

Part One

Financial Reporting and Financial Statement Fraud

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Chapter 1

Financial Statement Fraud Defined

WILL HISTORY REPEAT ITSELF?

The existence and persistence of financial fraud continues to be of great concern for regulators and the business as well as the investment community. Since July 2002, the Department of Justice (DoJ) has obtained nearly 1,300 fraud convictions. These figures include convictions of more than 200 chief executive officers (CEOs) and corporate presidents, more than 120 corporate vice presidents, and more than 50 chief financial officers¹ (CFOs). To combat this problem, the 2002 Sarbanes-Oxley Act (SOX), also known as the Public Company Accounting Reform and Investor Protection Act of 2002, was signed into law. Despite changes in regulation and oversight, a question remains: Are we destined to suffer through more of these types of nefarious acts? Or more simply, will history repeat itself? Ironically, the answer is yes, according to the 2008–2009 KPMG Integrity Survey, which suggests the prevalence of corporate fraud and malfeasance.²

Consider the following.³

Basis of the Fraud	Older Example	Year	Recent Example	Year
Fictitious revenue, documentation forgery, and theft of corporate assets	ZZZZ Best	1987	Enron	2001
Personal use of assets, false documentation, and financial statement fraud	Phar-Mor	1992	Adelphia	2002
Capitalizing expenses, among other issues	Waste Management	1997	WorldCom	2002
Abuse of accounting standards	Savings and loan crisis	1982	Stock options backdating	2006

While the more recent examples presented here began pre-SOX, readers may be skeptical about whether SOX will have its intended effect, especially given the 2008 subprime mortgage and financial institution meltdowns. Further concerns were raised when allegations of misconduct were leveled against Bernard Madoff and Stanford Financial for their Ponzi schemes, costing billions of dollars. While

Ponzi schemes are not new, the sheer magnitude is almost unprecedented, especially in a post–Sarbanes-Oxley world. The investing public was further shocked in January 2009 when news of the Satyam fraud hit the press. In the Satyam case, approximately \$1 billion in cash, supposedly the easiest asset to audit, was admitted by the CEO to be nonexistent.

A CLOSER LOOK

Efficiency, liquidity, safety, and robustness of financial markets are vital to the nation’s economic prosperity and growth, as more than 110 million Americans directly or indirectly invest in the capital markets. Investors participate in capital markets as long as they have confidence in the quality, reliability, and transparency of public financial information disseminated to the markets. High-quality financial information contained in financial statements prepared by public companies and audited by independent auditors greatly influences investor confidence. Auditor accountability and responsibility for searching, detecting, and reporting financial statement fraud are receiving considerable interest and attention in rebuilding investor confidence and public trust. Until recently, corporate America dismissed financial statement fraud as “irrational irregularities.” Now virtually any organization may be affected by financial statement fraud. Not a day passes without fraud-related news, especially in regard to financial reporting. This undermines the quality, reliability, and integrity of the entire financial reporting process and, thus, the efficiency and global competitiveness of our capital markets.

Emerging corporate governance reform, corporate and securities laws, corporate guidance, best practices regulations, and accounting standards are intended to identify and minimize potential conflicts of interest, incentives, and opportunities to engage in financial statement fraud. This chapter (1) addresses financial statement fraud, its definition, nature, and significance; (2) discusses the financial reporting process of corporations; and (3) examines the role of corporate governance, particularly gatekeepers, in preventing and detecting financial statement fraud.

DEFINITION OF FINANCIAL STATEMENT FRAUD

A complete understanding of the nature, significance, and consequences of fraudulent financial reporting activities requires a proper definition of financial statement fraud. *Fraud* is defined in *Webster’s New World Dictionary* as “the intentional deception to cause a person to give up property or some lawful right.” The legal definition of *fraud* can also be found in court cases. One example of such a definition is “A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions by suppression of truth and includes all surprise, trick,

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cunning, dissembling, and any unfair way by which another is cheated.”⁴ Fraud is commonly referred to as an intentional act committed to harm or injure others securing an unfair or unlawful gain.⁵ This intentional, wrongful act can be differentiated and defined in many ways, depending on the classes of perpetrators. For example, frauds committed by individuals (e.g., embezzlement) are distinguished from frauds perpetrated by corporations (financial statement fraud) in terms of the classes of perpetrators.

Clear definitions of financial statement fraud are difficult to discern from pronouncements and/or authoritative statements, primarily because it has been only during the past decade that the accounting profession has used the word *fraud* in its professional pronouncements. Previously, the terms *intentional mistakes* or *irregularities* were used. The American Institute of Certified Public Accountants (AICPA, 1997), in its Statement of Auditing Standards (SAS) No. 82, refers to financial statement fraud as intentional misstatements or omissions in financial statements. Financial statement fraud is defined by the Association of Certified Fraud Examiners (ACFE) as:

The intentional, deliberate, misstatement or omission of material facts, or accounting data which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision.⁶

The broadly accepted definition of financial statement fraud, which is also adopted in this book, is articulated by the National Commission on Fraudulent Reporting (Treadway, 1987, p. 2) as “intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements.”⁷

The common theme among these definitions is that fraud, particularly financial statement fraud, is deliberate deception with the intent to cause harm, injury, or damage. The terms *financial statement fraud* and *management fraud* have been used interchangeably, primarily because (1) management is responsible for producing reliable financial reports, and (2) the fair presentation, integrity, and quality of the financial reporting process is the responsibility of management. Exhibit 1.1 classifies fraud into management fraud and employee fraud and provides further classification of these two types of fraud.

Fraud can be classified into several types, with the most common category being asset misappropriations and financial misstatements. The former is often referred to as employee fraud involving embezzlement, theft of cash or inventory, payroll fraud, or skimming revenues; the latter is viewed as financial statement fraud, usually perpetuated by management. The DoJ defines corporate fraud in three broad areas: accounting fraud or financial fraud, self-dealing by corporate insiders, and obstructive conduct.⁸ Accounting fraud consists of falsifying financial information by cooking the books or misleading investors. The most popular accounting schemes are parked inventory sales, side deals, swap transactions, capitalizing expenses, channel stuffing, accelerated revenue, and deferred expenses. Self-dealing by corporate insiders is mostly related to misappropriation of corporate assets by senior

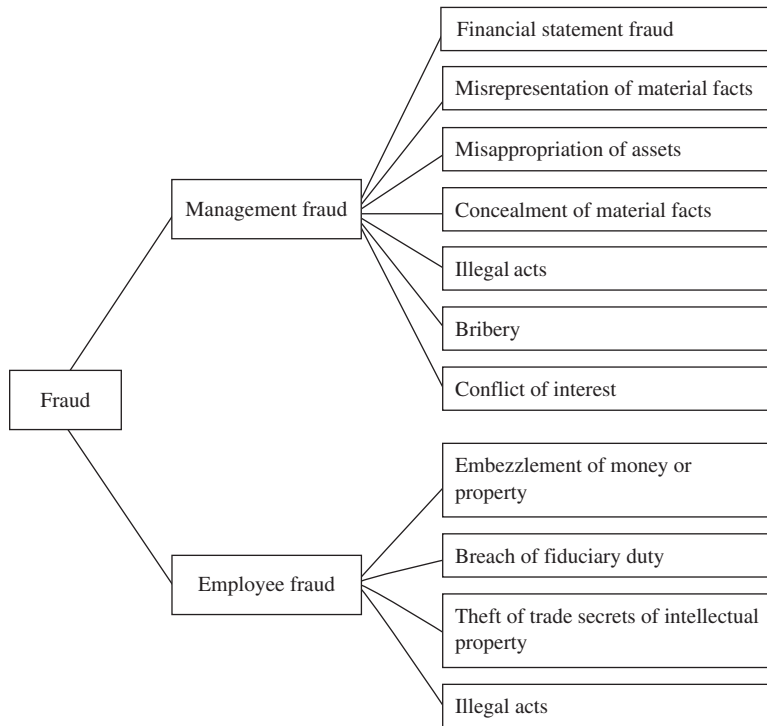


Exhibit 1.1 Types of Fraud

executives, such as loans granted to senior management that are never intended to be repaid, failure to disclose forgiven loans, reimbursed personnel expenses, and extraordinary personnel expenses charged to the company. Other schemes are insider trading, misuse of corporate property for personal gain, kickbacks, and individual tax violations related to self-dealing (e.g., convicted executives of WorldCom and Tyco). Obstructive conduct pertains to criminal penalties associated with falsifying testimony in Securities and Exchange Commission (SEC) depositions, influencing or threatening other witnesses, or lying to criminal investigators (e.g., Martha Stewart's conviction). Other examples of obstructive conduct are erasing computer files, shredding documents, creating or altering documents to support illegal conduct, or intentionally refusing to provide all documents or files required in subpoena.⁹

There are differences in the nature, courses, and determinants of financial statement fraud in the United States and other countries. In the United States, financial statement fraud is commonly caused by management manipulation of earnings to deceive dispersed investors, whereas in Europe, financial statement fraud is

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committed to benefit controlling shareholders at the expense of minority shareholders. These differences present challenges to the board of directors, audit committees, external auditors, and regulators in three ways:

1. Fraud prevention and detection methods that are effective in the United States in minimizing financial statement fraud may not work well in the other countries.
2. The primary focus in the United States is on earnings manipulations, which happen less frequently in other countries.
3. Laws, regulations, and standards (e.g., SOX) designed to prevent and detect financial statement fraud may not be effective in other countries to protect investors from fraud.

The focus of this book is on all victims of financial statement fraud, particularly investors and creditors. Thus, the definition of *financial statement fraud* adopted in this book is comprehensive, including both inside and outside victims. It is defined as deliberate misstatements or omissions of amounts or disclosures of financial statements to deceive financial statement users, particularly investors and creditors. In this definition, the class of perpetrators is publicly traded companies; the type of victims is investors and creditors; and the means of perpetration are misleading published financial statements. Financial statement fraud may involve these schemes:

- Falsification, alteration, or manipulation of material financial records, supporting documents, or business transactions
- Material intentional omissions or misrepresentations of events, transactions, accounts, or other significant information from which financial statements are prepared
- Deliberate misapplication of accounting principles, policies, and procedures used to measure, recognize, report, and disclose economic events and business transactions
- Intentional omissions of disclosures or presentation of inadequate disclosures regarding accounting principles and policies in addition to related financial amounts

The five basic elements of fraud are identified as:¹⁰

1. A false representation of a material nature
2. Knowledge that the representation is false or reckless disregard for the truth (Scienter)
3. Reliance on the false representation by the victim
4. Financial damages are incurred (to the benefit of the perpetrator)
5. An act that was intentional

NATURE OF FINANCIAL STATEMENT FRAUD

Financial statement fraud often starts with a small misstatement of earnings on quarterly financial reports that presumes not to be material but eventually grows into full-blown fraud and produces materially misleading annual financial statements. Financial statement fraud is harmful in many ways:

- Undermines the quality and integrity of the financial reporting process
- Jeopardizes the integrity and objectivity of the auditing profession, especially auditors and auditing firms
- Diminishes the confidence of the capital markets, as well as market participants, in the reliability of financial information
- Makes the capital market less efficient
- Affects adversely the nation's economic growth and prosperity
- May result in huge litigation costs
- Destroys the careers of individuals involved in financial statement fraud, such as top executives banned from serving on the board of directors of any public companies or auditors barred from practice of public accounting
- Causes bankruptcy or substantial economic losses by the company engaged in financial statement fraud
- Encourages excessive regulatory intervention
- Causes destructions in the normal operations and performance of alleged companies

The PricewaterhouseCoopers (PwC) 2005 survey¹¹ found that accidental ways of discovering fraud through calls to hotlines or tips from whistle-blowers accounted for more than a third of fraud cases, whereas internal audits detected fraud about 26 percent of the time. The survey reported that in the post-SOX era, since 2003, more incidents of fraud have been discovered and reported as evidenced by (1) a 71 percent increase in the reported cases of corruption and bribery; (2) a 133 percent increase in the number of reported money-laundering schemes; and (3) a 140 percent increase in the discovered number of financial misrepresentations. These findings can be interpreted to mean that many corporate governance measures (e.g., internal control, executive certifications, audit committee oversight, whistle-blowing) instituted as a result of SOX have contributed to the discovery of fraud incidents.

The 2008 report of the ACFE¹² included data on how fraud is commonly detected, including the role of the audit committee and internal and external auditors in discovering financial statement fraud. It highlights the need for the audit committee to establish and maintain objective and independent whistle-blowing policies and procedures. It also showed that external auditors should conduct surprise or unpredictable audits on their clients. The report indicated

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that among the 237 cases of fraud resulting in a loss of \$81 million or more, 16 percent were detected by external auditors, whereas 42 percent were discovered through a tip or a complaint. Frauds in small business were often uncovered through tips by internal auditors and most often by accident. These results suggest that antifraud policies and programs can play an important role in preventing and detecting fraud. Investors commonly assess the lower information risk associated with high-quality financial reports. This lower perceived information risk will make capital markets more efficient and safer and induce lower cost of capital and higher securities prices. Thus society, the business community, accounting profession, and regulators have a vested interest in the prevention and detection of financial statement fraud.

Keith Slotter, assistant director of the Federal Bureau of Investigation (FBI) Training Academy, stated in a January 6, 2006, live Webcast regarding fraud in the post-SOX era: "People always ask me if it's slowing down, getting better. Nothing has really slowed. It's the same volume as we saw in the initial rush in 2002."¹³ According to the FBI, in the three years post-SOX, there were more than 400 cases of corporate fraud pending, restitution totaling more than \$1 billion; 561 indictments, including 320 c-class executives, 379 convictions, and 3 to 6 new cases opening per month.¹⁴ Corporate fraud in this context is defined as financial statement fraud, obstruction conduct, and self-dealing by corporate insiders, which is occurring more frequently at the end of the reporting periods (quarterly annual reports).¹⁵

In the post-SOX period July 2002, the DoJ has processed about 1,300 corporate fraud convictions, including convictions of more than 200 CEOs and corporate presidents, 120 corporate vice presidents, and 50 CFOs. These convictions provide evidence of the persistence of corporate malfeasance and accounting scandals, as well as empowerment of federal agencies, regulators, and prosecutors to find, indict, and convict corporate wrongdoers. The number of financial restatements has also significantly increased since July 2002, which suggests a lack of quality and reliability in the previously published statements due to errors, irregularities, and fraud.¹⁶

Financial statement fraud can be classified into two categories: detected (reported) and undetected. It has been argued that only a small portion of financial statement fraud is detected (reported), and most cases continue until they are discovered. Currently, there is no comprehensive listing of all companies that were engaged in financial statement fraud.

In the past decade, we have confronted many financial scandals and fraud, starting with Enron and WorldCom, among others, market timing and late trading in mutual funds, stock options backdating, the 2008 subprime mortgage crisis, and recent Ponzi schemes. We need to step back to seriously consider and identify what went wrong, decide on what measures are needed to prevent further occurrences of these scandals, understand their impacts on reliability of financial reports, efficiency, and competitiveness of capital markets, and establish ways to ensure investor protection and confidence in our market and economy.

Common themes of reported financial scandals and fraud are the following:

- Lack of transparency and disclosures on complex financial products, including subprime loans, structured finance, off-balance sheet transactions, and credit derivatives
- Lack of accountability, as the financial companies were not responsible through market discipline or by regulators
- Lack of governance and oversight by those responsible for overseeing corporate governance, financial reporting, audit activities, and risk management
- Lack of effective engagement of “gatekeepers,” including the board of directors, legal counsel, and internal and external auditors
- Lack of effective analysis by credit rating agencies
- Conflicts of interest and conflicting incentives for corporate directors, officers, and auditors to maximize their interests at the investors’ expense
- Opportunities to engage in earnings manipulations and focus on short-term performance
- Incentive structure driven by fees and a process linked to short-term performance rather than sustainable performance
- Lax regulatory environment created by regulators’ attempt to follow the “principles-based” regulatory process used in other countries

Market discipline cannot and should not be a substitute for sound, cost-effective, and efficient regulations.

The recent high-profile frauds have raised serious concerns about the following:

- The role of corporate governance, including the board of directors and audit committees
- The integrity and ethical values of these companies’ top management teams, especially when CEOs and CFOs are indicted for cooking the books and, in many cases, are convicted
- The ineffectiveness of audit functions in detecting these financial statement frauds
- The substantial declines in the market capitalization of the alleged fraud companies and the likelihood of filing for bankruptcy protection
- Considerable lawsuits by injured investors, creditors, and employees
- Greed and incompetency of some corporate executives
- Efficacy and timeliness of regulation

Regulatory reforms seem to follow a financial crisis:

- Securities Act of 1933 and Security Exchange Act of 1934 were enacted and the SEC was formed in the aftermath of the Wall Street crash of 1929.

High-Impact Fraud Cases

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- Sarbanes-Oxley was passed in July 2002, pursuant to the reported financial scandal at the turn of the twenty-first century.

HIGH-IMPACT FRAUD CASES

Several key financial statement fraud schemes are summarized next and will be discussed in the next three chapters.

FICTITIOUS REVENUE, DOCUMENTATION FORGERY, AND THEFT OF CORPORATE ASSETS

ZZZZ Best (1987)

Barry Minkow, child genius, started ZZZZ Best as a carpet cleaning service provider at the age of 15 in his family's garage. He was a millionaire by the age of 18.¹⁷ Minkow's company, ZZZZ Best, went public in 1986 and eventually reached a market capitalization of over \$200 million. Yet the business scarcely existed and Minkow never ran a profitable operation.¹⁸ To accomplish his goals, Minkow created the perception that he had transformed his company from carpet cleaning to a building restoration business. Minkow set up Appraisal Services, a fake company that verified ZZZZ Best's business dealings. Meanwhile, a ZZZZ Best vice president forged all the documents and contracts necessary to support the jobs. To convince the company's auditor's when they insisted on visiting a restoration job, Minkow went so far as to rent a building and set it up to look like a ZZZZ Best work site.¹⁹

Enron (2001)

While Enron clearly had more substance than ZZZZ Best, a significant portion of the company's success was built on an elaborate foundation of smoke and mirrors. In 15 years, Enron grew from inception to America's seventh largest corporation, employing more than 21,000 persons in more than 40 countries. But the firm's success turned out to have involved an elaborate scam.²⁰ While the fall of Enron was due to a failed business model and spin-off ventures in water, international energy brokerage, and broadband communications, Enron's demise began when investors became aware of off-balance sheet partnerships and special-purpose entities that hid billions of dollars of losses. In both Enron and ZZZZ Best, the external auditors maintain that they were deceived by their clients and that important information was withheld.²¹

PERSONAL USE OF ASSETS, FALSE DOCUMENTATION, AND FINANCIAL STATEMENT FRAUD

Phar-Mor (1992)

Mickey (Michael) Monus founded Phar-Mor along with David Shapiro in 1982, based on the philosophy that Phar-Mor buying power gives the customer for more

buying power. It is said that Phar-Mor was one of the few companies that Sam Walton, founder of Wal-Mart, feared as he grew his discount retail mega-giant.²² Phar-Mor, based in Youngstown, Ohio, filed for Chapter 11 bankruptcy protection on August 17, 1992, after discovering an accounting fraud orchestrated by its top executives. Monus, president and chief operating officer, and Patrick Finn, chief financial officer, covered up approximately \$500 million in losses and diverted \$10 million in company funds to Monus's World Basketball League. The fraud was concealed through creation of deceptive documentation and manipulated inventory records.

Adelphia (2002)

Adelphia, a cable television company, was founded in 1952 by John Rigas. The company went public in 1986, and by 2000 Adelphia was among the largest cable television and telecommunications providers in the United States. In January 2002, following the collapse of Enron Corporation, the SEC provided guidance regarding disclosures that public companies should consider, including transactions with related parties. Adelphia's disclosures alarmed investors and analysts, leading to a formal investigation by a special committee of Adelphia's board of directors into related party transactions between Adelphia and the Rigases. Adelphia's stock price declined from about \$30 per share in January 2002 to \$0.30 per share in June 2002, and the stock was delisted from the NASDAQ market. Alleged fraudulent conduct included coborrowing by the Rigases, omission of Adelphia liabilities, and false and misleading financial statements. In addition, members of the family also owned private companies that used Adelphia personnel, inventory, trucks, and equipment to provide services.

CAPITALIZING EXPENSES AND OTHER ISSUES

Waste Management (1997)

Waste Management, Inc. is a waste management, comprehensive waste, and environmental services company in North America. In 1998, an accounting scandal led to a major drop in stock prices and to the replacement of top executives when the new CEO ordered a review of the company's accounting practices. The company had augmented the depreciation time length for their property, plant, and equipment, making their after-tax profits appear higher. The net result was \$1.7 billion in inflated earnings.²³ Furthermore, Waste Management refused to record expenses, established inflated environmental reserves (liabilities) in connection with acquisitions, improperly capitalized a variety of expenses, failed to establish sufficient reserves (liabilities) to pay for income taxes and other expenses, avoided depreciation expenses, and failed to record expenses for decreases in the value of landfills as they were filled with waste.²⁴

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MCI WorldCom (2002)

WorldCom, like Waste Management, was accused of failing to record operating expenses by treating them as capital expenditures and placing them on the balance sheet. WorldCom used two primary techniques: From 1998 to 2000, WorldCom reduced reserve accounts held to cover liabilities of acquired companies, adding \$2.8 billion to the revenue line from these reserves. Second, starting in late 2000, operating costs were capitalized as long-term investments, to the tune of \$3.85 billion.²⁵

ABUSE OF ACCOUNTING STANDARDS

Savings and Loan Crisis (1982)

The savings and loan crisis of the 1980s and 1990s resulted in the failure of 747 savings and loan associations (S&Ls) in the United States. While the major causes of the crisis were believed to be deregulation, imprudent real estate lending, keeping insolvent S&Ls open, brokered deposits, and lower inflation in the U.S. economy, fraud contributed to the problems. Most notably, valueless goodwill was recorded as an asset, and even when goodwill was recorded that appeared initially to have value, subsequent impairments were not recognized. The ultimate cost of the crisis is estimated to have totaled around \$160.1 billion, about \$124.6 billion of which was directly paid for by the U.S. government.²⁶

Stock Options Backdating (2006)

Like the S&L crisis, accounting and securities rules and regulations abuses contributed to the stock options backdating scandal. Issuers of stock options may grant options with any date that they choose. However, when the grant date (the day the options are granted to the recipient) differs from the options stated date, potentially the company would need to recognize compensation expense on the income statement, the company may have disclosure requirements, and the recipient would possibly have personal income tax ramifications. Thus, the issue of backdating is not illegal or problematic, but misleading stockholders, regulators, and the Internal Revenue Service will make backdating illegal.

It is interesting to note how similar the facts and circumstances of earlier high-profile frauds and scandals are to those of more recent events. The similarities show that history does, in fact, repeat itself.

COST OF FINANCIAL STATEMENT FRAUD

The costs to the companies where financial statement fraud is committed can be staggering. The collapse of Enron has caused about \$70 billion to be lost in market

capitalization, which is devastating for significant numbers of investors, employees, and pensioners. The WorldCom collapse, caused by alleged financial statement fraud, is the biggest bankruptcy in U.S. history. Loss of market capitalization resulting from the alleged financial statement fraud committed by Enron, WorldCom, Qwest, Tyco, and Global Crossing is estimated to be about \$460 billion. These and other corporate scandals have raised three important questions:

1. How severe is corporate misconduct in the United States?
2. Can corporate financial statements be trusted?
3. Where were the gatekeepers, including the auditors?

It is a matter of trust that the majority of publicly traded companies in the United States have responsible corporate governance, a reliable financial reporting process, and effective audit functions, and that they conduct their business in an ethical and legal manner, and through continuous improvements enhance their earnings quality and quantity. The pervasiveness of committed financial statement fraud caused by cooking the books and related audit failures have eroded the public confidence in corporate America.

Fraudulent financial reports are devastating to investors, as they can rock the alleged company's share price. A report by Glass Lewis & Co. shows that investors have suffered significant losses caused by fraudulent financial statements in the past decade.²⁷ The report indicates the lost market capitalization of 30 high-profile financial scandals caused by fraud during 1977 to 2004 is more than \$900 billion and resulted in a negative impact on stock returns for the fraud-prone companies of 77 percent.²⁸ A recent survey²⁹ reveals that reported incidents of fraud increased 22 percent worldwide in the past two years with the asset losses of, on average, more than \$1.7 million. KPMG's Forensic Fraud Barometer (2005) reported that fraud increased nearly three times in 2005 from the previous year and had the highest recorded level since 1995.³⁰ Financial statement fraud may constitute a small percentage of the total fraud occurrence, but its cost is definitely the largest with the average annual cost of \$250 million.³¹

The actual cost of fraud is difficult, if not impossible, to quantitatively measure for four main reasons:

1. Empirical studies show that only a small portion of all frauds, including financial statement fraud, is discovered.
2. Even if the fraud is discovered, not all cases are reported because companies attempt to preserve their images by firing the fraudsters and pretending that the incident never happened.
3. Fraud surveys in reporting the extent and magnitude of fraud are not always accurate, and they are subject to the limitation of any typical survey study in the sense that the respondents often report their perception rather than the reality.

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4. Companies typically do not pursue civil or criminal actions; by firing the fraudsters, many companies believe that they have prevented further occurrences of fraud.

Published statistics on the possible cost of financial statement fraud are only educated estimates; it is impossible to determine actual total costs since not all fraud is detected, not all detected fraud is reported, and not all reported fraud is legally pursued. The reported statistics, however, are astonishing. The ACFE in its “2002 Report to the Nation on Occupational Fraud and Abuse” shows that about 6 percent of revenue, or \$600 billion, will be lost in 2002 as a result of occupational fraud and abuse.³² By 2008, that figure had grown to almost \$1 trillion and 7 percent of revenue.³³ The report also found that financial statement fraud was the most costly form of occupational fraud, with median losses of \$2 million per scheme.

Other fraud costs are legal costs, increased insurance costs, loss of productivity, monthly costs, and adverse impacts on employees’ morale, customers’ goodwill, suppliers’ trust, and negative stock market reactions. An important indirect cost of financial statement fraud is the loss of productivity caused by dismissal of the fraudsters and their replacements. The top management team is typically involved in financial statement fraud, which forces companies to fire experienced top executives and replace them with less-informed executives. Although these indirect costs cannot possibly be estimated, they should be considered when assessing the consequences of financial statement fraud. Farrell and Healy stated, “The overall cost of fraud is over double the amount of missing money and assets.”³⁴

Financial statement fraud directly damages investors and creditors who are bound to lose all or part of their investments if such fraud results in a bankruptcy, near failure, substantial reduction in the stock prices, or delisting by organized stock exchanges. Financial statement fraud can also have a significant adverse impact on the confidence and trust of investors, other market participants, and the public in the quality and integrity of the financial reporting process. Decreased confidence in the reliability of financial statements, resulting from fraudulent financial activities, affects all statement users and issuers. Users of fraudulent financial statements will lose because their financial decisions (e.g., investment in the case of investors; transactions for suppliers; employment of employees) are made based on unreliable, misleading financial information. Even a small and infrequent financial statement fraud can affect investors and creditors as well as the public’s confidence in the quality of the financial reporting process. Public confidence depends on both the reported actual incidence of financial statement fraud and the perception of the extent that financial statements are threatened by fraudulent activities. Thus, even if the actual level of financial statement fraud may be low, investors and creditors may perceive that the problem exists. Corporate governance must take proper action to improve investor confidence in the financial reporting process.

British East India Company (1600–1874)

Fraudulent financial reporting and corrupt business practices go back to the beginning of the public corporation. While the Dutch East India Company was widely believed to be the first public company, the British East India Company, having started two years prior, in 1600, was also “taken public” with approximately 125 shareholders. The company grew throughout the 1600s. After a period of ferocious speculation following the “Glorious Revolution” in 1688, the company’s share price peaked at approximately £100 in 1693. During the next five years, the share price fell as a result of parliamentary inquiries into allegations of corruption. The stock price bottomed in 1698 when a rival company was established, hitting a low of £39. Scandal again returned to the East India Company in the late 1700s when Edmund Burke had Robert Clive, “the founder of the empire,” and Warren Hastings, India’s Governor-General, brought up on impeachment charges laden with corruption issues. While the trials were failed to convict either man, the company was brought under better parliamentary control. Adam Smith, in his 1776 treatise *Inquiry into the Nature and Causes of the Wealth of Nations*, recognized many of the shortcomings of the modern corporation, including shareholders suffering from extraordinary waste that results from fraud and abuse, a problem inseparable from the management of companies. These problems need not be fatal but need to be consciously and continually scrutinized.

Sources: W. Steve Albrecht, Conan C. Albrecht, and Chad O. Albrecht, “Fraud and Corporate Executives: Agency, Stewardship and Broken Trust,” *Journal of Forensic Accounting* 2004; John Keay, *The Honorable East India Company-A History of the English East India Company* (London: HarperCollins, 1992); Nick Robins, “This Imperious Company: The English East India Company and Its Legacy for Corporate Accountability,” *Journal of Corporate Citizenship* (Spring 2007); Nicholas Dirks, “What the Scandal of Empire Could Teach the Colonizers,” *Financial Times*, July 11, 2006.

FRAUD STUDIES AND REGULATORY RESPONSES

Vigilant and effective corporate governance can substantially reduce the instances of both employee and management frauds and considerably prevent and detect occurrences of financial statement fraud. The fraud studies listed in Appendix: Summary of Six Recent Fraud Studies provide these lessons and implications for corporate governance to prevent and detect financial statement fraud:

- Financial statement fraud is typically perpetrated by top management teams, including presidents, CEOs, CFOs, controllers, and other top executives. Thus, vigilant oversight function of the board of directors and its representative audit committee in (1) setting a tone at the top demonstrating commitment to high-quality financial reports; (2) discouraging and punishing fraudulent financial activity; and (3) monitoring managerial decisions and actions as related to the financial reporting process can substantially reduce instances of financial statement fraud.

Fraud Studies and Regulatory Responses

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- Financial pressures, including substantial declines in both the quality and quantity of earnings, high earnings growth expectations, and an inability to meet analysts' earnings estimates, are often cited in these studies as motivations for management engagement in financial statement fraud. The board of directors and audit committee should:
 - Closely monitor the pressures faced by senior executives
 - Be aware of the gamesmanship practices between management analysts and auditors
 - Attempt to control and monitor such practices
- Ineffective boards of directors and audit committees are cited as important contributing factors that increase the likelihood of the occurrence of financial statement fraud. Publicly traded companies should focus considerably on director independence and expertise as well as qualifications. Companies should comply with the new SEC, New York Stock Exchange, and National Association of Securities Dealers rules on audit committees and should establish vigilant and effective audit committees to oversee the quality, integrity, and reliability of financial reports. These audit committees should be independent, financially literate, well trained and experienced, and actively involved in corporate governance and the financial reporting process to be able to influence the prevention and detection of financial statement fraud.
- Lack of adequate and effective internal control structure has been cited as providing opportunities for the commission of financial statement fraud. The internal control structure can play an important role in preventing and detecting financial statement fraud by reducing the opportunities for perpetration of financial statement fraud and by red-flagging the indicators of financial statement fraud.
- Quality financial audits performed by external auditors are an effective way to reduce the likelihood of fraud occurrence and increase the possibility of fraud detection and prevention. The new O'Malley Panel on Audit Effectiveness suggests the use of forensic-type field work audit procedures on every audit to improve the prospects of detecting material financial statement fraud by external auditors.³⁵
- Forensic-type audit fieldwork requires auditors to modify their neutral concept of professional skepticism and presume the possibility of dishonesty at various levels of management, including collusion, gamesmanship, earnings management, override of internal controls, and falsification of financial records and documents. Forensic-type audit procedures are further discussed in Chapter 11.
- These fraud studies reveal that multiperiod financial statement fraud typically starts with the misstatement of interim financial statements. This finding suggests that quarterly financial statements should be thoroughly reviewed by external auditors and, whenever possible, continuous auditing should be performed throughout the year.

- Fraud studies underscore the need for involvement of all corporate governance constituencies, including the board of directors, the audit committee, management, internal auditors, external auditors, and governing bodies as part of a broad effort to prevent and detect financial statement fraud and thus improve the quality, integrity, and reliability of financial statements.
- The Enron debacle, caused by the commission of financial statement fraud, is expected to lead to the following:
 - The establishment of new regulations to improve corporate financial disclosures
 - The requirement of a more effective oversight of public accounting firms
 - The creation of a new accounting industry self-regulating organization that will operate under SEC supervision³⁶

SOX was intended to restore the investing public's confidence in corporate America, financial reports, and audit functions. In this context, SOX heightened public and media attention to corporate governance, financial reports, and audit functions. SOX could also have psychological rather than substantive effects. Despite the significance of the substantial effects of SOX, it created what investors could consider as "good news" in revitalizing the capital markets. Many provisions of SOX might have symbolic value and, through signaling effects, influence market participants' confidence in the securities market. Examples of these provisions are as follows:

- Senior executive certification requirements disclosing the already mandated certifications under securities laws
- Real-time disclosure of key information concerning material changes in financial condition or operations signaling the potential business and financial risks in addition to a discussion of their probability and magnitude from management's perspective
- Separation of audit and nonaudit services, which can signal the markets about the objectivity and effectiveness of audit functions as well as resulting impacts on credibility of published audited financial statements
- Improved corporate governance by signaling a more vigilant board of directors and audit committees (e.g., approval of audit and nonaudit services, code of ethics, financial expertise, loans to directors)
- Disclosure controls and procedures provision of SOX requiring public report on management's assessment of controls effectiveness in addition to auditors' attestation and report on management's control assertions
- Whistle-blowing protections for employees who lawfully provide information that they reasonably believe constitutes violations of securities laws
- Increased criminal penalties for violations of securities and other applicable laws and regulations

Antifraud Programs

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- Creation of the Public Company Accounting Oversight Board (PCAOB) signaling the improved changes needed in the self-regulatory structure in the auditing profession

These provisions of SOX are classified and summarized in the three overriding areas of corporate governance, financial reporting, and audit functions shown in Exhibit 1.2. The SEC has issued rules in implementing all provisions of SOX, and these rules are discussed throughout the book.

ANTIFRAUD PROGRAMS

Entities of all sizes are susceptible to both employee fraud (e.g., theft, embezzlement) and management fraud (manipulation of financial reports). Effective antifraud programs of focusing on fraud awareness and education in the workplace environment, whistle-blowing policies, and procedures of encouraging and protecting employees who report suspicious behavior, adequate internal control procedures designed to prevent and detect fraud, and conducting surprise audits can significantly reduce fraud. A 2007 survey conducted by Ernst & Young indicates that the majority of respondents (over 68 percent) do not have any antifraud prevention program, and they did not consider their fraud controls to be effective.³⁷ These results suggest that companies of all sizes should identify and assess fraud risks and design-related antifraud controls, and incorporate antifraud measures into their business operations.

Antifraud programs should be designed and maintained to deter, prevent, and detect all types and sizes of fraud, from misrepresentation of financial information to misappropriation of assets and employee fraud. An effective antifraud program should address corporate culture, control structure, and fraud procedures.

- *Corporate culture.* Corporate culture should create an environment that sets an appropriate tone at the top promoting ethical behavior and reinforcing antifraud conduct, demanding doing the right thing always. The corporate culture provides incentives for everyone in the company, from directors to officers and employees to act competently and ethically.
- *Control structure.* An effective control structure should eliminate opportunities for individuals to engage in fraudulent activities. Section 404 of SOX, SEC rules, and PCAOB auditing standard No. 5 underscore the importance of internal controls in preventing and detecting fraud.
- *Antifraud procedures.* Adequate antifraud procedures should be developed and performed to ensure prevention and detection of potential fraud.

A survey of ethics and workplace conducted by Deloitte & Touche in 2007 finds a strong link between ethics and work-life balance, as 91 percent of respondents felt

Exhibit 1.2 Summary of Provisions of SOX

Corporate Governance	Financial Reporting	Audit Functions	Others
<p>1. Enhanced audit committee responsibility for hiring, firing, compensating, and overseeing auditors and preapproval of non-audit services</p> <p>2. Disclosure, in the periodic reports, whether the audit committee has at least one member who is a “financial expert” and, if not, why not</p> <p>3. CEO and CFO certification of the accuracy and completeness of quarterly and annual reports</p> <p>4. Management assessment and reporting of the effectiveness of disclosure controls and procedures</p> <p>5. Ban on personal loans by companies to their directors or executives other than certain regular consumer loans</p> <p>6. Establishment of procedures by each audit committee for receiving, retaining, and handling complaints received by the company concerning accounting, internal controls, or auditing matters</p>	<p>1. CEO/CFO certification of financial reports</p> <p>2. Internal control report by management</p> <p>3. Attestation and report by auditors on management’s assessment of internal controls</p> <p>4. Disclosures of off-balance sheet arrangements</p> <p>5. Disclosures of contractual obligations</p> <p>6. Disclosures of reconciliation of non-GAAP financial measures pertaining to pro forma financial information</p> <p>7. Disclosures of material correcting adjustments by auditors</p> <p>8. Disclosures of transaction involving management and principal stockholders</p> <p>9. Accelerated filing of changes in beneficial ownership by insiders</p> <p>10. Real-time disclosures of information concerning material changes in financial condition or operations (form 8-K disclosures)</p>	<p>1. Establishment and operation of the Public Company Accounting Oversight Board (PCAOB), an independent nongovernmental agency that regulates and oversees the audit of public companies</p> <p>2. Registration with the PCAOB of public accounting firms that audit public companies</p> <p>3. PCAOB authority to issue auditing standards, inspect registered accounting firms’ operations, and investigate potential violations of securities laws</p> <p>4. Requirement that auditors be appointed, compensated, and overseen by the audit committee</p> <p>5. Many nonaudit services are prohibited from being performed contemporaneously with an audit</p> <p>6. Rotation of the lead (or coordinating) audit partner and the lead review partner every five years</p> <p>7. Auditors report to the audit committee</p>	<p>1. Professional responsibilities for attorneys appearing and practicing before the SEC</p> <p>2. Disclosures of corporate code of ethics</p> <p>3. Collection and administration of funds for victim investors</p> <p>4. Analyst conflicts of interest (Regulation AC)</p> <p>5. Whistle-blower protection</p> <p>6. Debts nondischargeable in bankruptcy</p> <p>7. Temporary freeze authority for SEC</p> <p>8. SEC can censure or bar any person who is not qualified, lacks the requisite character or integrity, or with unethical conduct from appearing before the SEC</p> <p>9. Lengthened statute of limitations for securities fraud</p> <p>10. Criminalization of corporate misconducts</p> <p>11. Criminal penalties for defrauding shareholders of public companies</p> <p>12. Retaliation against informants</p>

- 7. Review of each quarterly and annual report (forms 10-Q and 10-K) by officers
- 8. Forfeiture by CEO or CFO of certain bonuses and profits when the company restates its financial statements due to its material noncompliance with any financial reporting requirements
- 9. Improper influence on conduct of audits
- 10. Insider trades during pension fund blackout periods
- 11. Officers and directors bars and penalties for violations of securities laws or misconduct
- 11. Periodic review of published financial statements by the SEC at least once every three years
- 12. SEC-enhanced authority to determine what constitutes U.S. GAAP
- 13. Increased criminal penalties under securities laws and mail and wire fraud
- 14. Future studies on consolidation of public accounts by firm, audit firm rotation, accounting standards, credit rating agencies, and investment banks
- 8. Prohibiting where CEO or CFO previously employed by auditor
- 9. Auditor's attestation to and reporting on management assessment of internal controls
- 10. Limitations on partner compensation
- 11. Disclosure of fees paid to the auditor
- 12. Requirements for preapproval of audit and permitted nonaudit services by the audit committee
- 13. Retention of audit work papers and documents for five years
- 14. Increased penalties for destruction of corporate audit records

Source: Zabihollah Rezaee, *Corporate Governance and Ethics* (Hoboken, NJ: John Wiley & Sons, 2008), 47.

that workers are more likely to behave ethically at work when they have a work-life balance.³⁸ Survey results suggest that providing a balance between work and life through a more flexible work schedule provides incentives and opportunities for job satisfaction while fostering an ethical workplace culture. The survey identifies the following five key factors in promoting an ethical workplace:

1. Behavior of management (42 percent)
2. Behavior of direct supervisor (35 percent)
3. Positive reinforcement for ethical behavior (30 percent)
4. Compensation, including salary and bonus (29 percent)
5. Behavior of peers (23 percent)

These results clearly indicate that the majority of respondents (77 percent) believe that the behavior of top management and direct supervisors in setting appropriate tone at the top can significantly foster an ethical workplace environment. Management can create a workplace environment that is conducive to ethical behavior by setting examples and acting as role models for employees to behave ethically. Furthermore, the slight majority of respondents (57 percent) reported that they have observed supervisors setting positive examples of ethical behavior daily or several times per week.

OCCURRENCE, PREVENTION, AND DETECTION

Recently there has been substantial publicity about the extent and magnitude of alleged financial statement fraud that threatens the quality, integrity, and reliability of the financial reporting process and contributes to considerable economic losses by investors and creditors. These financial statement frauds have eroded the public's confidence in the financial reporting process and the audit function. This section describes financial statement fraud occurrence, prevention, and detection.

Exhibit 1.3 illustrates the five stages in which financial statement fraud occurs and can be prevented and detected. At Stage 1, financial statement fraud occurs because management is motivated to mislead financial statement users, particularly investors and creditors. The opportunity for deceptive actions by management exists, and management rationalizes its actions to engage in financial statement fraud. This first stage is thoroughly described and examined in Chapters 2 through 5.

At Stage 2, responsible and effective corporate governance, consisting of a vigilant and active board of directors, an effective audit committee, and an adequate and effective internal audit function, discovers the intended financial statement fraud and prevents its occurrence. If perpetrated financial statement fraud is prevented at this stage, its further damages are eliminated and its adverse effects

Occurrence, Prevention, and Detection

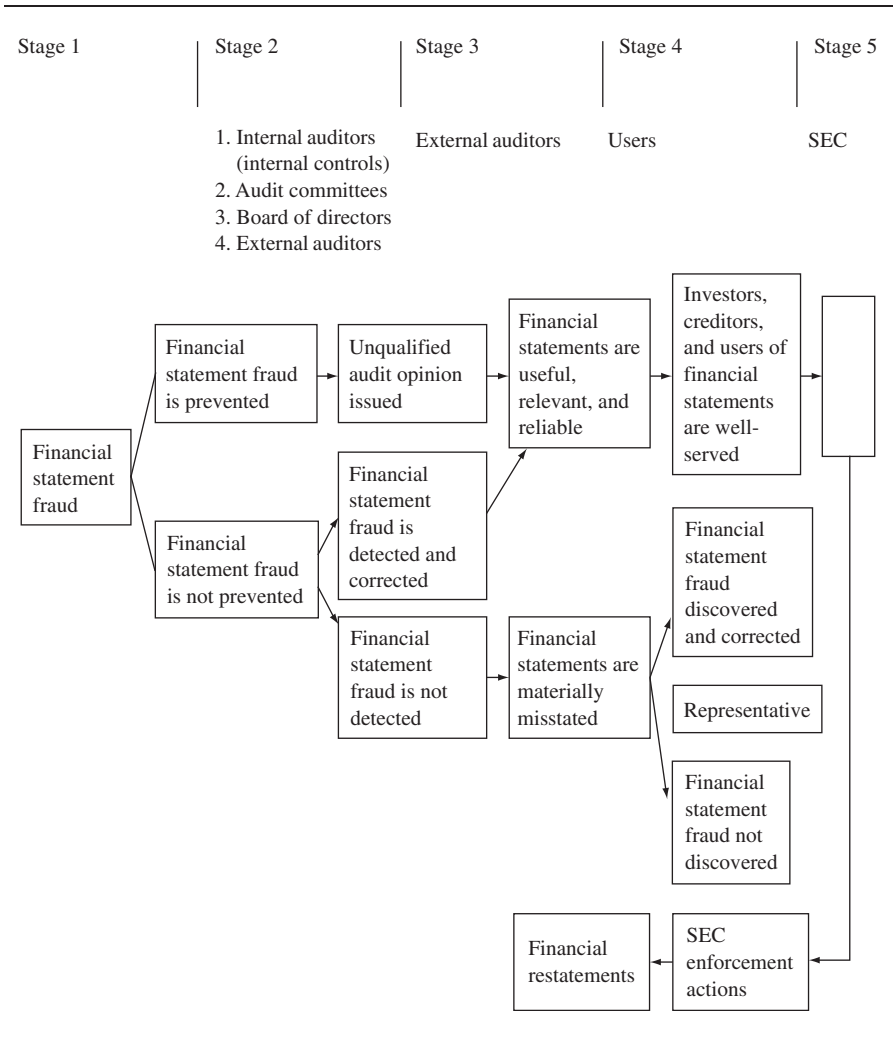


Exhibit 1.3 Financial Statement Fraud Prevention and Detection Process

on quality of financial reports are minimized. However, ineffective and irresponsible corporate governance, along with the gamesmanship attitude of corporate governance, fails to prevent deliberate financial statement fraud perpetrated by management. This stage of the process is described and examined in Chapters 7 through 10.

At Stage 3, financial statements that may or may not contain material misstatements are audited by independent auditors. Independent auditors perform

controls and substantial tests in gathering sufficient and competent evidence to provide reasonable assurance that financial statements are free from material misstatements, including fraudulent activities. When financial statement fraud is detected by independent auditors, the auditors are required to ask management to make corrections. If financial statement fraud is detected by the independent auditors and corrected by the company, then financial statements are fairly presented in conformity with generally accepted accounting principles and portray the company's true financial position, cash flows, and results of operations. Fairly presented financial statements accompanied by an unqualified audit report are considered useful, reliable, and relevant for decision making by investors, creditors, and other users of financial statements. These high-quality financial statements facilitate rational investment decisions and contribute to efficient capital markets. This stage of the process is discussed in Chapter 11.

Financial statement fraud that is not initially prevented and not subsequently detected by independent auditors, accompanied by an unqualified audit report, and disseminated to investors, creditors, and the public, is misleading. At this stage, whether the financial statement fraud is discovered or not, it is considered harmful and detrimental to the integrity and quality of the financial reporting process. This will cause inefficiency in the capital markets, which may result in misallocation of the nation's economic resources.

At the last stage, if financial statement fraud is discovered, either through formal investigations and probes by regulators or informal inquiries by investors, the company will be subject to SEC enforcement actions and will be required to correct and restate misstated financial statements. This final stage is discussed in Chapter 12. The company, its officials, and its auditors then are subject to civil and criminal lawsuit actions or administrative proceedings by the SEC. Any enforcement action by the SEC will have negative effects on the following:

- The reputation, prestige, and status of the alleged company.
- The top management team and other perpetrators of financial statement fraud. The company's officials will be subject to civil penalty, barred from serving on the board of directors or top management team of any publicly traded companies, and subject to criminal prosecutions, including jail time.
- The prestige, reputation, integrity, objectivity, and independence of auditors and auditing firms. Auditing firms may have to pay substantial fines to settle the alleged audit fraud. The partners involved may be subject to fines or be barred permanently or temporarily from auditing public companies.
- The investing public, especially investors and creditors. Investors and creditors may lose their investment substantially if the alleged company goes bankrupt or if stock prices are adversely affected by the alleged financial statement fraud.

Lessons Learned and Applications for Practice

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- The efficiency of the capital markets through reflection of high financial risk and low-quality financial reports.

LESSONS LEARNED AND APPLICATIONS FOR PRACTICE

Generally, white-collar criminals are intelligent, determined, committed to succeed, highly energetic, creative, good problem solvers, and aggressive. These are the same characteristics of successful entrepreneurs and leaders in business. So what separates professionals from fraudsters, and how do these people avoid the ethical slippery slope that may land them in prison?

The starting point for fraud prevention is “self”: “To thine own self be true!” To begin developing an antifraud framework for decision making, a three-pronged approach will assist professionals, managers, board members, auditors, supervisors and staff evaluate decisions:

1. Do you understand what you are being asked to do, the transaction being considered, its economics and related accounting and disclosure?
2. Does any part of the transaction, accounting, or related disclosure purport to hide or conceal important components of the activity from important stakeholders?
3. Does the transaction, accounting, or related disclosure violate basic tenants of ethical decision making?

UNDERSTANDING THE TRANSACTION

It is evident from evaluation of Enron’s financial misstatement that the board of directors did not understand the underlying economics of the transactions being proposed by management. While some aspects of the transactions were clearly being hidden by management from the auditors, the audit committee, and the board of directors, none asked for or demanded the necessary information. Consider the Powers Report finding:³⁹

It [the board of directors] cannot be faulted for the various instances in which it was apparently denied important information . . . However, it can and should be faulted for failing to demand more information and for failing to probe and understand the information that did come to light. The Board authorized . . . transactions. It appears that many of its members did not understand those transactions—the economic rationale, the consequences, and the risks.

Thus, the first prescriptive is to get the facts and understand them or ask probing questions until the transaction, proposal, or activity is understood. This advice applies equally to staff, supervisors, managers, executives, and corporate governance

participants. One cannot evaluate, account for, or transparently disclose what one inherently does not understand.

DOES THE ACTIVITY REQUIRE LYING?

Stock options backdating concerned the cherry-picking of the lowest stock price for the period of the options award. Once the selection was made, the Compensation Committee often created minutes or some other document trail to indicate that the option award was made on the date of the lowest closing stock price. The documentation was manufactured to conceal the true date when the options award was actually made. In some cases, the Compensation Committees withheld the release of meeting minutes to ensure that the options award was in fact granted on the date of the lowest stock price.

Concealing one's activities and creating false documentation is a form of lying. At a minimum, lying is considered bad form; in most cases, lying is less than desirable; in some cases, it is illegal. When the activity requires a form of lying, one should stop to question whether the activity is truly appropriate.

BASIC TENANTS OF ETHICAL DECISION MAKING

Violations of ethics, trust, and responsibility are at the heart of fraudulent activities. By their nature, fraud perpetrators are trust violators who have failed to meet their fiduciary responsibility. Trust violators come in two forms: the accidental fraudster and the predator. The predator is one who actively seeks opportunity to steal from others. Upon entry in a new position, the predator searches for the opportunity to achieve his or her goals—typically, financial or economic gain. The primary way to prevent predation is by performing thorough and complete background checks on potential new hires. While such a check may not indicate past transgressions related to fraud, it will likely lead to the realization that the applicant's resume has errors and irregularity or the observation of other anomalies that would normally cause most human resource professionals to question the hire.

By contrast, the accidental fraudster needs not only opportunity but usually acts under some form of distress or duress and has difficulty, at least upon the first fraud act, with the ethical dilemmas associated with fraud. Thus, first-time fraudsters act only if they feel some nonsharable financial or economic problem (pressure or distress) can rationalize the behavior as being for some good cause and have the opportunity to perpetrate the fraud act. These three attributes are known as the fraud triangle: pressure/motive, opportunity, and rationalization. The idea behind the fraud triangle is that it takes all three conditions for the accidental fraudster to perpetrate that first fraud. Internal controls tend to address the opportunity for perpetrators to perceive that they might be able to get away with the proposed scheme. Pressure is an internal characteristic felt by the potential fraud perpetrators, often unobservable to other persons.

Ethics tends to address the rationalization of fraud by considering the conditions under which an action may be considered right or wrong. By explicitly

Lessons Learned and Applications for Practice

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considering the ethics of a decision, one may be able to persuade potential fraudsters of the error of their ways *before* they initiate their first fraud act. This is important, because once a person becomes a fraudster, he or she seldom self-reforms. Michael Josephson, president of the Josephson Institute of Ethics, suggests several questions with which to evaluate decisions to determine whether you might be on the slippery slopes toward a bad ethical decision:⁴⁰

- If your decision was published on the front page of the local newspaper, would you be proud of your decision or embarrassed, possibly wishing that you would have acted differently?
- What does your gut say? Does the decision you are about to make cause you angst, cause difficulty sleeping, or cause your gut to tighten?
- If your child were with you, observing your action or decision, would you still make the same choice?
- Would this decision or action be something that your mentor, or a person that you admire, approve of?
- What would be the consequences if everyone did what you are considering?
- What if the consequences of your decision were applied to you? How would you feel if you were on the receiving end of the decision or action?

If the answer to any of these questions is less than desirable, you might be on the ethical slippery slope to no-man's land.

SCARED STRAIGHT

Notwithstanding the benefits of doing the right thing to oneself, colleagues, employer, and society, Exhibit 1.4 presents the results of some of the financial scandals discussed earlier in the chapter.⁴¹

Exhibit 1.4 Sentencing by Scandal and Executive

Company	Executive	Jail Term
ZZZZ Best	Barry Minkow, founder and CEO	Sentenced to 25 years at age 22; served a little over 7 years
Enron	Ken Lay, founder and CEO	Convicted of 25 charges in May 2006 at age 64; died before sentencing, while awaiting appeal
	Jeff Skilling, CEO	Sentenced to 24 years in jail at age 53
	Andrew Fastow, CFO	Sentenced to 6 years at age 46

(continued)

(continued)

Phar-Mor	Mickey (Michael) Monus, founder and COO	Sentenced to 19 years and 7 months at age 48
	Patrick Finn, CFO	Sentenced to 33 months in jail and testified against Monus
Adelphia	John Rigas, founder and CEO	Sentenced to 15 years at age 80
	Timothy Rigas, CFO	Sentenced to 20 years at age 48
Waste Management	Dean Buntrock, CEO	No charges filed
WorldCom	Bernie Ebbers, CEO	Sentenced to 25 years at age 63
	Scott Sullivan, CFO	Sentenced to 5 years at age 43

Other than Waste Management, Inc., where Dean Buntrock avoided criminal charges, founders and chief executives at each of the other companies will spend or are spending time behind bars. In addition, most had financial fines and community service attributes as part of their sentences.

THE MOST IMPORTANT IMPACT?

Walt Pavlo, perpetrator of a \$6 million embezzlement at MCI in the late 1990s, and coauthor Neil Weinberg, may have phrased it best:

His [Pavlo's] crime seemed victimless. A drop in the bucket for a soulless corporation. It suddenly hit him that the real victims might end up being his wife and sons. . . . The worst day of Pavlo's life came on March 14, 2001, when he kissed his wife Rhoda, Bubby (son age 11) and Howie (son age 9) and headed out the door for the ride to prison.⁴²

Wilkie (a coconspirator) told Pavlo that if people knew ahead of time what their crimes could do to their families, they would never commit them.

As part of the Enron scandal, Lea Fastow, wife of Andrew Fastow, CFO, was sentenced to serve one year in an 8-by-10-foot cell in an 11-story jail for signing tax forms she knew included ill-gotten income from her husband's schemes. Lea left behind two young sons at home.

The last thought:

In the end, it's only your reputation . . . so manage it wisely.

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