed in the company. However, it is evident that the board lacked oversight over the financial reporting process and that the monitoring of management was ineffective. The next two sections will deal with the auditor's and the board's responsibility and liability to detect fraud. Based on the information in the report by Ernst & Young I will evaluate whether the auditor or the board could have been expected to detect the fraud at an earlier time.

10. The Auditor's responsibilities

The Norwegian Corporation Law (aksjelov) and the Accounting Act places the primary responsibility for fraud prevention with the company management. However, there also rests a great responsibility on the auditor to detect and prevent financial statement misstatements. The auditor is required to obtain reasonable assurance that the financial statements are free of material misstatement (International Auditing Standard IAS 8), but cannot be expected to obtain absolute assurance that financial statements are without material misstatements. Grant Thornton (GT) was the auditor of Kraft & Kultur from 2003 to 2011, while PricewaterhouseCoopers (PwC) is the auditor of the parent company (Troms Kraft AS).

10.1 Grant Thornton

The auditor reported errors of an administrative art to the board on several occasions, including missing control statements and employment contract for the CEO and other employees. The auditor also reported more serious cases to the board, as the company consistently failed to pay taxes and other liabilities on time. This resulted in comments in the audit report more than one time. The financial reports were also delayed a number of times, consequently the accounts were not finished in time for the auditor to complete an efficient audit (Ernst & Young AB, 2012). Furthermore, the auditor revealed violations of the Swedish Accounting Act, when they found invoices relating to January that were not recorded in February. Together, these incidences should have made the auditor question the honesty and competence of management.

Accrued income

As the accrued income estimate can be quite a complex calculation, it is difficult for the auditor to evaluate the size of this account. Naturally, management has more information and competence of the different inputs that affects the estimate. However, the auditor has to critically assess if the size of the item seems reasonable, by looking at how accurate the estimate have been historically *in addition* to inquiring management. In this case, it might seem as the auditor was lead astray by management, as the auditor seem to have relied on the explanations from management. It is important that the auditor does not blindly trust and accept explanations provided by management (professional skepticism) and that the auditor finds supporting and corroborating evidence (ISA 500).

Bearing in mind that accrued income was a significant estimate and also a large relative size of the balance sheet, the auditor knew that the risk associated with this account was high. Consequently, the account should have been thoroughly reviewed and examined to get the necessary assurance that financial statements and earnings estimates were accurate. Moreover, the auditor has a responsibility to analyze the company's calculations and assess the reasonableness of these accounts. However, there were several years the auditor did not review accrued income, with the explanation that the audit was carried out too early in the year. The auditor should have done it subsequently and should also have done it for the previous years as the auditor also is required to review *prior* year's significant accounting estimates (ISA 240.32b). The fact that the auditor did not review this estimate every year is critical, and indicates that the auditor failed to execute his responsibilities satisfactory.

In some years the auditor reviewed the account during the year, and investigated how much of the amount that had been invoiced. In 2009 the auditor mentioned that only 12% of accrued income at year end in 2008 was billed per 19.02.09 (Ernst & Young AB, 2012). This seems to be quite low, but the auditor did not comment any further on the size. In June the same year, the auditor said that 114 MSEK of accrued revenue related to earnings in 2007. Half a year later, in December, this amount was still the same (ibid)! Nevertheless, the auditor reported that the size of the account were in accordance with GAAP and did not even comment on the possibility that accrued income could be overstated. This is a significant issue, as 114MSEK is quite significant the auditor should have required management to make an adjusting entry or should otherwise made a remark in the audit opinion.

Quality of audit evidence

The circumstances indicate that most of the auditing happened through email correspondence with Benulic (Ernst & Young AB, 2012). There are also a lot of referencing in the audit documentation to telephone conferences and mail, which seemed to be how the auditor got evidence and explanations. Another complicating fact is that the CEO is provides requested documentation late, and occasionally sends the wrong information. He also gives the auditor short time restrictions to deliver work, which unavoidably reduces the quality of the auditors work. In the audit of the 2010 financial statements, K&K were not done with the closing procedures when the audit started in May 2011. Because of the large amount and extent of emails, and the fact evidence and explanations is sent piece by piece it is difficult to keep track of what evidence is received and not. Moreover, it was always the CEO who had contact

and meetings with the auditor and provided documentation (Ernst & Young AB, 2012). The fact that the CEO spent his time on finding documentation for the auditor is quite unusual, and is a sign that the CEO had something to hide.

The circumstances indicate that it is questionable that the auditor possessed the required competence and resources to perform the audit. First of all, the auditor did not have previous experience in auditing clients in the power industry. Moreover, the auditor did not comment on the significant increase of accrued revenue in 2008, 2009 and 2010, even though both the absolute amount and ratio to sale is noteworthy and irregularly high. Moreover, they seem to lack sufficient and reliable information to base their audit opinion on. If this was the case they should have considered not continuing auditing the client. On the other hand, the report indicates that the manipulations include false invoices with K&K's subsidiaries and other associated companies (ibid). If this is the case, it is almost impossible for an auditor to discover fraud.

10.2 The Group auditor (PwC)

As the Group auditor of Troms Kraft, this places certain responsibilities on PwC to carry out certain controls relating to the local auditor. In 2009, the CEO of TK, who also was the chairman of the board in K&K, requested a separate review from PwC concerning risk factors in the revenue process, including the completeness of revenues and existence of receivables. The Group wanted a complete report, with a conclusion on whether GT had adequately audited the identified risks. PwC concentrated on the risk analysis and investigation on accrued income and receivables performed by GT earlier that year. They noted that GT had performed different tests to confirm the size of the account over the years. Most importantly, GT had sent external confirmations to customers to assure that the outstanding amount in the financial statement was accurate.

Confirmation of customer balances is the most important test to determine the existence of recorded accounts receivable and provides reliable evidence (Stuart, 2011). Auditing standards require that the auditor perform this test or document their justification of not doing so (Elder, et al., 2010). When GT performed the test, the response rate was 60% (Ernst & Young AB, 2012). The auditing standards require the auditor to perform follow up procedures on the non responding customers. It is common to send second and third request, or to perform alternative procedures if this is not effective. An alternative procedure is to examine

supporting documentation to determine whether cash was collected (Elder, et al., 2010). Due to the weak controls in K&K and the significant size of accrued income and receivables, follow up procedures on non replying customers are especially important. However, there is no evidence that such procedures were done and therefore it is difficult to judge how much assurance the auditor got on the existence and accuracy of the amount. Nevertheless, PwC concluded that GT had performed the audit work in accordance with the auditing standards (Ernst & Young AB, 2012).

PwC called attention to accrued income early in 2006, and pointed out the CEO's failure to separate accounts receivables from this estimate. The CEO seems to lack an understanding of this estimate, even though he was the one who prepared it. PwC forwarded an email from the CEO and his concerns to the board members in TK. At the same time, the board requested information on the calculation of accrued income, but management failed to deliver this. Later the same year PwC investigated the size together with the Group CFO without any significant findings. Moreover, the auditor requested better routines concerning the accrued income estimate as there was no approval of this estimates by the board or an independent employee (ibid). In April 2010, PwC investigated the size again, with the same results.

10.3 Conclusion

It is difficult to conclude whether the auditors performed their responsibility as auditors without all the facts. On one hand, GT were facing unreasonable time demands from management and were in addition presented wrongful information. This makes it particularly difficult to perform an audit of high quality and detect misstatements. Moreover, the auditor cannot be expected to examine the vast amounts of customer balances the company had.

On the other hand, an experienced and knowledgeable audit team should have questioned and investigated the large size of accrued income, and the unexpectedly high relative size of this account to earnings. This makes me question the competence of the audit team, as they should have been able to discover these discrepancies. Moreover, there is no evidence that GT performed subsequent procedures on the non responding customers. Such external confirmations are critical in order to get comfort on the existence and accuracy of the account. This raises doubts concerning the quality of GT's work. Furthermore, as the main part of the audit seems to have been done via email correspondence, this would necessary reduce the quality of the audit correspondingly. A lack of resources might be another plausible

explanation. Moreover, an explanation from the CEO does not provide enough evidence and the auditor should have evaluated the reliability of his explanation and should have used professional skepticism. This way they would have recognized the possibility of fraud in the company. Consequently, it is difficult to understand how the auditors could have obtained assurance on the reliability of the financial statement numbers this way. The quality of the audit was not good enough, and the circumstances indicate that GT should have detected the fraud earlier.

PwC asked relevant control questions and assessed the size of accrued income as a risk and also investigated the size multiple times together with management. They continuously reported on weak internal controls concerning both accrued income and other routines and highlighted the lack of segregation of duties. The auditor seems to rightly recognize the risk of material misstatements due to fraud, but was unable to uncover the fraud. As a group auditor, PwC had to rely on the evidence and the controls performed by GT.

11 The Board's responsibilities

11.1 The Board of K&K

The board had on average eight meetings a year from 2001 to 2011, all with high attendance. Except for a short period from 2005 to 2007, the board consisted of employees from K&K or TK (Ernst & Young AB, 2012). From 2001 to 2005, the former CEO was also a member of the board, while the deputy CEO was a member from 2001 to 2008. The CEO always decided the agenda for board meetings. One external member was hired in 2005, but no one replaced him from 2007. Hiring external members was a topic on many board meetings and although multiple candidates were identified, no one was hired. From 2007, owners of TK were represented on the board (Ernst & Young AB, 2012). These had competences in power, but were not familiar with the Swedish market and had no competence in culture. In 2008, the Group CFO and deputy CEO became members of the board in K&K, both had long experience within finance, accounting and auditing. In 2010, the CEO in TK, Oddbjørn Schei, was appointed chairman in the board of K&K.

No measures were taken to *reduce* the accrued income account until 2011. The auditor also commented on the poor quality of documentation of accrued income and continuously

requested better routines relating to this account. Even though this represented a significant risk, there are no indications that the board questioned the existence of accrued income.

Directors expressed concern with the quality of reports and supporting documentation in board meetings. Supporting documentation was sent management to the board in emails and sometimes handed out at meetings. According to the board minutes, the CEO had the upper responsibility that financial reports were adequate and functioned as the CFO until 2010. Hiring a CFO was discussed at many board meetings. GT pointed at significant control deficiencies in the company and how it affected their audit from 2001 to 2005. In 2008 the board requested the GT to examine internal controls, but this did not result in any findings. In 2009, the auditor identified reconciliation differences and reported this control deficiency to the board. The auditor also reported that the separation of duties in the company was blurred.

Discussion

Board composition and diversity

The fact that K&K had many internal members on the board was probably advantageous, as members were better able to supervise the daily management of the company due to experience and knowledge of the operations and business. On the other hand, having only internal members increases the possibility that discussions and decisions happens outside the board room and that decisions are influenced by personal interests. In addition, internal members are more likely to approve management's decisions and less likely to be critical. Independent board members on the other hand are more likely to be objective and therefore more efficient in monitoring management. Moreover, there is a risk that groupthink may have impacted the decision making process in K&K, a situation where members try to minimize conflict and strive to reach consensus (Thomsen & Conyon, 2011). This way, critical thoughts and realistic assessments might have been overridden. As the company seemingly was very successful, and since the CEO was a strong individual, it was probably difficult to raise critical questions. It takes competence and courage to be critical of a visionary and strong CEO or chairman. Consequently, the composition of the board was not optimal to monitor management.

Further, the board had a lot of competence in power, but lacked competence in culture, business and finance. Without the necessary competence, the board members could not be

expected to fully understand the business model and risk and the numbers in the financial statements. In other words how the different accounts are connected and the risks associated with the different accounts. It is the owner's responsibility to elect the members of the board, but in this case they failed to create a board with the necessary competence to detect irregularities in the financial statement. The financial competence in the board was limited until 2008, when the Group CEO and deputy CEO became members. Other newly elected members also had more competence in these areas compared to previous years. From this point on, the board should have had the necessary competences and ability to understand and independently analyze the financial position of the firm, including the large size of accrued income!

Board activity and Follow-up

Some issues are on the agenda several times, without any evidence of follow up at later board meetings. In 2007 the board started logging all decisions to make sure they were followed up, but the log disappeared after only a short time period. The most critical failure to follow up is on requests to the CEO on a specification of income calculations in 2008 and discussions to hire a CFO. Moreover, as the board was presented quarterly financial reports, they had the necessary information to follow up the increasing size of accrued income and receivables. Hence, even though the board had a high activity level in the period, the follow-up of board decisions seems poor and insufficient. The board also failed to react to the reported internal control deficiencies with corrective actions. Although control deficiencies do not indicate that anything is wrong in the financial statements, they are important to secure the accuracy of the financial statements. Moreover, the board had a duty to ensure that the company's accounts were subject to adequate controls. Even though the auditors reported that internal controls were weak concerning the revenue process, the CEO was responsible to prepare the accounts up until 2010. The board should have made sure the company had appropriate segregation of duties by ensuring that a CFO was hired. Consequently, the board failed to fulfill their responsibilities and could therefore be held accountable that the fraud was not discovered earlier.

Financial reporting to the board

As mentioned earlier, the financial reports of K&K were of poor quality. Moreover, management restricted the board's access to documents by not providing requested documentation, or providing documents late. This probably made it hard to keep track of what

information was missing and to get an overview. Moreover, all emails from the CEO to the board concerning financial results were consistently positive - even the increase in accrued income was portrayed this way, claiming that the relative increase against growth in customers actually corresponded to a decrease in outstanding (Ernst & Young AB, 2012).

The board has an independent responsibility to do research. However, analysis of cash flows and profitability is almost absent in board meetings. From 2008, this is still the case, even though the board now had the necessary resources and financial competence. It is surprising that the board did not focus on improving cash flow or question why the cash flows from operations were negative at the same time they had positive earnings. The recurring negative cash flow is an obvious indication of poor routines and control, and could also indicate that the financial state of the firm was in a bad place. The board did not see the red flags. The board should have performed peer analyses and questioned the size of accrued income at an earlier point instead trusting the explanations of the CEO. Moreover, when the auditor reported that f 114 MSEK of income relating to 2007 was not invoiced yet in 2009, they should have investigated the matter and dug deeper to find the case why earnings relating to previous years were not invoiced and did not appear in the bank account. This is especially true since they were aware of the risk associated with the account. Instead, the board was occupied with discussing growth possibilities and expansion into new markets and to new products (Ernst & Young AB, 2012).

The board failed to fulfill their responsibility to make sure controls in the revenue process were adequate, as the CEO was the one both in charge of bookkeeping and preparing the financial statements and income estimate. Thus, the board failed to prevent the fraud. Considering that the board had the necessary financial resources from 2008, it is reasonable to criticize the board for not seeing and acting on the red flags in the financial statements. They should have performed analyses and investigated the size of accrued income already at this point as they were aware of the risk associated with the account. This way they could have detected the fraud earlier. To conclude, the board did not assure that information reflected the real financial position of the firm and should have prevented and detected the fraud earlier.

11.2 The board of Troms Kraft

K&K contributed with half of the Group's revenues in 2010, and the company was described as a great success (Troms Kraft, 2011). As the company continued to diversify into new

business areas, the complexity increased and the board faced an increasing challenge to understand the different business areas of its subsidiaries. The composition of the board was diverse and directors had competence both in power, finance and business, which was quite different from the board of K&K. The board discussed several matters concerning K&K in this period, such as the high working capital, the long credit time and the lacking financial competence in the company. The board also discussed the company's poor invoicing routines on multiple occasions and requested both the board and management in K&K to carefully watch the invoicing routines. In the following, I will present significant findings in the external report from Ernst & Young (2012) and discuss the implications of these findings.

Accrued income

The board discussed the size of accrued income as a separate topic on a board meeting in 2006, where the CEO informed that all sales relating to 2003 and 2004 had been invoiced. Further, the CEO blamed grid operators for the slow invoicing process as reports on meter readings arrived late. In 2006 the CFO and Group CFO together with PwC visited K&K to map how different risk was handled in the audit of the company. Afterwards, a report documenting the visit was distributed to the board in TK, including GT's assessment of risk factors in the company. The report concludes that GT was content with the level of segregation of duties in the revenue process, but that roles and responsibilities were not clearly defined. The report also states that the large size of accrued income was a result of both long invoicing periods and distinctive Swedish conditions.

The board expressed concern for the significant increase in accrued income in 2007, as they assumed credit risk was increased due to an increasing amount of private customers. Management ensured that the risk associated with these sales was low, as the largest source of revenue still came from municipalities. The board emphasized the importance of internal controls in this area, due to the considerable effect on earnings. The increasing size of the account continued to be a topic on board meetings the following years as they were worried that the valuation was incorrect. In 2010, the chairman questioned the significant size of accrued income compared to competitors (Energibolaget), and received an aggressive and rude reply from the CEO, explaining that the difference was due to the many municipalities in K&K's customer base.

Issues relating to invoicing routines were brought to the board's attention early in 2011, and actions were taken to reduce the amount of accrued income and receivables. However, the CEO was unsuccessful in reducing the outstanding amount. Shortly after, the board received an internal notice from employees in Sweden concerning the reality of the size of accrued income. The board then reacted and called an extraordinary meeting. The explanation the board received from the CEO at this point was not perceived as credible. As a response, the board initiated internal investigations to map cash flows in the company and this was when the accounting irregularities and alleged fraud was uncovered.

Discussion

Like the board in K&K, the board in TK also failed to follow up on issues in the company. A plausible explanation is a shortage of time at board meetings. In addition to the time constraint, the board also noted that information and financial reports often came late, which limited the board's ability to analyze and discuss issues.

The report from 2006 does not discuss the possibility that the accrued income estimate could be wrong or the risk of misstatement due to both errors and fraud. Thus, the board could not be expected to understand the risks associated with accrued income and internal controls based on information in the report alone and detect the fraud at this point. On the other side, the board should have been familiar with the risks associated with revenues and should therefore have ensured that appropriate controls were implemented in the revenue process. The board neglected their responsibilities to make sure financial statements were accurate, and placed too much responsibility with management. The CEO had his own interest to be in charge of the preparation of accounts and accrued income, which explains why a CFO was not hired until 2010.

It looks like the board focused too much on the top line and growth in revenues when they should have been concerned with the company's negative cash flow and increasing debt. Although the increasing size of accrued income was a topic on meetings, there are no signs that required measures were taken to reduce the account or investigate the existence of these amounts. As accrued income is above what can reasonably be expected in the industry, the board should have investigated and mapped the cash flows earlier, as there were plenty of warning flags. Compared to the board in K&K, the board in TK actually had the necessary knowledge and financial capabilities to understand and analyze both risk factors and the

financial development in the firm. One possible explanation might be that they had too much trust and faith in the CEO. Even though the board assessed the size of the account, they believe the CEO's explanations and did not investigate the existence of the account until 2011. In 2008 the company reported the size of accrued income to be 1 billion, amounting to 60% of sales and equaling an increase of 46% from previous year. The development in cash flow was also negative on the second year in a row. These warning signals should have been followed up and investigated already at this point. The hypothesis that accrued income was significantly different due to the Swedish market conditions, could have easily been rejected if the board had done a peer analysis on the size of accrued income. The fact that operations were located in different countries probably made it difficult for the board to keep itself informed but should nevertheless have seen the warning signs in the financial statement, as accrued income was significantly increasing compared to sales.

Furthermore, as the Group went through a series of changes during the period, this probably required much attention and resources from top management, leaving less time for follow-up and control of K&K. This provided a chance for management to behave opportunistically; as the company was not closely monitored they could do as they pleased.

11.3 Conclusion

The board has a responsibility to review and analyze the company's calculations and estimations and assess the reasonableness of these calculations to make sure financial statements are accurate and reflect the real financial position of the firm. As the development in accrued income account and financial ratios showed many warning signs, one would think they at some point would discover the errors as they have a duty to investigate irregularities.

The board in K&K had knowledge in power industry, but did not have enough financial knowledge to independently analyze financial statements and understand the development in critical ratios. Hence, the board could not have been expected to understand the underlying information in the financial statements. However, the board is responsible to obtain information in a manner they can understand so this is a poor excuse. The CEO presented documentation the board found to be reasonable and true to support the results, financial situation and accounts of the company. The board therefore claims they had no possibility to uncover the fraud as they were misled and manipulated by the administration. However, the

board is supposed to be critical of the management, but seems to blindly trust the CEO's judgment and honesty.

Moreover, the board failed to identify fraud risks on a timely basis and to adequately monitor identified risks. For instance, the company lacked satisfactory internal controls in the revenue process, a serious weakness considering the large size of the firm and the presence of a dominant leader. In reality there were no separate CFO role in the company, and the CEO functioned as a CFO until 2010. The board should have made sure that management hired an external CFO at an earlier stage, hence both boards failed to make sure the appropriate mechanisms were in place to prevent EM and fraud. By implementing controls to the identified fraud risks, the board could have limited the opportunity to commit fraud. Instead, the board consistently failed to follow up on critical issues. These are all reason why I argue the board did not fulfill their duty to monitor management. If they had fulfilled their responsibilities, the fraud could have been prevented or detected at an earlier point. The CEO was given freedom to act, direct and control the company as he wanted although this is the duty of the board.

The board in K&K seems to have acted as a rubber stamp on the CEO's decisions as he seems to have had considerable control over the board. The lack of business and financial competence meant that the directors did not have the ability to analyze financial statement numbers and ask critical questions. Moreover, they were more concerned with growth and the *top line* than the liquidity and solidity of the firm. This made the owners lose their ability to monitor the company's activities and financial position. It is also censurable that no actions were taken to improve the company's high capital bindings until 2011, even though this was repeatedly discussed in meetings. The general follow up of board decisions were lacking throughout the whole period. As the board's control function was weak, management had both the opportunity and possibility to manipulate the financial reports.

12. Conclusion

The aim of this paper is to explain the factors in the environment that allows earnings management and fraud to occur in a company, by using the case of Kraft & Kultur. The case analysis shows how conditions in the company and environment enabled central management to manipulate financial statements over many years. First of all, the complexity and uncertainty concerning revenue provided an opportunity for management to manage earnings, as revenue relating to yearend sales had to be estimated. Hence, the risk of misstatements due to errors and fraud is significant in the power industry. Secondly, weak internal controls and poor monitoring from the board made the fraud possible. Thirdly, the desire to cover up a lack of control might have been the motivation behind the fraud.

The CEO had a strong and visionary personality, and he exercised a great deal of power and influence over the board as well as other members of the company. The CEO was responsible for the preparation of accounts as well as all communication and with the auditor. This is a key explanation to how the fraud could occur. By inflating the size of accrued income, he managed to show incredible growth levels each year. Moreover, the circumstances indicate that the CEO deliberately failed to record costs relating to the purchase of power, as employees failed to hedge prices on fixed price contracts. This could have been an attempt to increase earnings by speculating that prices would fall. However, when prices increased management seem to have activated these costs on the balance sheet instead.

The board is to be blamed that appropriate controls were not implemented in the company, as stronger internal controls would have limited management's possibility of fraudulent reporting. Most importantly, the board should have ensured that a CFO was hired at an earlier point. The board also failed to make sure that financial statements was accurate and reflected the real financial position of the company, as they did not react to red flags and inconsistencies in the financial statements, even though they had the necessary competence to do so from 2008. Consequently, the circumstances indicate that the board should have detected the misstatements at an earlier stage.

Moreover, the quality of the audit performed by Grant Thornton can be questioned as the auditors failed to obtain sufficient evidence and assurance concerning the existence of the accrued revenue.

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