



# **MOTIVES AND CONSEQUENCES OF FRAUDULENT FINANCIAL REPORTING**

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## **Introduction**

According to Webster's Dictionary, the word Fraud is generally defined as "the act of deceiving or misrepresentation." Though there is a diversity of frauds, mostly are considered difficult and hard to prevent.

Publicly traded companies are required to prepare and issue financial statements that fairly reflect their performance and financial condition. The SEC requires public companies to obtain an audit by an independent auditor. The various users of the audited financial statements rely on their information content to make a diversity of investment, credit, and other decisions. Prior to and after the well known case of the 2001 Enron and its external auditor "Arthur Andersen," for a diversity of reasons, trusted corporate executives of many public companies had published fraudulent financial statements, which embody intentional perversion of the truthful accounting information. In monetary amounts, these fraud cases involved billions of dollars. In 2002 and thereafter, a wave of separate but often related accounting scandals became known to the public in the U.S. The Big 4 accounting firms (Deloitte & Touche, Ernst & Young, KPMG, PriceWaterhouseCoopers), who are responsible to uncover, identify and prevent the publication of falsified financial reports, were all charged with negligence in the execution of their duty as auditors.

This paper is undertaken to highlight 22 cases of real life corporate frauds, which were reported by the Securities and Exchange Commission in the early 2000s. For so doing, the paper consists of three parts. Part I deals with trend and costs of frauds. Part II consists of two subparts, the first deals with types of creative accounting techniques, and the second focuses on the 22 real life cases of corporate frauds. Part III provides concluding remarks. A long list of references is provided at end of paper.



## **I. Trend and Costs of Frauds**

The costs of business frauds have incredibly reached \$400 billion dollars a year. In 2002, the Institute for America's Future reported that the corporate scandals have caused the public more than \$200 billion in lost investment savings, lost jobs (over one million workers lost their jobs as their looted companies tumbled into bankruptcy), losses of private and public retirement savings (individual retirement account "401(K)" savings lost \$178 billion, and public pension funds lost at least \$6.4 billion), and lost tax revenues of nearly \$13 billion from companies with questionable accounting practices underreporting their taxable profits.

The report also added that corporate insiders cashed more than \$15 billion by selling stock since 1999 before the bottom sellout and corporate filing for bankruptcies. Moreover, extravagant compensation and retirement packages were received by many corporate CEOs, such as Ken Lay of Enron received \$33.5 million in total compensation for 2000, Joseph Nacchio of Quest Communications received \$103 million for 2001, Dennis Kozlowski of Tyco received \$62.4 million for 2001, Samuel Waksal of ImClone received \$40.3 million for 2001, Raymond Gilmartin of Merck received \$28 million for 2001, and so on (see Gordon, 2002).

Price Waterhouse Coopers' 2005 "Global Economic Survey" disclosed a dramatic increase in the number of companies reporting fraud, as compared with its 2001 and 2003 results. For example, the number of restatement of financial statements has been increasing over the years:

- (a) The number almost doubled from 616 cases in 2004, to 1,195 cases in 2005, representing almost 8.5% of the U.S. publicly traded companies.
- (b) In 2006, the number of restatements totaled 1,420 representing one out of 10 publicly traded companies.

Corporate accounting frauds typically involve creative, complex methods which aim to overstate revenues, understate expenses, over-valuing corporate assets, and/or underreporting existing liabilities. Creative accounting practices which amount to fraud are subject to investigations which are typically launched by government oversight agencies: the SEC, the PCAOB, and the Department of Justice (DOJ). Almost all



corporate fraud cases are eventually settled with the government through Deferred Prosecution Agreement.

## **II. Creative Accounting and 22 Real Life Cases of Corporate Frauds**

### **(a) Creative Accounting Techniques**

The period since late 2001 has been a turbulent time for corporate America, the U.S. public accounting firms, and other professionals (namely, Wall Street financial analysts, investment bankers, underwriters and brokerage firms, and lawyers) who are associated with publicly held companies and the financial markets. These corporate financial scandals had eventually caused several high profile corporate bankruptcies and financial market plunge. As a result, various corporate stakeholders (e.g., shareholders, creditors and suppliers, employees and workers, competitors, customers, retirees, government tax authorities, among others) suffered adverse financial consequences, such as material shrinkage of investment savings, lost jobs, depleted private and public retirement funds, and loss of government tax revenues.

To hide corporate financial problems (i.e., potential losses), intent to manipulate stock prices, minimize taxable income, and/or maximize compensation and retirement packages, corporate top executives and directors implement a variety of creative, aggressive or deceptive accounting and disclosure techniques.

Creative accounting techniques are violation of the fundamental accounting principles and disclosure requirements: revenue recognition, matching, capitalization, off-Balance Sheet transactions, and creation of fictitious special purpose entities for financing reasons.

The bottom line is the intention to overstate corporate earnings and economic resources (assets), to minimize financial obligations (liabilities), and disclosure in vague language relevant footnote information.

### **(b) 22 Real Life Cases of Corporate Frauds**

The following is a list of 22 cases of real life corporate accounting frauds and scandals [Forbes, July 25, 2002]. Corporate entities involved in accounting frauds are listed in an alphabetical order. In each case, date when scandal went public is stated, and nature of



allegation (corporate fraud) is highlighted.

1. **Adelphia Communications**. April 2002. Founding Rigas family collected \$3.1 billion in off-balance-sheet loans backed by Adelphia; It overstated operating results by inflating capital expenses and hiding debt. Three of the Rigas family members and two other ex-executives were arrested for fraud. The company sued the entire Rigas family for \$1 billion for breach of fiduciary duties, among other things.

2. **AOL Time Warner**. July 2002. As the ad market faltered and AOL's purchase of Time Warner loomed, AOL inflated sales by booking barter deals and ads it sold on behalf of others as revenue to keep its growth rate up and seal the deal. AOL also boosted sales via "round-trip" deals with advertisers and suppliers. Shredding documents related to audit. AOL said it may have overstated revenue by \$49 million. New concerns are afoot that the company may take another goodwill write-down, after it took a \$54 billion charge in April.

3. **Bristol-Myers Squibb**. July 2002. Management inflated its 2001 revenue by \$1.5 billion through "channel stuffing" or forcing wholesalers to accept more inventory than they can sell to get it off the manufacturer's books. Efforts to get inventory back to acceptable size reduced earnings by 61 cents per share through 2003.

4. **CMS Energy**. May 2002. Management was engaged in 23 "round-trip" trades to boost trading volumes and revenues. Management appointed Thomas J. Webb, a former Kellogg's CFO, as its new chief financial officer, effective in August 2002.

5. **Duke Energy**. July 2002. Management was engaged in 23 "round-trip" trades to boost trading volumes and revenue. The company said an internal investigation concluded that its round-trip trades had "no material impact on current or prior" financial periods.

6. **Dynegy**. May 2002. Management had executed "round-trip" trades to artificially boost energy trading volume and cash flow. Management had conducted a re-audit. Standard & Poor's had cut its credit rating to "junk," and the company expected to fall as much as \$400 million short of the \$1 billion in cash flow it originally projected for 2002.

7. **El Paso**. May 2002. Management executed "round-trip" trades to artificially boost energy trading volume. Oscar Wyatt, a major stockholder and renowned wildcatter engineered a management shakeup.



8. **Enron.** October 2001. Management artificially boosted profits and hid debts totaling over \$1 billion by improperly using off-the-books partnerships; manipulated the Texas power market; bribed foreign governments to win contracts abroad; manipulated California energy market. Ex-Enron executive Michael Kopper pled guilty to two felony charges; acting CEO Stephen Cooper said Enron may face \$100 billion in claims and liabilities; company filed Chapter 11; its auditor Andersen was convicted of obstruction of justice for destroying Enron documents.
9. **Global Crossing.** February 2002. Company engaged in network capacity “swaps” with other carriers to inflate revenues. Management shredded documents related to accounting malpractices. Company filed Chapter 11. Hutchison Telecommunications Limited and Singapore Technologies Tele-media paid \$250 million for a 61.5% majority interest in the firm when it emerged from bankruptcy.
10. **Halliburton.** May 2002. Company improperly booked \$100 million in annual construction cost overruns before customers agreed to pay for them. Legal watchdog group Judicial Watch filed an accounting fraud lawsuit against Halliburton and its former CEO, Vice President Dick Cheney, among others.
11. **Homestore.com.** January 2002. Management inflated sales by booking barter transactions as revenue. The California State Teachers’ Retirement Pension Fund, which lost \$9 million on a Homestone investment had filed suit against the company.
12. **Kmart.** January 2002. Anonymous letters from people claiming to be Kmart employees alleged that the company's accounting practices intended to mislead investors about its financial health. The company, which was in bankruptcy, said the "stewardship review" it promised to complete by Labor Day 2002 wouldn't be done until the end of 2003. Kmart was merged into Sears’ Holding Company.
13. **Merck.** July 2002. Company recorded \$12.4 billion in consumer-to-pharmacy co-payments that Merck never collected.
14. **Mirant.** July 2002. The company maintained that it might had overstated various assets and liabilities, and revenues were inflated by \$1.1 billion.
15. **Nicor Energy, LLC.** July 2002. Nicor Energ was a joint venture between Nicor and Dynegy. An independent audit uncovered accounting problems which boosted revenue and underestimated expenses.



16. **Peregrine Systems.** May 2002. Management overstated \$100 million in sales by improperly recognizing revenue from third-party resellers.
17. **Qwest Communications International.** February 2002. Company inflated revenues using a network capacity (swaps) and improper accounting for long-term deals.
18. **Reliant Energy.** May 2002. Management engaged in “round-trip” trades to boost trading volumes and revenues.
19. **Qwest Communications International.** February 2002. Company inflated revenue using network capacity “swaps” and improper accounting for long-term deals.
20. **Tyco.** May 2002. The Ex-CEO L. Dennis Kozlowski was indicted for tax evasion. He was investigated by SEC whether the company was aware of his actions of possible improper use of company’s funds and related-party transactions, as well as improper merger accounting practices.
21. **WorldCom.** March 2002. Management overstated cash flow by booking \$3.8 billion in operating expenses as capital expenditures and gave founder Bernard Ebbers \$400 million in off-the-books-loans.
22. **Xerox.** June 2000. Management falsified financial results for five years, boosting income by \$1.5 billion.

### **III. Concluding Remarks**

The direct and indirect financial consequences of frauds are staggering. In addition to damaging employee and stockholders morale, fraud can threaten an organization’s prized reputation and existence, not only for ethical standards, but also as a trusted fiduciary of stakeholders.

Board of Directors and top management should be on the look for red flags that indicate a possibility of fraud, and should encourage management to conduct regular fraud risk assessment and seminars, as well as compliance with the entity’s code of ethical conduct. With the entity’s integrity at stake, preventing fraud –or, at least, promptly addressing it to minimize damage- is of the utmost importance.

Though the accounting profession has accepted a fair share of the blame for the nation’s crisis of confidence in the financial markets, Wall Street investment bankers, financial analysts, underwriters and brokerage dealers, and lawyers, are also to be



blamed for the nation's shaken faith in business and the accounting profession. These professions have been under eye-watch of SEC and the department of justice. Finally, one of the major concerns of the American Institute of CPAs is that the new legislation by Congress could become a template for parallel state legislation or rule changes that directly affect both non-publicly held companies and the CPAs who provide services to them.

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