Universe International Journal of Interdisciplinary Research
(International Peer Reviewed Refereed Journal)
DOI No. – 08.2020-25662434

© UIJIR | ISSN (O) – 2582-6417
DEC 2023 | Vol. 4 Issue 7
www.uijir.com

ACCOUNTING FRAUDS

Author's Name: Satwick Mishra[1]

Affiliation:

1. Student of BA Accounting and Finance – Middlesex University Dubai, Dubai Internet City, Dubai, United Arab Emirates.

Corresponding Author Name and Email Id: Satwick Mishra, SM3805@live.mdx.ac.uk

ABSTRACT

There are plenty of accounting processes and systems in place, but despite that, accounting frauds do not seem to be stopping. More checks and strict actions are required to deter individuals from indulging in such activities. The details below talk about how these can be achieved while also giving an insight into how professional ethics plays the most crucial role in preventing such corruption.

Keywords: ***Accounting, Fraud, Financial, Assets, Liabilities, Loans, Audit***

DOI Link :: https://doi-ds.org/doilink/12.2023-16235641/UIJIR

© UIJIR | ISSN (O) – 2582-6417

INTRODUCTION

As seen worldwide, accounting is a task, knowingly or not, performed by everyone, not just corporate entities. But what is accounting? Accounting is simply the task of gathering, recording, analyzing, and then acting upon the information to reach a desired outcome. To put things in simple perspective, let's take the example of a classroom without enough desks to accommodate all the students. Here, the professor will eventually speak to those in charge of logistics and solve the problem by arranging more desks. In this example, the professor gathered information regarding fewer desks, perhaps recorded the number of desks needed in the classroom, analyzed why such an issue arose in the first place, and then acted upon the information by asking the logistics team to increase the number of desks in the classroom. While this is a very small example of where and how accounting is used, it proves that without it, our lives could not possibly continue in the manner it does. In any corporate entity, accounting is used on a far grander scale and perhaps holds more significant value regarding how efficiently the business is run. Accounting is said to have been developed alongside writing, counting, and money. It is said that the Egyptians and Babylonians came up with auditing systems, and Romans first created detailed financial information [1]. As is the case with nearly everything in the world, each coin has two sides. While accounting is such a big part of our lives, it can also be 'cleverly' used to misrepresent information and show others what they want to show and not what is there to see. This 'clever' accounting is known as accounting fraud and leads to scandals, where businesses use loopholes to hide billions of dollars' worth of losses to appear healthy and financially stable in front of the world. While accounting has been around for as long as humankind is known to Earth, accounting principles are relatively new. This, combined with unethical and dishonest employees and management, allow such fraudulent activities to occur. While accounting principle bodies such as GAAP (Generally Accepted Accounting Principles) and the IFRS (International Financial Reporting Standards) are constantly trying to improve the principles in place to prevent any such scandals, we also need to come to terms with the fact that we may never reach perfection and that it may always come down to the honesty and professional ethics of an employee to pursue and extort these loopholes or not.

The case study discussed below is a perfect example of poor accounting and record keeping, leading to one of the biggest financial scams known in recent years. The paper elaborates on the leaks while trying to provide insight into the case.

DOI Link :: https://doi-ds.org/doilink/12.2023-16235641/UIJIR

© UIJIR | ISSN (O) – 2582-6417
DEC 2023 | Vol. 4 Issue 7
www.uijir.com

WHAT IS ACCOUNTING FRAUD

Accounting fraud is the false representation of an organization's financial statements to favorably show the company's financial position [2]. Accountants in a company are most able to commit these frauds as it requires accounting knowledge to identify and exploit loopholes.

EXAMPLES OF ACCOUNTING FRAUD

Overstating Revenue: Companies incurring greater expenses than earnings may commit accounting fraud by overstating their revenues and falsely inflating their profits, presenting an image of a strong financial position.

Unrecorded Expenses: Another way accounting fraud is committed is by recording selective expenses on the company's income statement, which increases the net profit, giving a positive impression of the company when it may be incurring a loss.

Misstating Assets and Liabilities: A company is said to be in a solid financial position when it has enough liquid assets to cover its current liabilities. A company committing accounting fraud may achieve this by understating its liabilities and overstating its assets, hence imitating vital financial health [2].

PREVENTION OF ACCOUNTING FRAUD

There are two methods to prevent accounting fraud, internal control and external control. While the Board of Directors must decide to implement both these control systems, internal controls also need to be exercised by the organization's management, whereas external controls are performed by employees of companies outside of the organization.

INTERNAL CONTROL:

Control Environment: The first and foremost way to avoid accounting fraud in an organization is by creating an ethical environment, which starts right from the top of the managerial chain. Many further control methods can easily be neglected without a strict disciplinary environment.

Division of Responsibilities: Ensuring no one person controls all financial transactions is another vital control method. It makes it difficult for anyone to commit accounting fraud if they control only a limited number of transaction processes. This also includes division of responsibility within the Board of Directors while making sure that separate individuals hold the posts of CEO and Chairman. Reconcile agency bank accounts regularly: Reconciliation

DOI Link :: https://doi-ds.org/doilink/12.2023-16235641/UIJIR

© UIJIR | ISSN (O) – 2582-6417
DEC 2023 | Vol. 4 Issue 7
www.uijir.com

should be conducted by an independent individual free from bookkeeping or check signing responsibilities and doesn't require supervision while reconciling. Canceled checks must be examined and ensured that the vendors are recognized and signed by an authorized signatory. It is also essential to ensure that the checks are not issued out of sequence and that a reconciliation report is generated, initialed, and dated to document that a review was conducted. Avoid or discourage related party transactions: Ensure that a written conflict of interest and code of ethics policy is in place and regularly updated. Discourage the employment of relatives and business transactions with the Board and employees while requiring that the board disclose and approve related party transactions [5]. Related party transactions should also be transparent between parent, subsidiary, and sister companies. In the case of transfer pricing between related parties, the tax laws of both countries must be abided by.

EXTERNAL CONTROL:

Conducting regular audits: External auditors are independent companies separate from the client company and must ensure that the client's financial statements are generated honestly and in compliance with the accounting framework. In case an accounting fraud eventually unravels, the audit company will be held equally responsible as the client company, as seen in the Enron scandal in 2001, where the company responsible for their audits, Arthur Andersen, once part of the 'Big 5' accounting firms, were aiding the fraud and turning a blind eye to visible red flags, also faced such heavy fines and backlash that it has since never been able to redeem itself [6].
Balance confirmation with suppliers and customers: This method of control is usually associated with account statements, in which case it is termed as account reconciliation, or accounts receivables and payables. You can request your customer and supplier to confirm individual amounts and ask for a reply, whether the amounts correspond or not. Balance confirmation enables you to detect and rectify any inconsistencies that may exist between your records and that of your business partners[7]. Use of E-commerce platforms: By using E-commerce platforms for interactions with business partners, transparency is assured, which makes it more challenging to perform and get away with fraudulent activities. It is also essential to know that while all the methods mentioned above help reduce the chances of fraud being committed, none of these are foolproof and have inadequacies that can be used.

DOI Link :: https://doi-ds.org/doilink/12.2023-16235641/UIJIR

CONSEQUENCES OF ACCOUNTING FRAUD

If a company committing accounting fraud is eventually caught and their fraudulent activities come to light, they could face severe charges. Apart from the company, the board, shareholders, employees, and audit company may also feel the repercussions.

Organization: The business organization will be the first to deal with the ramifications if caught committing fraud. These could range from fines to a situation where the company may have to dissolve. The company will have to bear vast sums of costs apart from the penalties as the business will now be open to lawsuits that may last for years, so legal fees will be one of the most significant issues. It is also challenging to return to the same stature as before because of the image damage in the eyes of employees and other stakeholders. Investors only invest in companies they can trust; a company with a record of fraud doesn't give them the assurance and belief to invest their money. Board of Directors: Usually, after getting caught in accounting fraud, most of the Board of Directors provide the company with their resignations as it is seen as a failure in leadership and judgment to prevent such a grave mistake. Those directly involved in the fraud may face hefty fines to be paid and even be jailed for their wrongdoings. Irrespective of who commits the fraud, it is the highest leadership's responsibility to ensure that the company is being run ethically and that no such fraudulent activities occur under them. Shareholders: Although shareholders outside the BoD don't face fines and jail sentences, they are also inevitably hurt by the backlash. Stock prices of such companies take a massive dip, and with almost no one willing to buy the shares now, shareholders lose a lot, if not all, of the money they invested. Shareholders are now also eligible to sue the company for wrongful representation, and if they do choose to do so, it may cost them a lot of time and money, along with other resources. Employees: If the fraud committed by the company is severe enough, the company may have to dissolve, leaving all its employees stranded and unemployed. Apart from this, future employers don't take a keen interest in hiring employees with a record of working in a company that participated in such fraudulent activities, making it harder for them to get back on their feet. Audit Company: An accounting fraud cannot be committed without either the assistance or the incompetence of the external audit company. The role of the audit company is to make sure that the financial statements presented by the company are honest and accurate. If fraud has been carried out, it tells us that the financial reports generated by the said company were dishonest and inaccurate, overlapping the duties of the audit company. In such events, the audit company may face harsh backlash, both financially and non-financially, in terms of fines

DOI Link :: https://doi-ds.org/doilink/12.2023-16235641/UIJIR

and tarnished reputation, as can be seen with Arthur Andersen in the Enron scandal [8].

THE LEHMAN BROTHERS SCANDAL, 2008

Lehman Brothers were founded in 1844 by German brothers Henry, Emanuel, and Mayer Lehman in Montgomery, Alabama. The company started as a general store and, by 2008, was one of the largest investment banking companies in the United States. Before the US housing market collapsed, which eventually caused the Lehman Brothers to disintegrate, the company had dealt with and survived its fair share of economic downfalls and other political adversities. The organization got through the railroad bankruptcies of the 1800s, the Great Depression, two world wars, a capital shortage when American Express spun it off in 1994 in an initial public offering, the Long Term Capital Management collapse, and the Russian debt default of 1998. The company's sudden and precipitate decision to enter the subprime mortgage market caused its downfall, as it did with many other financial firms [9].

The subprime mortgage market is one where companies lend loans to others who don't have a par credit score. The company lending the loan would charge higher interest rates to compensate for the additional risk of providing the loan to someone without an excellent credit score [10].

From 2005 to 2007, Lehman Brothers recorded yearly profits as its real estate business caused its revenues to skyrocket by 56% in that market. The organization securitized $146 billion in mortgages, a 10% increase from the previous year. In 2007 the company recorded profits of $4.2 billion as net income on $19.3 billion in revenues[9]. However, all of this came tumbling down in 2008. As things started falling away for Lehman Brothers, it was also found that the company had hidden around $50 billion in loans disguised as sales, showing healthier financial statements [11].

Further investigation showed that the Lehman Brothers had used accounting law Repo 105 as a loophole to hide loans and camouflage them as sales. Repo 105 allows companies to keep assets as collateral while borrowing loans from financial institutes and repurchasing them at 105% of cash received. Lehman Brothers would receive cash for their assets and pay back immediate liabilities, making them appear more financially stable than they were in the eyes of its stakeholders. Soon after their quarterly financial statements were published, they would use this healthier leverage to secure loans and buy back their assets at 105% of the cash received. While all this is legal, while obtaining loans, Lehman Brothers would record the loans for risky assets as a sale of assets, reducing their liabilities and increasing their income and cash. Since Lehman

© UIJIR | ISSN (O) – 2582-6417
DEC 2023 | Vol. 4 Issue 7
www.uijir.com

didn't actually make a sale, they should've kept the assets in their book. They would then use these claimed "sales" proceeds to pay down their liabilities. Hence their balance sheet had fewer risky assets, lower debts, and more cash. This resulted in healthier financial leverage, which shows that the company is earning a return on borrowed funds that exceed the cost of said funds [12].

During the bankruptcy trial of Lehman Brothers in April 2010, then-CEO Mr. Richard S. Fuld, Jr, was questioned about the accounting techniques used within the company that allowed them to mask billions of dollars of risky assets and debt. He, however, denies any wrongdoings[10]. It was later found that the CFOs set forward the accounting practices used in the institution during the 2000s, had ample knowledge about the Repo 105 transactions, and didn't want to do anything about it. The thinking then was that since these practices were being used for a long time, if anything had to go south ways, it would've by now, and hence there is no point in fixing something that isn't broken [13].

Due to the failure of Lehman Brothers and the crisis in the subprime mortgage market, mortgage lending practices have been publicly criticized. Furthermore, it has raised questions about the adequacy of investment banking institutions' accounting practices when it comes to the accounting of mortgage transactions, which makes their financial statements appear better than they were [12].

FAILURE OF CONTROLS

Referring to paragraph 3: Lehmann Brothers would intentionally misstate their loans (liabilities) as sales to inflate revenues and prepare healthier financial statements.

Referring to paragraph 5: It is visible that the environment in the company wasn't as strict and disciplined as it should be and would neglect basic accounting principles to show shareholders that the company was blooming.

It is also visible that there is significant complacency in preventing the scandal from Ernst and Young (EY), Lehmann Brothers' designated audit company at the time, by failing to detect and report these frauds.

DOI Link :: https://doi-ds.org/doilink/12.2023-16235641/UIJIR

OTHER EXAMPLES OF ACCOUNTING FRAUD

Satyam Computer Services Ltd.
Primary cause: Falsifying revenues, cash balances, and margins of nearly 50 billion Indian rupees (607.8 million USD) to meet shareholder expectations.

Enron Corporation
Primary cause: Hiding debts in order to keep their stock prices high.

Carillion Plc
Primary cause: Misrepresenting debt figures and showing a healthy picture by increasing yearly dividends.

CONCLUSION

Corporate entities that follow accounting practices profoundly have been held in high regard and are always well respected in the market. However, there will always be individuals who will, despite all laws and principles, want to engage in fraudulent activities only because they may be more profitable in the present, not considering future repercussions. The above case study confirms that irrespective of accounting principles, fraud can still occur if the people involved don't behave ethically and pretend that some loopholes are only for exploitation rather than treating them as loose guidelines.

Good accounting practices and strict internal and external controls will always bring out any possibility of accounting fraud in the company. These auditors should be given absolute freehand in reporting the flaws as well as taken very seriously for the recommendations they offer without any bias.

Aspects such as IFRS regulations and procedures haven't been touched upon in the research paper and leaves room for further discussion.

© UIJIR | ISSN (O) – 2582-6417
DEC 2023 | Vol. 4 Issue 7
www.uijir.com

REFERENCES

1. https://yourfuture.accaglobal.com/global/en/blog/how-humans-invented-accounting.html#:~:text=Accounting's%20history%20can%20be%20traced,Romans%20collated%20detailed%20financial%20information.
2. https://www.investopedia.com/ask/answers/032715/what-accounting-fraud.asp#:~:text=Accounting%20fraud%20is%20the%20illegal,ways%20to%20commit%20accounting%20fraud.
3. https://cleartax.in/g/terms/financial-fraud
4. https://www.aura.com/learn/types-of-financial-frauds
5. https://omh.ny.gov/omhweb/resources/internal_control_top_ten.html
6. https://www.grin.com/document/499795
7. http://saphelp.ucc.ovgu.de/NW750/EN/ea/cfd45398184308e10000000a174cb4/content.htm#:~:text=These%20enable%20you%20to%20detect,any%20necessary%20individual%20value%20adjustments.
8. https://smallbusiness.chron.com/fraud-hurts-organization-58563.html
9. https://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp
10. https://www.consumerfinance.gov/ask-cfpb/what-is-a-subprime-mortgage-en-110/
11. https://corporatefinanceinstitute.com/resources/wealth-management/lehman-brothers/
12. https://digitalcommons.montclair.edu/cgi/viewcontent.cgi?article=1008&context=acctg-finance-facpubs#:~:text=Essentially%2C%20Repo%20105%20is%20an,sales%20rather%20than%20as%20loans.
13. https://www.ipl.org/essay/Lehman-BrothersFinancial-Fraud-In-2008-PJAEW7Q36G

DOI Link :: https://doi-ds.org/doilink/12.2023-16235641/UIJIR