International Journal of Science and Research Archive
eISSN: 2582-8185
Cross Ref DOI: 10.30574/ijsra
Journal homepage: https://ijsra.net/

(Review Article)

Accounting Fraud in Western Corporations - Factors and Impacts during the early 21st century

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International Journal of Science and Research Archive, 2026, 18(01), 738-743

Publication history: Received on 13 December 2025; revised on 19 January 2026; accepted on 22 January 2026

Article DOI: https://doi.org/10.30574/ijsra.2026.18.1.0130

Abstract

Corporate governance commands the ultimate way any corporation acts. Corporations are now more involved in accounting fraud. This is however no longer an uncommon crime in today's world but when this fraud is committed by top leadership management it can go down in history as some of the greatest corporate scandals. Over the years after the millennium, the increase of high-profile accounting scandals has emerged within our eyes. The impact of reporting inaccurate financials cannot be over emphasized. There are series of consequences that arise from an inappropriate financial reporting from any corporation.

A case study on major culprits to this crime will show how deep this premeditated offense can go and how well-orchestrated the fraudulent activity is achieved. These are such huge wrongdoing that it involves more than one person. The idea of having the Chief Executive Officer (CEO), Chief Financial Officer (CFO) and top Directors in the corporation participate is alarming. In some cases, the auditors play an essential role in the coverup of this misconduct. The price to pay is so costly as convicted persons face prison sentences not to talk all their assets and money disappeared. Standards have now been raised in terms of auditing. Financial servicing organisation had modified their audit approach and procedure to enable the firms detect fraudulent activities. This has enabled stakeholders and shareholders to rely more on audited financial statements in making strategic decisions.

Also, the vetting and appointment of board of directors have been strengthen to assure the right person is appointed. Getting the right person cannot just be enough, effective internal controls need to be put in place to mitigate audit and fraud risk. Many corporations now have internal auditing teams to avoid these occurrences. This study further ends with the recommendations on resolutions of these crimes as the repercussions are stiff and detrimental.

Keywords: Accounting fraud; Data analysis; Data collection; Audit; Financial statements; Impact

1. Introduction

In the modern era, the financial statements of a company are the source of truth for the financial position of the corporation. This provides details and highlights areas of the sales, income and also the cash flow position. These are useful information for stakeholders, possible investors, potential employees, customers, government (for tax purposes) and even the employees of corporation. The reporting of these financials is solely the responsibility of the corporation. Nevertheless, the auditors hold a curial role in ensuring the reports gives a true and fair representation of the corporation.

The rise of larger scale corporations in the 19th century, and the need for the separation of management and shareholder control introduced the financial statement for majorly the purpose of accountability (Rutherford, 2000).

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Management leadership team run the day-to-day business of the corporation and also strategy discussion. The board of directors and shareholders need the financials to be reported in accordance with all standards; accounting, country and business standards. This information will provide insights into the condition of the organisation and it has been noticed that management in some cases try to window dress financial numbers to portray good numbers even though the business is suffering from all corners just as to salvage their jobs and monthly incomes and bonuses.

The importance of having issued an audited financial statement which shows the correct position of a corporation cannot be over emphasized. Many corporations fall in leaving up to the standards of corporate governance and have faced major counts of crimes reaching to prison terms of offenders and also tabled with high fines. This instils a big threat to investors and potential new employees' confidence in the financial information.

Research on the emergence of inappropriate financial reporting is something which needs to be discussed. It can be said that a financial statement is as good as the competence of the auditing firm but it is important to know that the procedures and steps embarked by a financing services organisation are not to detect fraud but to represent the financial books in the fairest possible way. Even as that been said, a closer look into how this crime would have been done based on the literature review available could prove a one man show; in terms of the corporation concealing information and also a two-man show were both corporation and audit firm are culprits to this grievous crime.

Financing services organisation tends to improve on their audit approach to enable the detection of fraudulent activities. However, these corporations are also getting smarter in concealing these crimes. It cannot be completely known to what extend corporations undergo inappropriate financial reporting as this research is based on the public information and not forensic audit performed on a sample number of corporations.

However, the awareness of the implications of wrongfully misleading the public with incorrect financial information is paramount. These responsibilities are to be bound by those in corporate governance position of these corporations and measures are needed to be put into place by the shareholders and owners. Also, precautions are to be considered by investors before embarking on a major investment because once any corporation goes under, they will definitely declare bankruptcy and major losses for both investors and any stakeholder.

2. Literature Review

There are many reasons for the downfall or bankruptcy of an organization, over the years falsified financial reporting has been one of them. The pressure from stakeholders and the greed for continual success has pushed directors and those in running the day-to-day businesses get their hands dirty. It not unusual for businesses and corporations to go through different tough cycles. It is left to the management to turnaround the bad situation into a better one and even make the organisation stronger – at least that is why they are paid the big bucks.

Li (2010) argued in his article for the International Journal of Business and Management that the collapse of Enron can be viewed from two perspective; firstly from the individuals (Chairman, CEO, CFO) who were given the mandate to run the business and secondly, from the corporation view; here, the shareholders did not question the high stock prices that were been achieved due to the fact that special purpose entities were created by management. These entities were used to conceal and transfer debt. These debts were obviously not reported in the financial statements by Enron. Enron is still the biggest financial reporting scandal till date; in 2001, $63.4 billion in assets were literally gone as directors and executives covered up large losses which was eventually uncovered and these individuals' faced years in prison. The impact of this grievous and intentional crimes did not come without further consequences; the then auditors of Enron; Arthur Andersen (one of the then big five financial services corporation in the world) also suffered closure as it was seen as an untrustworthy and unfaithful organization which hid and destroyed documents relating to the Enron scandal. In 2002 it surrendered its CPA license and right to practice – thereby going out of business. Rasheed and Nisar (2018) links the Enron scandal to the importance of corporate governance which ultimately ensures both shareholders and agents of the shareholders should have their intentions in line.

The reward for good work is more work they say. The taste of success only makes anyone want to continue having more of it. Success is the same everywhere, be it winning a video game, a bet with a friend, a basketball game or having the best quarter in an organization. It gets harder to achieve the same success or get greater success because it is more difficult to achieve again. The question here is how this will be done? Many organizations take the long road of having the leadership and management team spring up new and better strategies and ideas to maintain the lead or get ahead which ever case. The largest bankruptcy in the United States history was that of the Lehman Brothers in 2008 as described by Johnson (2011). The corporate governance was again the main reason for the collapse of Lehman Brother with $639 billion in assets and $619 billion in debt. Lehman senior managements and executives used series of cosmetic accounting to manipulate and improve appearance of quarter close and year end close financial numbers as stated by Investopedia (2010). The impact of the Lehman bankruptcy brought the Dow Jones to plunge to -7% in September 2008 (Investopedia, 2010). Many companies and organization who invested in the Lehman brothers took a drop in their investments. Many jobs were lost during the folding up of the corporation and many lives affected. It was part of the many corporations that suffered during the 2008 financial crisis. The current market was not in a good position to withstand another inaccuracy in financial reporting therefore Lehman Brothers did not have the support of the government. In a corporate world, those given the power to govern need to be aware that their actions have consequences and directly affect those around them. This is not a one-man business or a small-scale business where decisions can only impact a select few individuals. Corporations need to have this mind when making and taking strategic decisions. Lehman Brothers financial strategy was to invest in mortgage debt and get involved in repurchase agreements (repo) Investopedia (2010). They handled it the wrong way and got into debts and eventually filed for bankruptcy. This ripple effect triggered a collapse in the financial market meltdown.

Lyke and Jickling (2002) describes the incident about WorldCom, American largest long-distance telecommunications, at that time; it announced an overstatement of its earnings and revenue in 2001 and quarter one of 2002 of over $3.8 billion. WorldCom capitalized expenses instead of taking them to the profit & loss statements, therefore they overstated their assets while understating their losses or expenses for that particular period in time. At stated in Carson (2003) on functions of corporations as regards the stakeholders, he puts forward that the stakeholder theory says that corporations should be run for the benefit of all "stakeholders," not just the shareholders. Also cited in Carson (2003) by R. Edward Freeman is that corporations should consider the interest of stakeholders which were defined as customers, employees, financiers and communities.

WorldCom performed what is known as accounting fraud to deceive investors and ultimately stakeholders as earlier defined. Business ethics and corporate governance are key qualities for every corporation to possess as this will determine the quality of decisions made by management. The internal auditors were also Arthur Andersen who were meant to be the check to ensure there are no accounting errors or/and accounting, unfortunately the Auditors could not detect these crimes and gave an unqualified audit opinion on the financial statements declaring the financial numbers free and fair representation of WorldCom financial position. The auditors were later replaced with KPMG.

In 2005, Bayou Hedge Fund Group; a hedge fund group of companies who defrauded investors up to $500 million by manipulating illiquid security prices with the help of its own associated brokerage company as stated by Cole, Feldberg and Lynch (2007). Again, the auditor should have caught this. Bayou fired its independent auditors and hired a bogus auditor who helped them report false earnings. This was a huge deceit on the part of the corporation as Investors put in more than $300 million to Bayou in 1996 for which the corporation promised to return in investments of $7.1 billion in 10 years (Yu, 2005).

Refco, a financial services company founded in 1969 got caught in accounting fraudulent activities. In 2015, the chairman and CEO hid bad debts worth $430 million from investors and auditors by buying the bad debts with the company own funds (Davison, 2008).

Enron, Lehman Brothers, WorldCom, Bayou and Refco are cases showing the deliberate intentions of management to falsify numbers to continue to gain undue advantage in the very competitive business industries. The consequences are their actions have had impact on people, communities near and wide.

Harvard Law School (2016) stated that to have an effective corporate governance, a precise comprehension of roles of shareholders, board and management in correlation with their relationships with the stakeholder and themselves is critical. The five case studies all happened between the year 2001 to 2008, and there were pivotal scandals regarding accounting fraud and these brought about more discussions into the importance of corporate governance. One of the roles of the board is to appoint the auditors for the corporation. As seen in some of the case studies; the auditors played important roles in the collusion and conspiracy of these crimes. Arthur Andersen was once a great financial services organization – one of the so called 'Big Five' auditing, advisory and taxation services firm. In most fraud scandals, the auditors are always been questioned on why they had missed this in the audit engagement performed. This brought about the downfall of Arthur Andersen in 2001, as they were convicted by a US court for the obstruction of justice by destroying files and documents relating to the Enron scandal. Both parties were found guilty and eventually declared bankruptcy due to accounting crimes.

3. Methodology

The research methods suitable for this kind of research paper has to be seen from the point of view of what has happened in the past and it is based on the public information available. These were hideous crimes committed by high profile people in the society, some of these people are still serving jail sentences. Yin (2009) stated that a case study methodology can be used to show what worked then, how it was done and how it examines real life phenomenon.

The research methodology simply tilted to the qualitative perspective – Here case study research on accounting fraud by management of multinational corporations during the 2000s. It entails a detailed description of the events of that occurred and experiences of that occurrence should be told as it was. This type of methodology comes with its own pros and cons. Ayres (2017) put forwards advantages and disadvantages of a qualitative research method. Due to the subject materials available; in dept details can be gotten which will provide better insights into the messages and information been passed. Also, using case studies; these are based on only human experiences and observations.

Creativity is key for a researcher to formulate its conclusion and findings. Qualitative analysis helps the researcher to address this by reviewing several materials for which the author of such articles is presenting the facts and not just reaching to 'please' the audience. Ayres (2017) also discussed some of the limitations of qualitative research – it can be a very subjective to the data and information received, since there are actually no new interviews from the corporations of persons of interest. Furthermore, researchers need to have in dept or expertise for the subject matter to be able to follow on all available information. Qualitative research does not have the backing of statistic *(numbers do not lie.)* However, qualitative method of research really does not provide those kinds of statistics.

4. Data Collection

Tellis (1997) described a case study as a particular type of methodology where an in-depth, holistic investigation is required. The source of data used in the making of a conclusion is important but the mode of collection is equally as important as this will show if the information was obtained in the possible way available. This research paper was based on different accounting fraudulent cases in the early 2000. Articles, eBooks and study books have been made available in the internet and on the shelves of book shops.

The principle of data collection by Yin as cited by Tellis (1997) states that there are 3 principles in data collection for case studies which are; using of multiple sources, creating a case study database and finally, maintaining a chain or series of evidence. The- reason behind the use of multiple sources is that the reliability and worthiness of the data and the way the data was collected. A case study database was established for the paper in a way that the information been passed is properly documented and well organized so that an experimental study can be achieved.

The process of data collection with regards case studies possesses a limitation especially high-profile corporations is that the data collected as based of other people view but the method to establish a strong idea and personal opinion is to ensure acquisition of multiple sources. Due to the scope on inappropriate financial reporting; only approved personal or bodies can have unlimited access to the corporations and organizations books and financial numbers used for this paper. The ability to have personal checks and interviews or focus groups which can aid the data collection is unavailable for this particular scope. Notwithstanding, the data used have been verified from multiple sources and collected mostly via the web and proves to be sufficient to make a solid conclusion and pass the message intended, which is the impact and scale of which management can affect the quarter or year ends results to get undue advantages and power.

5. Data Analysis

Methods of collection of data is key, so as the analysis of such data. The data collected on inappropriate financial reporting of five corporation were carefully selected between 2001 and 2008 to highlight the scandal immediately after the millennium. The corporation's businesses were fields relating to telecommunications, energy, hedge fund, broker, banking and accounting (adding Arthur Anderson – whom were the auditors for Enron and WorldCom).

These five corporations were multinational organizations and global corporations. There all had international trades with top auditing firms; Arthur Anderson, Ernst & Young, Grant Thornton, even KPMG. The reason for this was to show that accounting fraud can exist wherever regardless of how big or who are the auditors.

Yin (2009) discusses that data analysis consists of categorizing, examining and bringing together proofs to deal with the intention of the study. This paper intention is to review the deliberate act and intention by Directors, Managers and the leadership team of corporation. In these cases, ignorance was not the question here, these were predetermined acts by those in power. Their actions were mainly to have a perception that their corporations are doing excellent in terms of revenue, profits and assets.

The essence of corporate governance cannot be over emphasized. This paper considered five scandals between those time frames, but there were still fourteen high profile scandals involving accounting fraud and ignorance within the years 2001 to 2008 (Wikipedia, 2019). Accountability is key to any business success and most importantly getting right leaders into the right place is essential for the continuous growth as stakeholder wealth are at stake with wrong and greedy leadership management.

6. Conclusion and Limitations

The main purpose of this research work is to highlight the impact and involvement of top management in association with accounting fraud. The consequences of reporting an inaccurate financial statement are enormous. The duties of the board of directors can be put into three legal duties; the duty to act carefully, the duty to act lawfully and duty to act loyally (Eisenberg, 2005). The top management hold the key to upholding the law. Ignorance is not accepted and incompetence is also a no-go area. When the tone at the top tolerates fraudulent activities, it is very difficult for the middle management to cease from this act. The elements presented in this research describes the impact of inappropriate reporting of corporations' financial numbers. The repercussion for a corporation to restate a previous quarter of year-end financial statement are numerous; ranging from loss in trust by investors, customers, employees and potential employees. Also, the corporation will take a hit as regards it stock prices as these are greatly influenced by changes in the perception of an organization.

Accounting fraud has always been present in the modern-day world companies but after the millennium there were several high-profile cases of fraudulent activities. Lehman Brothers was a major contributor to the world financial crisis in 2008. After year 2000 there have been fourteen major scandals in the USA, before the year 2000, there was just a single scandal in the year 1998 and the next major scandal was in the year 1989 (Wikipedia, 2019). This puts in context the dawn of fraudulent activities. The focus was drawn towards Corporate Governance; which is the ultimate assertion of an organization in terms of codes of conduct. The motives for these crimes range from greed to power. One of the functions of the board of directors and top management is the maximization of shareholders wealth. The wrongly acts of persecuted management have been stiff to ensure things of these are avoided.

This research paper focused primarily on data source and collection from author's view. The case study method was appropriate for this particular type of research. Like other methods of research there are limitations and constrains. The case study research could have a high degree of subjectivity as bias could occur from the point of the researcher. The content used for this paper were materials from sources who explain and express the topics from how it is viewed from their perspective. The scale of this research makes it practical impossible to conduct one-one interviews with the accused person or persons. There are always multiple sides to story. What has been published can be put in ways to buttress the opinions of the researchers. This closely relates to the point of been ethical in portraying a research topic. It is not uncommon for researchers to select from the available data that justifies the point been passed. Furthermore, another constrain can be seen from the point of reliability of results. The solution is to use multiple sources as much as possible but it is also known for researchers to jump on the bandwagon is some cases. Yin (2019) further described the biggest concern of case study as the lack of systematic procedures in conducting these types of research.

Notwithstanding, this research paper has shown the flaws of having an incompetent leadership team and the consequences of reporting inaccurate financial statements together with the impact to the corporation and community at large. These results are not numbers just because it is mandatory by law to have an audit financial statement. Investors make life changing decisions off these numbers. The practical solution or recommendation to reduce the risk of having intentional accounting fraud does not just start with the auditors or advisory bodies for the corporation, it begins with the tone at the top and the conscious awareness of corporate governance as the main canopy to ensuring shareholders and stakeholders investments and commitments are truly considered.

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