Global Case Studies in Forensic Accounting Education: The Case of Audit Failures

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ABSTRACT

Globalization often makes it difficult to detect and combat fraudulent financial reporting activities. We have witnessed several accounting scandals of big global firms such as Enron, Worldcom, Olympus, etc. We most recently learned of the "systematic" overstatement of operating profits by Toshiba. Although some frauds were typical and have been previously experienced, new accounting frauds, that we have never seen, are increasing. Every company and organization faces the possibility of fraud, regardless of industry or country. Additional financial statement frauds we have experienced before have further eroded investors’ confidence. Therefore, the development of forensic accounting education plays a significant role to find ways to confront fraud and rebuild investors’ confidence. Forensic accounting education can help both accounting professionals learn from international fraud cases and educators teach students how to detect and control fraud. The global fraudulent cases in this paper could provide ideas and tools toward these educational goals. This paper studies several global financial reporting fraud cases.

Keywords: Forensic accounting Education, Fraud, Globalization, Auditing Firms

BACKGROUND

Increased globalization worldwide highlights the variety of accounting frauds in financial reporting cases. Whenever it is detected, it affects global capital markets and ultimately increases regulation. Already, we have faced financial statement frauds by global companies across Asia, Europe, and the Americas. Many global companies have operations and trade in equity markets globally. For example, in the United States, there are many listed foreign firms from Asia, Europe, and other areas. Some of them are related to U.S. companies. The complexion of borderless business relationships makes it harder to find frauds and to uncover them.

Margaret McGuire, the Vice Chair of the SEC’s Task Force for Financial Reporting and Audit, pointed out on February 11, 2014 that it is hard to determine whether less fraud occurred or whether the SEC missed fraud that occurred, acknowledging that there have been fewer financial reporting enforcement actions over the last several years (McGuire, 2014). This demonstrates the potentiality of future fraud cases. Naturally, we have to prepare to detect and to combat fraud in global companies. We continue to see new and ingenious global frauds with different characteristics and dimensions than we have seen in the past. Along with this recent trend, we must increasingly question the ability of auditors in identifying financial statement fraud. According to the Wall Street Journal on June 17, 2014, the head of the U.S. Securities and Exchange Commission (SEC), Andrew Ceresney explained the reason that we see a lot of activity there and they have just turned to audit fraud as the next area of enforcement. This underscores the importance of auditors working carefully and ensuring that they fully comply with their professional obligations.
To encourage audit quality as well as to combat more complex financial reporting frauds involving global companies, we examine exemplary frauds in global companies through several global fraud cases in this paper, supported by JSPS KAKENHI Grant No.15K13215. Forensic accounting education plays a significant role in giving students the opportunity to learn and experience such global and culturally-oriented fraud cases. Subsequently, the learning and experience gives them the knowledge and tools to combat new types of frauds. Meanwhile, forensic accounting education emphasizes to auditors, managers, business persons, and even educators the significance of continuous lifelong learning. Therefore, even accounting educators need to make an effort to study frauds in order to understand, detect, and prevent these activities. The result is our contribution to enhanced, effective corporate governance in the global financial market. Finding teaching methods to prevent scandals like Toshiba, Enron, WorldCom, Olympus, and Parmalat etc., are essential to restoring eroded investors’ confidence.

GLOBAL EXAMPLES IN SEVERAL COUNTRIES

We introduce the following four fraudulent cases of global companies from Japan, China, Europe and India. Each case is summarized in a short story abstract so that students can easily understand the issues. We hope that these educational materials help the students learn a variety of financial statement frauds with cultural or other dimensions, such as audit failures, fabrication of documentation, abuse of managers’ privilege, and the misuse of M&A (mergers and acquisitions) and so on.

Japanese Firms’ Case: Manipulating the audit

1. Long Management History

Olympus Corporation is a Japanese manufacturing firm of precision machinery and instruments. The firm has a long management history of almost one hundred years since it was established on October 12, 1919. Olympus’ main businesses are Medical (diagnostic and therapeutic technologies like endoscopes), Life Sciences (microscopes and peripherals), Industrial (nondestructive testing technologies, like detectors, scanners, probes, and transducers), and, of course, Camera and Audio (digital cameras and optical components).

2. Failure of Financial Investment

In a bubble economy, Olympus positively embraced strategic financial statement enhancement using financial instruments. However, in an effort to continue to appear profitable, the collapse of the bubble motivated Olympus to take on even riskier investments. This resulted in accumulated losses of 10 million dollars by the end of 1990. In 1999, Japan decided to adopt a “fair value” accounting rule that valued loans and loan-like instruments at cost and everything else at fair value. This new “mark-to-market” accounting rule forced companies to disclose losses on their investment securities in a timely manner.

Chairman, Tsuyoshi Kikukawa; Vice President, Hisashi Mori; and Auditor, Hideo Yamada chose not to disclose the losses in the financial statements, since the losses would materially and negatively affect income. They decided to execute a series of mergers and acquisitions (M&A) of unrelated companies such as Gyrus Group PLC, a British medical equipment manufacturer; Altis, a waste disposal and recycling firm; News Chef, a seller of microwave cooking ware; and Humalabo, a producer of nutritional supplements, in 2008. These M&A were used to obscure the financial statements to cover the losses incurred over the previous twenty year period. Olympus then established a third party committee to
investigate the series of M&A transactions previously brought to light (The Third Party Committee of Olympus Corporation, 2011).

3. Manipulation of Audit and Management Power

Finally at the end of 2009, the auditing firm of KPMG AZSA LLC detected Olympus’ fraud, but the facts of the fraudulent activities were not made public. Soon thereafter, Olympus’ top executives released KPMG AZSA of its audit responsibilities and changed to another firm, Ernst & Young ShinNihon LLC. Why did the former auditing firm keep silent? Why did it hand the facts to the next firm? What should it have done for the audited company as a discharged auditing firm? On April 1, 2011, Michael Christopher Woodford, a British businessman and an Olympus veteran of nearly 30 years, was named president and chief operating officer.

Woodford, who had worked for KeyMed, a unit of Olympus, since 1981, had become the executive managing director of Olympus Medical Systems Europa in 2008 and had been given a seat on the executive committee. After KeyMed, a manufacturing company for medical instruments in England, became a subsidiary of Olympus in 1986, Michael Christopher Woodford became the first President in 2011, as a foreigner, and chief operating officer (CEO), the irregular financial reporting continued. In the year as the new foreign President, Woodford was fired by the Chairman as he tried to investigate the truth and request explanations, referred to the third party’s report and information in the FACTA magazine. Who could stop the fraudulent activities? How should the internal control system for financial reporting function?

European Firms’ Case: Family Business Fraud

1. Italian Family Business

Unfortunately, many people believe falsification of accounting records is a victimless crime affecting only investors. Not only is that incorrect, but it hurts many stakeholders both related and unrelated to investors. We will use some notorious examples to demonstrate. Parmalat started as a small family business selling cheese and sausages in Parma, Italy. The capofamiglia, Calisto Tanzi, grew the small family business into a major dairy product, baked goods, and beverage business with products sold worldwide. At its peak, Parmalat had over 36,000 employees in 30 countries. It did $3.3 billion in business in North America, where it sold Black Diamond Cheese, Archway Cookies, and other recognizable brands (Bloomberg Businessweek Magazine 2004).

2. Unethical Techniques

Unfortunately, the rapid growth came at a cost and motivated some unethical behavior. Parmalat, well-known as the Italian dairy foods company, was one of the largest financial scandals. The company was prosecuted for vanishing assets of $12 billion. The default of $185 million of the company bonds in November 2004 motivated related stakeholders, including bankers, investors, and auditors to investigate the financial statements. Of Parmalat’s assets, 38 % were recorded to be held in a $ 4.9 billion (4 billion euro) Bank of America account of a subsidiary in the Cayman Islands. The account itself did not exist. According to the charges, there were numerous fictions that appeared to generate profits in Parmalat and its subsidiaries. The financial director admitted that he made a number of forged documents in Bank of America’s name with a copy and paste method (Sverig 2004). In 2004, the actual value of the liabilities was 14.3 billion euros. That was an amount eight times the book value of the liabilities (World Finance 2011). Over 15 years later, we now know the extent of the fraud:
Numerous companies set up to appear to generate revenue.
Bank letterhead used to create false deposits.
Artificial receivables generated from subsidiary companies to the parent company.
Falsification of revenue.
Falsification of cash balances.
Cash siphoned from Parmalat to a separate business.
Key officer positions held by family members.
Destruction of key company documents.

3. Europe’s Enron

Parmalat was a well-known global company in Europe. In spite of its reputation, Tanzi, various family members and several executives were arrested on a charge of accounting fraud. What motivated them toward the fraudulent accounting practices? Ultimately, the influence of the Parmalat collapse was large and wide-spread as there was a $14 billion black hole in cash. The company became notorious as “Europe’s Enron.” What happened to the related stakeholders and how were they affected? Parmalat was also a primary client of Grant Thornton, the seventh ranked auditing firm in the United States. The Italian branch of Grant Thornton International did not want to lose Parmalat as a client. Consistent with Italian law, the auditing firm of Parmalat, Grant Thornton, was changed to Deloitte Touche Tohmatsu in 1999, but Grant Thornton continued to audit the subsidiaries.

The Case in India: Lack of Managers’ Ethics

1. Rapidly Growing Business

Everyone believed that Satyam Computer Services Ltd. (M/s SCSL) was a “rising-star” IT Company in India (Bhasin 2013, 29). In 1987, the company was founded in Hyderabad (India) by B. Ramalinga Raju. Satyam rapidly grew to be the fourth largest company in the country, with over 53,000 employees and operations in 66 countries at its peak. The big wave and increased scale of the internet business made the company expand across the world. Satyam reached to USD $2.1 billion in annual sales of 2008 and the highest stock price was Rs.723 on March 7, 2000 (Kalavalapalli 2013). Gradually, both the reputation of the company and the owner rose higher. The owner, who came from a modest background and received an MBA from Ohio University, was awarded by Ernst & Young with the ‘Entrepreneur of the Year’ award in 2007. On April 14, 2008, the company got awards from MZ Consults for being a ‘leader in India in CG and accountability’ and the World Council for Corporate Governance ‘Global Peacock Award’ for global excellence in corporate accountability in September 2008 (Agrawal and Sharma 2009).

2. Dynamism and Boldness in Accounting Fraud

In January 2009, the owner and chairman, Mr. Raju confessed and was arrested on the charge of fraud totaling $1.47 billion. He resigned over myriad financial misstatement issues including systematically falsifying cash balances, overstating income, and overstating receivables, while understating liabilities (Sheth, Range, and Anand 2009). Over ninety percent of the cash balance, approximately $1.04 billion that showed in the balance sheet of the second quarter ending in September 2009, did not exist. The revenue was overstated by 75 percent. The company was involved in a series of fraudulent activities for over eight years. There was a variety of falsification techniques including multiple sets of accounting books. There were more than 7,000 forged invoices (of 11 different types),
bundles of false bank statements, and many unnecessary employees intending to attract prospective customers and investors (Timmons 2009).

3. Shock Wave to the Market

The Central Bureau of Investigation (CBI), the premier investigative police agency of India, announced that the scale and scope of this company’s fraud was the biggest accounting scandal in India. The loss of investors created a $2.4 billion (or Rs.14,162 crore) loss in equity. Satyam has been listed on the New York Stock Exchange (NYSE) since 2001 and also on Euronext since January of 2008. PricewaterhouseCoopers has been the auditing firm since the listing on the NYSE. Part of problem, in this case, was related to rapid growth and expansion into unrelated industries. What are some governance issues in this company? The owner, Mr. Raju became too confident and powerful as he escalated the fabrication, wanting prestige in the global economy. Satyam managers perpetrated the fraud to eliminate the gap between actual profit and book profit. They continued the fraud until it was finally discovered. The auditing firm, PwC did not uncover the fraud for nine years. The Indian Post reported on April 9, 2015 that two PwC partners were arrested after the discovery. Merrill Lynch discovered the fraud within 10 days. The word ‘Satyam’ has the historic meaning of the truth in India, but the name of the 21st century company in India was not consistent with the historical meaning (Basilico, Grove and Patelli 2012, 142).

Chinese Firms’ Case: Manipulating the employees

1. History

Longtop Financial Technologies Limited (NYSE: LFT) is a Chinese financial software company in the banking sector. Its main businesses are software development, technology service, and customized software design. It first listed on the New York Stock Exchange (NYSE) on October 23, 2007 (LFT 2007). Goldman Sachs (Asia) LLC and Deutsche Bank Securities supported the IPO as joint underwriters and Deloitte Touche Tohmatsu Certified Public Accountants LLP served as its auditing firm. At the beginning of the next year, the estimated fair value reached 15.4 billion dollars.

2. Citron Report on April 26, 2011 for LFT Fraud

On April 26, 2011, Citron Research’s Andrew Left noted the following financial statement frauds subsequent to Longtop’s IPO (Left 2011). First, a majority of the employees were not directly employed by Longtop. Ninety five percent were employed by a Chinese firm called Xiamen Lontop Human Resources Services Co. (XLHRS). XLHRS’s only business was with LFT. In the financial statements, it was not disclosed that XLHRS was a related party.

Second, the Chairman, Mr. Xiaogong Jia and CEO, Mr. Weizhou Lian had the unfortunate background of being sued by their former employer for unfair business practices before they founded Longtop. In 1996 when they worked at Xiamen Dongnan Computer Co. (XDCC) as managers, they founded Xiamen Dongnan Rongtop Electronic Co. (XDREC) and signed a contract with a XDCC client using their company name XDREC, rather than XDCC. They used a name trick to establish a false contract. They also deceived their customers and employees by using a P.O. Box. The complex series of fraudulent activities was brought to light in the Citron reports.
3. Responsibility as the Auditing Firm

As soon as the CFO of Longtop resigned on April, 2011, the China arm of Deloitte Touche Tohmatsu, Deloitte Shanghai (D & T Shanghai) also resigned. Subsequently, D & T Shanghai sent Longtop a letter that indicated Longtop’s fraudulent activities. The lack of finding the fraud is still questionable as Longtop’s auditor for six years. In fact, the Longtop group was ranked at the top 500 of the fastest growing companies of Deloitte Asian Pacific Technology in 2008 (Deloitte Asian Pacific Technology 2008). On September 8 of 2011, SEC disclosed the enforcement against D & T Shanghai to fail to produce a bundle of the related documents for the investigation for Longtop’s fraud. SEC applied for the U.S. Federal Court to order it to comply with SEC for D & T Shanghai that still refused the SEC request to follow the Chinese Law submit the documents, though it had the responsibility as the accounting firm for the unqualified opinion gave on the fraudulent financial statements of LFT.

ANALYSIS

While studying the above four cases of financial reporting frauds by global companies, we see several common trends in them. We will explain these in the following section.

Frauds Across Business Lines, Sectors, and Countries

It is evident that the fabricated financial reporting appeared across business lines, sectors, and countries. Olympus and Parmalat were manufacturing companies, but in different business lines. Olympus mainly had product lines such as precision machinery and instruments, while Parmalat’s business was food and drinks. Both Longtop and Satyam were IT companies. Longtop provided software development, technology services, and software design, mainly for bankers. Satyam was a rapidly growing Company in India that provided outsourced e-business services to companies around the world. This means that many business sectors in the global economy are exposed to the risk of accounting fraud. In other words, stakeholders in all countries face potential financial statement fraud.

The Existence of Audit Failures

Throughout the cases used in this research, we investigate possible audit failure. Each case shows that large auditing firms were directly or indirectly involved in the audit failures. The mission of the public auditor is to represent the interests of outside stakeholders rather than with management. Auditors take on risk by representing the public interest in assuring reliable information, and also to change inappropriate conduct of management of the audited firms (Doty 2013). As the chairman of the PCAOB stated, the auditors should be independent as the protector of free markets. However, the auditors of these global companies did not function as they should have.

Under severe competition, global companies struggle from pressure to do business well and be attractive to investors, creditors, and consumers in the global marketplace. In this economy, growth is a target of companies and management. Management performance is often measured by growth. Therefore, even with the shrinkage of the global economy, the goals do not change, but the pressure for growth increases. Many global companies continue to seek expansion into new countries and markets. This environment increases the pressure to perform and can lead to fraudulent activities by management in an effort to appear successful.
We also learned about the creatively diverse methods of fraud by these global companies. For example, one manager simply made false documents attached with a bank name using his computer. The cash and bank loan account amounts, shown in the balance sheet, never existed. In another case, the majority of the employees were not even employed by the parent global company, but over ninety percent were employed by a related local company without acknowledgment in the financial statements.

CONCLUSION

We studied four financial reporting fraud cases of global companies including Olympus, Parmalat, Satyam, and Longtop. There are some common implications as follows; (1) potential accounting frauds exist across types of business, sectors, and countries, (2) the audit failures need to be examined (3) there are a variety of the types of fraudulent and fabricated transactions, and (4) the lack of ethics of some managers is surprising! These findings show the importance of global forensic accounting and auditing education. Educators can contribute to ethical conduct of students as future candidates for management and business people of global firms from various countries to foster their ethical thinking through the learning using a series of global fraud cases.

Also, auditors needs to positively protect the public interest to assure financial statements are fairly presented, without material misstatement, discussion useful, follow Generally Accepted Accounting Principles, and provide transparent information. The joint role of academia and practice is to raise awareness of and discuss the important topic, the so called ‘audit failure.’ Of course, we as educators need to increase students’ awareness of these global issues in class.

REFERENCES

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