

The Greatest Frauds of the (Last) Century

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An editorial in the *Journal of Accountancy* stated:

Like a torrent of cold water the wave of publicity raised by the . . . case has shocked the accountancy profession into breathlessness. Accustomed to relative obscurity in the public prints, accountants have been startled to find their procedures, their principles, and their professional standards the subject of sensational and generally unsympathetic headlines.

If you guessed the editorial was referring to Enron, WorldCom, or one of the other recent accounting scandals, you would be off by more than sixty years. The preceding paragraph was published in February 1939 in the wake of the infamous accounting fraud at McKesson & Robbins, Inc. Unknown to the company's auditors, fictitious inventories and accounts receivable comprised more than 20 percent of McKesson & Robbins' purported assets as of December 31, 1937.

Seven years earlier, an even more outrageous fraud had been discovered at the international conglomerate, Kreuger & Toll, Inc. Investigators discovered that nearly \$250 million of the company's reported assets had never existed.

While it is much too early to call Enron and WorldCom the greatest accounting scandals of the 21st century, there is little doubt that Kreuger & Toll and McKesson & Robbins were the two most notorious, and influential, frauds of the 20th century. Investors' complaints about losses from the Kreuger & Toll fraud built political support for passage of the U.S. securities acts in 1933 and 1934 and the subsequent requirement of mandatory audits for public companies. Within months of the discovery of the McKesson & Robbins fraud, a special committee of the American Institute of [Certified Public] Accountants recommended significant changes to procedures for appointing auditors and conducting audit tests. The reforms that followed these two frauds shaped the accounting profession for the next seventy years.

Kreuger & Toll

The mastermind of the Kreuger & Toll fraud was a Swedish engineer named Ivar Kreuger. Kreuger's picture adorned the cover of the October 29, 1929 issue of *Time* magazine. The accompanying article described how his company, Kreuger & Toll, controlled approximately 75 percent of the European and American match market. During the 1920s, Kreuger & Toll loaned hundreds of millions of dollars to cash-starved European governments to help them rebuild their war-torn economies. Kreuger & Toll's loans helped western European countries avoid the fate of Czarist Russia and earned Kreuger the nickname "Savior of Europe." During the late 1920s Kreuger was rumored to be a candidate for the Nobel Peace Prize.

Ivar Kreuger assumed control of his family's three small match factories in 1913. A few years later, Kreuger came up with a bold plan to control the world's supply of matches. After the First World War, many European countries were desperate for funds to rebuild their economies. Kreuger & Toll offered loans of up to \$125 million to governments in return for receiving the exclusive right to sell matches within the countries' borders. Prices were set by contract and the loans were repaid through an excise tax on matches. This strategy enabled Kreuger & Toll to obtain absolute monopolies in fifteen countries and dominate the match market in nineteen others.

To raise the hundreds of millions of dollars he needed to lend to the European governments, Kreuger organized an American subsidiary and began selling stocks and bonds to U.S. investors. Kreuger & Toll attracted investors by paying dividends of up to 20 percent annually. Even with 75 percent of the European match market, Kreuger & Toll did not earn enough profit to support such generous dividends especially when several countries began defaulting on their loan payments. What began as a seemingly ingenious plan to dominate the

world market eventually deteriorated into an enormous “pyramid” or “Ponzi” scheme. Dividends were paid out of capital, and proceeds of subsequent loans and bond issuances were used to repay initial investors. Kreuger & Toll became dependent on continually obtaining funds from new investors and lenders so it could pay its ever growing obligations.

The Kreuger & Toll fraud, which worked so spectacularly during the “roaring” 1920s, collapsed during the Great Depression of the 1930s. Illiquid banks and unemployed investors stopped buying new shares of Kreuger & Toll securities. Without new investment dollars flowing into the company, Kreuger simply ran out of cash to pay his company’s dividends and repay its loans.

Rather than suffer the disgrace of being exposed as a failure and swindler, Ivar Kreuger shot himself through the heart on March 12, 1932. Newspapers reported Kreuger’s suicide as a tragedy—one more “victim” of the Great Depression. It was not until a month after Kreuger’s death that auditors discovered the magnitude of his fraud and the reason for his suicide.

The Kreuger & Toll fraud, discovered in the spring of 1932, helped build political support for passage of the U.S. securities acts in 1933 and 1934. These two acts required companies to publish audited financial statements before selling securities to the public and established the Securities and Exchange Commission (SEC) to oversee corporate financial reporting. Although Congress debated creating a corps of government auditors to audit public companies’ financial statements, it finally decided to grant the public accounting profession responsibility for ensuring the reliability of financial reporting.

McKesson & Robbins

The mastermind of the McKesson & Robbins fraud was Philip Musica. Although born to poor Italian immigrants and raised in poverty, Musica became a nationally recognized leader in

business and politics. At the height of his popularity, in 1937, a delegation of prominent Republicans urged Musica (who was then using the alias F. Donald Coster) to seek their party's nomination to run for U.S. President.

Musica's criminal career began early. By his 30th birthday, he had been convicted of fraud twice. The first conviction was for avoiding import tariffs by bribing customs officials to record incoming shipments at a fraction of their true weight. The second conviction was for using forged invoices to obtain large bank loans.

In 1919, after adopting the name Frank D. Costa to conceal his criminal record, Musica founded the Adelphi Pharmaceutical Manufacturing Company. Adelphi manufactured high alcohol-content products such as hair tonic and cosmetics. Adelphi's best customers were bootleggers who bought huge quantities of the company's products and distilled out the alcohol to make booze.

In 1925, using the assumed name of F. Donald Coster, M.D., Ph.D., Musica used his bootlegging profits to buy McKesson & Robbins, a ninety-year-old company that sold milk of magnesia, cough syrup, and quinine. During the next twelve years, Musica/Coster built a pharmaceutical distribution network that rivaled national chains such as Liggett, Rexall, and Walgreen.

To inflate McKesson & Robbins' reported assets while skimming cash into his own pocket, Musica enlisted the help of his three younger brothers. One brother, using the alias George Vernard, was placed in charge of a fictitious sales agency—W.W. Smith & Co. The W.W. Smith office was actually a "letter-writing plant" containing seven typewriters, each with a distinct typeface and a unique supply of stationery. Musica/Vernard's role was to write purchase orders bearing the names of fictitious companies and mail them to McKesson & Robbins.

Another Musica brother, using the alias Robert Dietrich, was placed in charge of McKesson & Robbins' shipping department. This brother would forge shipping documents to make it appear that inventory had been delivered by McKesson & Robbins to legitimate customers. The fourth Musica brother, using the alias George Dietrich, was appointed McKesson & Robbins' assistant treasurer. This brother would transfer money between numerous company bank accounts to create the appearance of cash payments for purchases and cash receipts from customers. For each sale, McKesson & Robbins paid W.W. Smith & Co. a commission of .75 percent. The four Musica brothers divided the Smith commissions among themselves with Philip, the oldest brother and mastermind, getting the largest share.

The McKesson & Robbins fraud was not discovered until late 1938 when the company's treasurer, Julian Thompson, became suspicious of the large payments McKesson & Robbins was making to W.W. Smith & Co. Thompson obtained copies of the Dunn & Bradstreet (D&B) credit reports that had been used to satisfy McKesson's auditors of W.W. Smith's viability. When he showed the credit reports to a D&B representative, he learned that D&B had never heard of W.W. Smith & Co. and that the credit reports in his possession were forgeries.

On December 6, 1938 the SEC opened an investigation into McKesson & Robbins' accounting and the New York Stock Exchange suspended trading of the company's shares. One week later, federal agents arrested Coster, fingerprinted him, and released him on bond. The next day, investigators discovered from his fingerprints that respected businessman F. Donald Coster M.D., Ph.D. was really twice-convicted fraudster Philip Musica. They ordered Musica/Coster taken into custody, but like Ivar Kreuger before him, Musica put a gun to his head and took his own life.

The McKesson & Robbins fraud led to significant changes in procedures for appointing auditors and conducting audits. After four months of hearings, during which forty-six witnesses produced 3,000 pages of testimony, the SEC recommended that non-officer members of the client's board nominate the auditors and that auditors be elected by and address their report to the shareholders. In the summer of 1939, the American Institute of [Certified Public] Accountants appointed its first standing committee on auditing procedures. The committee's first standard, Statements on Auditing Procedure No. 1, "*Extensions of Auditing Procedure*," made observing inventory and confirming accounts receivable—two procedures that would have helped detect the McKesson & Robbins fraud—standard audit procedures.

Conclusion

The 1939 *Journal of Accountancy* editorial concluded:

We feel that in the long run this publicity will not be entirely harmful to the profession. On no other occasion has there been as much public discussion about accounting simultaneously in all parts of the country. The importance of independent audits and of accounting procedure will not be forgotten. We predict that in the future auditors will encounter less resistance to examinations of wider scope and less effort to place limitations on their work than in the past.

While this might have sounded like wishful thinking during the depths of the McKesson & Robbins scandal, the subsequent sixty years were a time of unprecedented prosperity for accountants. The two scandals prompted reforms that helped, rather than hurt, the profession. Requirements for mandatory audits that followed the Kreuger & Toll fraud increased the market for accountants' services. Changes in audit procedures that followed the McKesson & Robbins fraud improved audit quality.

The reforms being enacted now in response to the Enron and WorldCom scandals have similar potential to help the accounting profession. The Sarbanes-Oxley Act's requirement for auditors to attest to the adequacy of their clients' internal accounting controls will provide

millions of dollars of additional revenues to accounting firms. The increased use of forensic auditing procedures during audits should discourage or catch more frauds and reduce the frequency of lawsuits against accounting firms. With luck, accounting students sixty years from now will remember the scandals of the 2000s as painful, but constructive, events in the history of the profession.