**Report on corporate frauds**

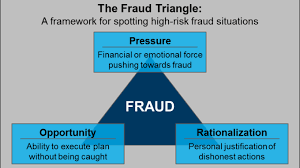
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**Introduction**

The report focuses on the reasons, happenings and consequences of three frauds committee by companies. The basic theme of these frauds can be set in any of the reasons shown by the fraud triangle. Our findings suggest that the opportunity aspect ws common to all the companies. Enron and HIH were accounting frauds while Tyco was a governance failure.

**The fraud Triangle**

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**ENRON**

**How the irregularities were perpetrated?**

On the 16th of October 2001 the Enron company announced a huge cut in the after tax income and the shareholder’s equity. The company further announced to restate the net income of the years 1997 to 2000. This action decreased the shareholder’s wealth by $ 508 million. In the end of the year 2001, the company filed a case for bankruptcy. This was the largest bankruptcy of the history of the country. It was the fifth largest company in the energy sector. The above restatements were announced by the company as accounting errors regarding the transaction with various firms or companies. Some of these companies were owned by the ex-staff of the company. The employees of the company were benefitted and filled their pockets with millions of dollars that they should have never received. The employees had not taken any prior permission from the board of directors to have some interest in the partnership. The major problem that affected the company was the conflict of interests between the management and the board of directors. The policy adopted by the company regarding the compensation paid to the employees also raised certain questions. Another aspect of the conflict of interest is seen when we discuss the overall role played by Arthur Anderson. He was an auditor as well as a consultant to the company. The company had filed for chapter 11 bankruptcy which allows the company to reorganize while being protected from the creditors. The Chief executive has been changed and an expert of restructuring has been brought in. The company made use of the loopholes in the generally accepted accounting principles and made huge frauds. The pressures element of the fraud triangle was more applicable in this case as the top management wanted the lower staff to show the higher prices of the stock of the company by showing increased income.

**The reasons behind them**

The major reason behind the fraud was the intention to provide undue benefit to the employees involved. The management did not present the true condition of the company in front of the stakeholders especially the shareholders. The top people in the company wanted to save the reputation of the company as well as their own jobs and lucrative incomes attached to them. The complete information was not provided by the top management when encouraging the employees to buy the stock of the company, the directors did not tell them that they were selling the stocks.

**Why these irregularities were not discovered by the auditors?**

The company was audited by Arthur Anderson. The audit firm was completely involved in the scandal and helped the company to manipulate the earnings. The company invited some other audit firms occasionally to the office to show that it has changed the auditor but soon it reverted back to the services of Arthur Anderson. The auditors may fail to detect the fraud that the company is trying to do in terms of error or misstatement. The auditors may have detected the fraud but are not able to identify it because the audit they have done is not up to the mark. The misstatement is not reported by the auditors rather they allow the directors to put the things back on the right track. This will mean that the independence aspect from the auditors is still missing. The audit performed by Andersen had certain discrepancies. The auditor was biased towards a certain set of people to provide them with undue benefit to them. The judgments made by the auditor were biased so as to provide benefits to the directors of the company. The auditors provided misstated and uncertified financial statements to the stakeholders. This mad them believe that the company was doing very well. These statements should be accompanied by a certificate signed by the auditors which was missing in the case of Enron.

**What the auditors should have done to overcome such practices?**

The external auditors should not be managing the organization in any capacity. The external auditors should not carry on any kind of investment services for the company. No other services should be provided to the company than the audit. This list can be added in by any regulations passed by the accounting board to be impermissible.

First of all the auditors should have resolved the conflicts of interest that were in place. The company should not have allowed Arther Anderson to work in two such positions which had connected aspects. The inappropriateness in the books should have been properly reported and investigated. The proper look into the books would have shown that the company was misusing two accounting concepts to conceal the facts. These were the mark to market and special purpose entity. The agreements that the company had entered into with many of the related parties had used this aspect. The company pressurized the other parties to show higher future expected cash flows and lower discount rates to show a rosy picture on the operations of the company. The picture was made to look good by some unrealistic estimates of the future income of the company that did never pay off. The company made use of the special purpose entity concept to convert the debt into income.

**What action the regulators have taken subsequently to address these problems?**

The Sarbanes Oxley act has pressurized the companies to disclose any material transaction immediately. The complexity in the finance strategy is not allowed to be kept. This should be replaced by the corrective disclosure policy. The act also made it compulsory for the companies to give the governance and management responsibilities to completely separate and independent sets of people.

**The HIH Company**

**How the irregularities were perpetrated?**

The company showed a very good report to the outsiders about its financial position. The internal story had been concealed as some action brought it to the brink of bankruptcy. The debt leverage was raised to the highest limits and the insurance liabilities were rising every passing day. In the year 2001, the company could no longer sustain the false reporting done by it and the result was the biggest financial collapse of the history of Australia. The scandal is as much dependent on the poor policies of corporate governance as it was on the weak accounting practices and policies. If we talk about the frau triangle, we can see that the company made use of the opportunities presented by the loopholes present in the generally accepted accounting principles.

**The reasons behind them**

The major reason behind the collapse was the aggressive takeover policies undertaken by the company. The expansions were made in either a saturated or highly competitive as the US. The other option undertaken by the company was an unknown and risky market as the one in UK. There were some low priced takeovers in the 1990s among which the transaction of 300 million to buy the FAI was the most controversial. The owner of the FAI was entered on the board of directors in the HIH insurance. The investigation showed that the company purchased was worth only a 100 million at max. Some experts say that at the time of the transaction, both these companies were commercially insolvent but predicting to be financially strong. The CEO and his group reached this stage due to consistent mismanagement over a long period of time

**Why these irregularities were not discovered by the auditors, if applicable?**

The audit of HIH was done by Arther Anderson who was not found to be independent enough during the audit of the company. There were three members on the board of directors of HIH insurance who were formally employed by Arther Anderson. The auditors and the executives were very closely related to each other. The auditor received huge sums of money on account of some non audit services from the company. The audit report prepared for the year 2000 was an unqualified one. The report stated that the financial statements showed a true and fair view of the organization and complies with all the relevant accounting standards in practice. The company showed a surplus of operating income over the operating expenses worth $ 939 million. The picture changed in just 4 months when it was revealed that losses worth 800 million have forced the company to apply for bankruptcy. The auditor failed to ascertain that the insurance claims were undervalued. The reinsurance contracts were assessed in a wrong way by the auditors. The inability to detect that some of the assets was overvalued. Arther Anderson had changed the audit practices undertaken to conduct the audit of the HIH insurance company. The traditional approach looked into all the accounts prepared by the company. The new approach also known as the business audit approach focused mainly on the risks involved in the customer contracts. The main aim on the part of the audit company was to reduce the staff and earn profit.

**What the auditors should have done to overcome such practices?**

The external auditors are the attesters of the internal audit services undertaken by the company. They will also report the effectiveness of internal controls implemented by the company. This is important because in the absence of effective internal control methods, the company will not be able to prepare the accurate and correct financial statements. They have to give their opinion regarding the internal control processes. The report that contains this assessment on the part of the auditors is attached to the financial statements of the company.

The auditors should have reported a true picture of the company to the external stakeholders. The change of the audit policy specifically for the company was dubious. There should have been the independence of the interests between the auditors and the top management of the company. The lack of independence should have been reported by the auditors. However they were very much involved in the overall scenario. The recent reforms on the subject have been forcing the audit side to improve rather than the disclosure side.

**What action the regulators have taken subsequently to address these problems?**

The minimum capital requirements for the entry in general insurance market were raised considerably. The work was also started on the development of reforms for the general insurance companies. The market developments were more easily accommodated in the laws made. The SAS no. 99 requires the auditors to discuss the possibility of fraud through misstatement in the financial statements before and during the general discussions for gathering information. This requires that the auditors should be reasonably sure about the fact that there is no misstatement in the financial statements that can have a material effect on any of the stakeholders. This aspect has two major parts. The first part shows that the new team members take the adequate information about the client from their senior team members who have already worked with this client. The sessions will be held with a mind to question the various happenings. This will mean that the auditors are properly engaged in their work. The sas 99 has three major aspects, pressures, opportunities and attitudes. The company used the opportunities that were presented for fraud by the weaknesses in the accounting system. The attitude towards the fraud activities was not professional rather it was like closing the eyes from it.

**TYCO**

**How the irregularities were perpetrated?**

The company was formed in 1960 by Arthur J. Rosenberg. The main focus of the company was high level research and development. The managers of the company used the weaknesses in the accounting rules and regulations to mislead the investors about the financial position of the company. This aspect of the management was perceived as being a part of the corporate culture. The terms like financial engineering were openly used by the company employees during communication. The company had said that the financial mismanagement had not gone to the bases of the organization and only the former CEO was involved in some looting. The interesting fact is that many of the acts of the company did not go against any of the generally accepted accounting principles. The company operations had extended so much that the fraud was almost inevitable. The accounting results were made such that they show the company much better than it originally was. The fraud includes the misappropriation of assets at the hands of the two executives.

**The reasons behind them**

The main reasons behind the fraud were to increase the personal earnings by three persons. CEO Kozlowski, CFO Mark Schwartz and Mark Benlick were accused of theft. The three people paid themselves an approximate amount of $ 170 million. The company had a program regarding the personal employee loans which did not require any approval. Further these loans were kept off the balance sheet and were not shown in the balance sheet. Two of these were found to give themselves interest free loans without any approvals. These people were also accused of giving themselves huge amount of bonuses.

**Why these irregularities were not discovered by the auditors, if applicable?**

The external auditors prepare the financial statements of the organization. They also report to the Securities and Exchange Commission about the various accounting policies and practices followed by the company. This will also include any discussions between the management and the auditors pertaining to the changes or the alternatives for these policies. If the two parties are not able to reach a common solution to any of the issues, this must also be reported to the Commission.

These irregularities were not pointed out by the auditors because apparently they were a part of all the set up. The opportunity and the intense greed played a vital role in the fraud. There was no whistle blowing from inside the company. The internal controls were not enough to stop the executives from committing the fraud. The tone set by the top managers was such that the behavior leading to fraud was acceptable. This fraud did not result in the bankruptcy of the company. The share price did drop but not by a huge amount. The auditors were paid huge compensations for a large set of services provided to the company. The company missed huge misrepresentations of the incomes. These were related to the payments to the three executives. The company has issued a long report that shows every aspect of the fraud committed by the company.

**What the auditors should have done to overcome such practices?**

The auditors should have questioned the company allowing too much power to a small number of executives. The concentration of power within the company was one of the reasons why the company eventually failed. The auditors should have forced the top managers and executives to have regular meetings with the shareholders and share the complete information with them during these meetings. Shareholders could have taken more informed decisions based on the information. The top management should have acknowledged the fact that they work for the advantage to shareholders and not for their personal benefits. This understanding should have been reinforced by the auditors. However the auditors were themselves involved in the fraud to a certain extent. The company also came across the conflict of interests between the directors and auditors which resulted in the fraud to happen.

**What action the regulators have taken subsequently to address these problems?**

The Sarbanes Oxley act has been put in place to make sure that the conflict of interests does not affect the performance of the company. This law has also improved the aspects related to the accounting disclosures.

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