ACCOUNTING FRAUD: CASE STUDY

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Abstract: *This paper aims to be a qualitative research, respectively a case study. I will analyze two famous cases of accounting fraud: Enron and Lehman Brothers. The analysis considers the techniques used to manipulate the result, the accounting fraud, the causes, the effects, the people involved and the sanctions applied. Although they occurred at different points in time, both have gone down in history as accounting manipulations with a significant economic impact and showed the failure of supervisors. Enron took advantage of accounting policies that allowed the creation of special purpose entities to hide off-balance sheet debts and losses. Lehman Brothers profited from the use of Repo 105, which involved a repurchase agreement that abusively allowed loan transactions to be recorded as sales. Both cases ended up being, due to the accounting manipulations used and the economic impact of those manipulations, resounding bankruptcies.*

Key words: *accounting fraud, Enron, Lehman Brothers, bankruptcy*

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1. Introduction

Accounting fraud is and will be a threat to financial data, affecting both management decisions and investor confidence. It can even lead to economic destabilization of companies and bankruptcy.

Accounting fraud can be increasingly prevalent where internal control mechanisms are completely lacking, or in an increasingly competitive and complex economic environment where certain manipulated financial statements can be used to advantage. In order to avoid such situations, internal control needs to analyze the causes leading to fraudulent financial accounting data, find solutions and establish procedures to avoid such situations. The forms that accounting fraud can take range from manipulating income to concealing debts. For example, some balance sheets, even if they appear perfect, can hide inconvenient truths. The past shows that many companies have used accounting tricks to hide losses and attract investors, as well as to avoid paying taxes.

Accounting fraud, in all its forms, affects the image of companies as well as the confidence of financial markets. Companies frequently become involved in financial scandals, often caused by accounting fraud of various sizes. Whatever the size of the company, the deliberate manipulation of accounting data can lead to significant losses and, in some cases, even insolvency or bankruptcy.

Accounting fraud can take many forms: overstatement of income or assets; omission of significant financial obligations; understatement of expenses or liabilities; recording of fictitious transactions, etc. In the context of a globalized and digitalized economy, where financial information circulates rapidly and influences major decisions, the importance of transparency and accuracy of accounting reporting becomes essential and mandatory.

The consequences of accounting fraud are significant: investors pull out; huge financial losses; management investigations; loss of confidence of business partners and customers.

Only a pro-active approach, together with effective internal control and prevention mechanisms, can significantly reduce the risks associated with accounting fraud and ensure the long-term sustainability of an organization.

In the article I will present the research methodology and then the two selected case studies and finally some conclusions.

2. Research methodology

The research is qualitative, based on the multiple case study method with the aim of analyzing famous case studies on accounting fraud. In order to choose the most famous cases I did an initial Google search on "biggest accounting fraud" and formed a list of 128 famous scandals and then for each of them I searched on the Web of Science as follows: Title/Abstract scandal/company name, English language, document type Article, Web of Science Categories: Business or Business Finance or Ethics. The search returned the most articles for the following cases: Enron and Lehman Brothers. For each of these I will analyze the manipulation techniques, the fraud, the causes and effects of the fraud as well as the people involved and the sanctions that were imposed. I have chosen the cases with the most writings because it means that they are the most relevant to the academic community and resounding scandals at the same time. Among the limitations of the research is that I have chosen to use only Web of Science articles in this research and exclude other types of writings and other data sources that might also be relevant to the topic.

3. Results and discussions

Enron

The Enron case is one of the biggest bankruptcies in the US at the time (2001). Enron was a company that sold energy in America that later started to sell various types of derivatives such as forward contracts and options. Enron took advantage of accounting rules that allowed the creation of special purpose entities (SPEs) to hide liabilities and losses off the balance sheet. These entities were not consolidated by the parent company, i.e. Enron, given a US GAAP provision that allowed the assets and liabilities of an SPE to not appear on the balance sheet of the company that established it if two conditions were met (Deakin & Konzelmann, 2004). The fictitious transactions using SPEs were discovered in the fall of 2001 and an inevitable collapse of the company followed. The auditor, Arthur Andersen at the time called for the consolidation of these special purpose entities even though it initially agreed that they should not be consolidated because this contravened accounting principles. Consolidation years earlier increased earnings by several hundred million dollars and reduced the value of the company by several billion dollars. These restatements and revaluations did not, in themselves, bankrupt the company, but the loss of confidence in the credit and capital markets did. Enron had cash flow problems and in order to save itself it made efforts to access a line of credit and planned to merge with its rival Dynegy but this merger did not materialize due to the size of its debts and so the company went bankrupt on December 2, 2001. Within the company the independence of non-executive members of the Enron board was affected by the fact that they received consultancy payments and other gifts in addition to their compensation. The independence of the auditors was also impaired by the fact that they were paid not only for their audit services but also for their consulting services. At a time when the stock price was falling and the company's future was uncertain Enron management took advantage of tens and even hundreds of millions of dollars in stock option proceeds. All of this drove the company into bankruptcy.

In short the fraud was the use of special purpose entities to report large fictitious profits and hide debts, thus manipulating the financial statements and stock price presented to investors. The effect of the fraud was the company's bankruptcy in 2001, the biggest scandal to date, with the company going bankrupt and its auditor Arthur Andersen disappearing from the market. Employees not only lost their jobs but some of them lost their savings. Shareholders lost over 85 billion dollars as a result of this bankruptcy (Henderson et al., 2009). The Enron scandal led to the introduction of the Sarbanes-Oxley Act (2002), which provides for greater independence of directors and auditors, with the aim of better aligning management actions with shareholder interests.

Among the parties involved in this bankruptcy were managers who in many cases made decisions that destroyed the company, they went along with the decision of senior management and the board to focus on increasing earnings per share (Stewart, 2006).

Lehman Brothers

The Lehman Brothers case represents the 2008 bankruptcy of the fourth largest US investment bank following the use of Repo 105, permitted in the 2000s by SFAS 140 which involved a repurchase agreement that improperly allowed loan transactions to be recorded as sales. Lehman developed a policy to take advantage of this standard, the cash received was not recorded as a loan, and the repurchase obligation was not recorded as a debt. This policy also allowed him to eliminate securities received as collateral from the balance sheet by decreasing assets. It was intended to show apparent economic stability by reducing the net leverage ratio.

In 2007, before bankruptcy, the company had to reduce their leverage ratio due to an unfavorable situation in the financial market and falling real estate prices that did not allow them to sell assets without taking a loss and used Repo 105. They applied this policy on about 50 billion dollar transactions every quarter before bankruptcy to make the balance sheet look better.

In 2008, Lehman made several presentations to credit rating agencies but in none of them did they present the Repo 105 practice or its effect on the leverage ratio.

Lehman's choice of accounting method hid its problems to the point that at one point bankruptcy was the only option (Hines et. all, 2011).

The external auditor Ernst & Young apparently was informed about Repo 105, had a copy of this policy but did not inform the board of directors or the investing public. The auditor did not feel obligated to look at the volume and timing of Lehman's so-called Repo 105 repurchase agreements. The external auditor also did not consider himself responsible to look at the composition of the liquidity fund and how liquid it was believing that this was the responsibility of the regulators and so even though the bank announced a liquidity fund of about $41 billion on September 12, 2008 the bank had a liquidity fund of less than $2 billion and virtually did not have enough cash to open.

The failure of Lehman Brothers also points to weak regulation by the SEC and the Federal Reserve Bank of New York (FRBNY), which acted more as a lender to Lehman, had 2 employees within Lehman to monitor its ability to repay the loans, but had no authority over the disclosures it made.

The use of repurchase agreements led to the bankruptcy of Lehman Brothers in 2008, which is considered a turning point in the global crisis at the time, showed a lack of oversight and regulation of financial institutions and ethical problems in the financial system. The collapse meant losses for investors and customers and increased distrust in auditors and institutions with a regulatory and supervisory role in the sector.

The external auditor Ernst & Young has been sued several times in the case, in two major lawsuits, having failed to fulfill its duties as auditor, it agreed to pay $99 million in 2013 and $10 million in 2015. Lehman's management was not criminally convicted because there was not enough evidence to show that the fraud was willful. (Kirsiene & Miseviciute, 2017)

4. Conclusions

Accounting fraud is a threat to the integrity of financial information impacting investors, financial institutions and other stakeholders. It distorts reality and even leads to bankruptcy, as was the case of the two bankruptcies presented, which have gone down in history because of their scale.

These scandals showed the failure of the supervisory institutions and the poor corporate governance of the companies involved. In the aftermath of these scandals, steps were taken to ensure that such situations would not be repeated. In the wake of the Enron bankruptcy, the famous Sarbanes-Oxley Act (2002) was introduced to increase the independence of directors and auditors.

This article has been limited to analyzing only two famous cases of accounting fraud but I am planning to extend it by analyzing more cases in the order established according to the research methodology.

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