Chapter 15
Corporate Scandals and Systemic Risk

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ABSTRACT

Corporate scandals are unpredictable misbehaviors of person/people that have engagement within corporate ended by bankruptcy of corporate. In the global world, companies are related with each other, and one bankruptcy triggers another company; moreover, it may cause a systemic risk depends on size of company as occurred in 2008 economic crisis. Corporate scandals are unpredictable; however, experience from history may guide regulators to avoid in the future by effective regulations. In this chapter, corporate scandals will be studied carefully to classify subjects of scandals and their impact.

INTRODUCTION

Corporate scandals not only cause corporate go bankruptcy but also impact economy deeply. It has impact on stock markets, dept. securities and even governments bond. The last experience proofed that one scandal may cause wave of panic. 15th of September Lehman Brothers, fourth largest investment bank of America bankrupted as a consequence that FED rejected bail out of corporates which carries mortgage-backed securities in their assets. Bankruptcy of Lehman Brothers triggered panic into economy, stock market crushed, and these consequences caused to one of the largest economic recession in the world. Lehman Brothers wasn’t only responsible of the economic crises, it was the result that misbehavior of financial institutions, credit agencies, regulators and even though real estate firms that make great profit from house financing. 2008 economic crisis wasn’t only corporate scandals that caused huge impact to economy. First corporate scandals reported in March 1792, which is also called as panic of 1792 caused by William Duer who is used knowledge from his official position as an assistant secretary of the Treasury for speculation (Geisst, 1997). Beginning of the 2000s, United States economy was damaged by financial accounting scandals of large corporates on purpose to manipulate investors and stock market by hiding debt or creating fake revenues. Afterwards these scandals erupted, even though corporation
went bankruptcy it caused series damaged to economy by cause of many people lost their job, many investors lost their money, and thus economy was shrink.

These corporate were large and well regulated. Moreover, they had strong internal and external auditing nevertheless these companies managed to keep fraud many years and took many advantages. Frequency of corporate scandals launched a discussion about accounting auditor firms responsibility especially The Big Four that provides credibility on financial reports of corporates. However, according to Hemraj (2004), accounting auditor firms are not responsible on detection of fraud. Corporate scandals are the consequences of fraud. And, fraud is ‘an intentional deception, misappropriation of corporates’ assets or the manipulation of financial dates’ to get advantages and may be classifies in employee and management fraud (Hemraj, 2004). So that, corporates scandals generally are consequences of management fraud rather than employee. Enron scandal was a result of using creative accounting principles supported by senior management (Skeel, 2005), while Lehman Brothers sold toxic asset again and again to create liquidity that was management strategy. Even though corporate scandals have strong impact on financial market, we may see recurrent of the examples. According to (Skeel, 2005), after he wrote article on accounting scandals, 4 years after accounting scandals and 3 years before 2008 economic crises, corporate responsibility in United States is still inefficient and need new regulations. Corporate scandals may cause to heavy regulations. However, there is a debate what is the main reason of corporate scandals whether regulations are insufficient or inadequacy control.

Corporate scandals may result in systemic risk by falling to run economy. Systemic risk is an entire market risk triggered by financial institutions and would cause widespread damage in economy (Mishkin & Eakins, 2015). In the connected world, potential of systemic risk is higher than ever and critical for sustainable of world as seem in 2008 economic crises. In 2008, corporate scandals triggered financial panic that increases the financial effects of corporate scandals by running to banks and fire sales and caused widespread damage not only in United States both also around the world. Since 10 years past from 2008 economic crises, world economy has its side effects. In this article, financial system is introduced to understand how financial system player depended to each other and corporate scandals; The case of the Madof, Libor Scandal, Sub-Prime and Mortgage Scandals, Olympus Scandal, Enron, Worldcom, Danske Bank, Raj Rajaratnam, H.J. Heinz Company, Deepwater Horizon, Volkswagen case’s being researched to understand reasons behind corporate scandals, financial effect after the scandals arises and how regulation play proactive role rather than reactive role to avoid large corporates scandals that have potation trigger systemic risk.

LITERATURE REVIEW

Corporate scandals are very common an illegal activity that occurred in financial markets and classified under white collar crimes that involve by high educated people that generally works in senior management positions. (Geis, 2011) white colors crimes as “…a misrepresentation in financial statements of corporations, manipulation in the stock exchange, commercial bribery, bribery of public officials directly or indirectly in order to secure favorable contracts and legislation, misrepresentation in advertising, and salesmanship, embezzlement and misapplication of funds, short weights and measures, and dishonest grading of commodities, tax frauds, misapplication of funds in receiverships and bankruptcies.” In this part, literature was reviewed to understand reason behind corporate scandals and their effect both market and corporates.