CORPORATE FRAUDULENT FINANCIAL REPORTING IN EUROPE AND GLOBAL RESPONSE

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ABSTRACT

Several global actions have been undertaken to respond to recent series of global corporate fraudulent financial reporting incidents, mostly in the U.S. and Europe. Almost all cases of European corporate accounting frauds are committed by international corporations which conduct their business in many countries, and mostly are listed and traded on the U.S. stock markets. Global actions of reform are prompted by American and European regulatory bodies, such as the U.S. SEC and the EC, and by other international organizations, such as IFOA and OECD, in order to restore investor confidence in financial reporting, the public accounting profession, and the global financial markets. This study provides a sample of corporate accounting frauds in Europe and highlights the various actions for reform.

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I. INTRODUCTION
Three groups of business people who commit financial statement frauds. They range from senior management (CEO and CFO), mid- and lower-level management, to organizational criminals (Crumbley 2003; Wells 2005). CEO and CFO commit accounting frauds to conceal true business performance, to preserve personal status and control, and to maintain personal income and wealth. Mid- and lower-level employees falsify financial statements for their area of responsibility (subsidiary, division, or other unit) in order to conceal poor performance and/or to earn bonuses based on their conceived higher performance. Organizational criminals falsify financial statements to obtain loans or to hype a stock they plan to sell “pump-and-dump” scheme.
Methods of financial statement schemes range from fictitious or fabricated revenues, timing differences of recognizing revenues and expenses, improper asset valuations and reporting, concealed liabilities and expenses, to improper full disclosures (Crumbley 2003; Wells 2005).
The primary purpose of this descriptive, library-based paper is twofold: (1) to identify the European companies which were involved in fraudulent financial reporting, and highlight the nature of accounting irregularities committed; and (2) to emphasize the urgent need for corporate and accounting reforms by summarizing nature of legislative-regulatory corporate reforms in the USA and Europe, and the recommendations provided by the International Federation of Accountants (IFOA) and the Organization of Economic Cooperation and Development.
For so doing, the paper consists of three parts. Section II enlists European companies which committed accounting frauds and highlights types of accounting irregularities committed. Section III outlines global corporate and accounting reforms by the U.S. legislative-regulatory bodies (SEC), the IFOA, OECD, the European Union, and individual European countries to improve corporate laws and the regulation of the public accounting profession. Section IV provides concluding remarks.
II. CASES OF EUROPEAN CORPORATE ACCOUNTING FRAUDS
Seven large companies based in six European countries (France, Ireland, Italy, the Netherlands, Sweden, and Switzerland) are reported to commit accounting frauds. Exhibit 1 identifies the seven international companies and nature of accounting irregularities committed (Badawi 2006, 2005; James 2002).
### Exhibit 1

**Cases of Corporate Accounting Frauds in Europe**

<table>
<thead>
<tr>
<th>Company</th>
<th>Description</th>
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<tbody>
<tr>
<td>Adecco International (Switzerland)</td>
<td>The world’s largest employment services, the Swiss company was formed in 1996. Company confirmed existence of weakness in internal control systems and accounting staffing operations in certain countries, especially in the U.S. Manipulation involved IT system security, reconciliation of payroll, accounts receivable, and documentation in revenue. These irregularities forced an indefinite delay in the company’s profit figures, which eventually caused significant decline in the company’s stock prices in Switzerland and the U.S., and intervention of SEC.</td>
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<tr>
<td>Ahold NV (The Netherlands)</td>
<td>Company is the world’s third largest food services group after Wal-Mart and Carrefour. The Ahold USA is the regional office in the USA. In July 27, 2004, the Dutch parent company announced that the SEC brought charges against four former executives of its U.S. Foodservices relating to 2003 accounting fraud and conspiracy. USA executives were accused by SEC of orchestrating an accounting fraud that battered the food</td>
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</table>
inflating the
doctor’s earnings by roughly $800 million over a two year period. The invented cost savings technique recorded fictitious rebates known as “promotional allowances” that give the appearance of cost savings, which in turn boosted profits.

Executives also face charges of filing false SEC documents.

The Swedish-Swiss firm Asea Brown Boveri was seen as “a paradigm of European capitalism at its best.” In 2002, it suddenly turned into a “Swedish version of Enron.”

Company discovered that after CEO Percy Barnevik was resigned, he cashed in secret a $148 million severance package for himself and his successor Goran Lindahl.

A pharmaceutical company listed on Nasdaq. In January 2004, the company admitted to use off-balance-sheet vehicles which placed the company under SEC investigation. It suffered a setback on a drug developed to treat Alzheimer’s disease. CFO and chairman left the company, but retained as consultants.
Parmalat (Italy) is Italy’s eighth-largest company and the No. 3 provider of dairy and maker of cookies in the U.S. In December 2003, a bank account with Bank of America holding euro 3.9 billion was revealed not to exist.

More than 50 individuals, including the founder and former chairman, chief financial officers, two Parmalat external auditors of Grant Thorton and Deloitte Touche, and seven bank officials from several banks, have been under investigation. They are in suspicion of committing false accounting and fraud of the dairy giant’s books leading to the company’s bankruptcy. Company acknowledged a multibillion-dollar hole in its balance sheet and filed for protection from its creditors, a case similar to Enron because both companies used related companies to hide losses.

Parmalat’s jailed founder put the size of the hole in its finances at $10 billion, and admitted that he shifted $620 million from the company’s coffers to loss-making travel businesses controlled by his family.
| (The Netherlands) group of energy | Shell, the third largest oil company, is a global and petrochemicals companies, operating in more than 145 countries. In July 2004, company reported to pay a total of $150 million in fines to SEC and its British counterpart, the Financial Services Authority (FSA), following investigations into the company’s overstatement of its oil and gas reserves in 2004. Since January 2004, the company was subject to intense criticism and scrutiny when executives made the first of four restatements to the group oil and gas reserves. Ultimately, the group has shaved 4.47 billion barrels, or 22%, from these estimated. Shell agreed to abuse provisions paid 17 million British pounds fine, the largest the regulator has ever levied. Shell company violated Britain’s FSA’s findings that it breached market abuse provisions of the Financial Services and Markets Act. It also agreed to an SEC order that finds the company violated antifraud, reporting, recordkeeping and internal control provisions of the U.S. federal securities laws. The company is still under investigation by the U.S. Department of Justice and Netherlands FSA do not rule.
could be fined out the possibility that individual executives

Vivendi Universal (France) separately by regulators.
company of
financing statements.

The Company is based in Paris. SEC accused
to meet earnings misleading investors in its news releases and
Management was engaged in misconduct trying
goals and had violated accounting principles.

For 18 months, senior executives refused to acknowledge the
company’s liquidity problems and earnings shortfalls. Former CEO
transformed the company from a water utility into a films and
media empire but saddled it with huge debts (euro33 billion)

making it difficult to satisfy its debts. On December 23, 2003,
company agreed to pay $50 million to settle accusations by the SEC and
it did not have to revise any financial statements.

III. GLOBAL RESPONSES TO CORPORATE ACCOUNTING FRAUDS IN EUROPE
American Legislative-Regulatory Reforms (The SOA 2002)
Badawi (2003) provided a large sample of cases of corporate fraudulent financial
reporting and nature of accounting frauds committed by major U.S. publicly traded
companies. In response to American corporate and accounting scandals, and in order to
protect public interest and to restore investor confidence in the capital market, U.S.
lawmakers, in a compromise by the House and Senate, passed the Sarbanes-Oxley Act
2002, which was signed by President Bush into a law (Public Law 107-204) on July 30,
2002. The Act resulted in major changes to compliance practices of U.S. and non-U.S.
large companies, whose securities are listed or traded on U.S. capital markets, requiring executives, boards of directors, and external auditors to undertake measures to implement greater accountability, responsibility and transparency. The statutes of the Act and SEC new initiatives [see, AICPA 2002; Badawi and Fitzsimons 2002; Gornik-Tomaszewski and McCarthy 2005; PCAOB 2003; SEC 2002] are considered the most significant legislation and regulation affecting the corporate community and the accounting profession since 1933. Other U.S. regulatory bodies such as NYSE, NASDAQ, and State Societies of CPAs have passed new regulations which placed additional burdens on publicly traded companies and their external auditors.

The SOA is also applicable to any non-U.S. company registered on U.S. exchanges under either the Securities Act or the Exchange Act, regardless of country of incorporation or corporate domicile. Furthermore, external auditors of such registrants, regardless of their nationality or place of business, are subject to the oversight of the PCAOB and to the statutory requirements of SOA.

The U.S. SOA has reverberated around the globe through the corporate and accounting reforms addressed by the International Federation of Accountant (IFAC), the Organization for Economic Cooperation and Development (OECD), the European Union (EU), and individual European countries.

**International Federation of Accountants (IFAC)**

The IFAC is a private governance organization whose members are the national professional associations of accountants. It formally describes itself as the global representative of the accounting profession with the objective of serving the public interest, strengthening the worldwide accountancy profession and contributing to the development of strong international economies by establishing and promoting adherence to high quality standards (IFAC 2002). The Federation represents accountancy groups worldwide and has served as a reminder that restoring public confidence in financial reporting and the accounting profession should be considered a global mission. It is also considered a key player in the global auditing arena which, among other things, constructs international standards on auditing and has laid down an international ethical code for professional accountants (Telberg 2003). The IFAC has recently secured a degree of support for its endeavors from some of the world's most influential international organizations in economic and financial spheres, including global Financial Stability Forum (FSF), the International Organization of Securities Commissions (IOSCO), the World Bank, and, most significantly, the European Commission (EC)

In October 2002, IFAC commissioned a Task Force on Rebuilding Public Confidence in Financial Reporting to use a global perspective to consider how to restore the credibility
of financial reporting and corporate disclosure. Its report, “Rebuilding Public Confidence in Financial Reporting: An International Perspective,” includes recommendations for strengthening corporate governance, and raising the standard of regulation of issuers. Among its conclusions and recommendations related to audit committees are (IFAC 2002):

1. All public interest entities should have an independent audit committee or similar body.
2. The audit committee should regularly report to the board and should address concerns about financial information, internal controls or the audit.
3. Audit committee must meet regularly and have sufficient time to perform its role effectively.
4. Audit committees should have core responsibilities, including monitoring and reviewing the integrity of financial reporting, financial controls, the internal audit function, as well as for recommending, working with and monitoring the external auditors.
5. Audit committee members should be financially literate and a majority should have “substantial financial experience.” They should receive further training as necessary on their responsibilities and on the company.
6. Audit committees should have regular private “executive sessions” with the outside auditors and the head of the internal audit department that do not include members of management. There should be similar meetings with the chief financial officer and other key financial executives, but without other members of management.
7. Audit committee members should be independent of management.
8. There should be a principles-based approach to defining independence on an international level. Companies should disclose committee members' credentials, remuneration and shareholdings.
9. Reinforcing the role of the audit committee should improve the relationship between the auditor and the company. The audit committee should recommend the hiring and firing of auditors and approve their fees, as well as review the audit plan.
10. The IFAC Code of Ethics should be the foundation for individual national independence rules. It should be relied on in making decisions on whether auditors should provide non-audit services. Non-audit services performed by the auditor should be approved by the audit committee.
11. All fees, for audit and non-audit services, should be disclosed to shareholders.
12. Key audit team members, including the engagement and independent review partners, should serve no longer than seven years on the audit.

13. Two years should pass before a key audit team member can take a position at the company as a director or other important management position.

**Organization for Economic Cooperation and Development (OECD)**

The Organization for Economic Cooperation and Development (OECD) is a quasi think tank made up of 30 member countries, including the US and UK, and it has working relationships with more than 70 other countries. In 2004, the OECD unveiled the updated revision of its “Principles of Corporate Governance” that was originally adopted by its member governments (including the U.S. and U.K.) in 1999. Although the principles are non-binding, the principles provide a reference for national legislation and regulation, as well as guidance for stock exchanges, investors, corporations and other parties (OECD 2004; Taub 2004).

The principles have long become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries. The 2004 updated version includes recommendations on accounting and audit standards, the independence of board members, and the need for boards to act in the interest of the company and the shareholders. The updated version also sets more demanding standards in a number of areas that impact corporate executive compensation and finance, such as (OECD 2004; Taub 2004):

1. Granting investors the right to nominate company directors, as well as a more forceful role in electing them.

2. Providing shareholders with a voice in the compensation policy for board members and executives, and giving these stockholders the ability to submit questions to auditors.

3. Mandating that institutional investors disclose their overall voting policies and how they manage material conflicts of interest that may affect the way the investors exercise key ownership functions, such as voting.

4. Identifying the need for effective protection of creditor rights and an efficient system for dealing with corporate insolvency.

5. Directing rating agencies, brokers and other providers of information that could influence investor decisions disclose conflicts of interest, and how the conflicts are being managed.
6. Mandating board members to be more rigorous in disclosing related party transactions and protecting so-called “whistle blowers” by providing the employees with confidential access to a board level contact.

**US-EU Cooperation for Corporate Reforms (US-EU)**

Initially, the European Union resented applicability of SOA reforms on European companies and accounting firms operating in the US. However, after a series of negotiations, the U.S. and EU authorities have agreed to cooperate and decided to develop a compatible set of regulations. The regulatory bodies in both continents have undertaken a two-way cooperative approach based on effective equivalence of regulation and oversight authorities (Gornik-Tomaszewski and McCarthy 2005). Furthermore, member states of the European Union have proposed a code of conduct on the independent auditors, which includes five-year auditor rotation (CFOEurope 2002).

Notably, the national governments of the individual European countries have proposed reforms of their corporate laws. For example, in July 2002, the British government, for example, released a white paper proposing changes to the Company Law, which include harsher penalties for misleading auditors, redefining the roles of the directors, and creating standards for boards in accounting supervision and other disclosure issues. The British government is also reviewing the roles of non-executive directors and is considering the regulation of audit committees (CFOEurope 2002).

**IV. CONCLUDING REMARKS**

The SOA 2002 passed new strict statutes to avoid a repeat of the corporate financial disasters. The Act controversially covers non-US large companies whose securities are listed or traded on US stock markets, as well as their non-US external auditors regardless of their nationality or place of business. Foreign entities have to comply with the SOA by June 2005. Across the Atlantic, the IFAC, OECD, and EU have recognized the recent eruption of the corporate scandals in Europe, and affirmed the inevitable need for corporate governance reforms and regulation of the public accounting profession worldwide. The IFAC has passed Code of Professional Ethics for international accounting firms. The OECD has passed guidelines for improving corporate governance. The European Union has proposed a code of conduct on the independent auditors, which includes five-year auditor rotation. European countries are also individually involved in improving their corporate laws through governance codes of practice.
REFERENCES


