Financial Statement Fraud: The Saga Continues

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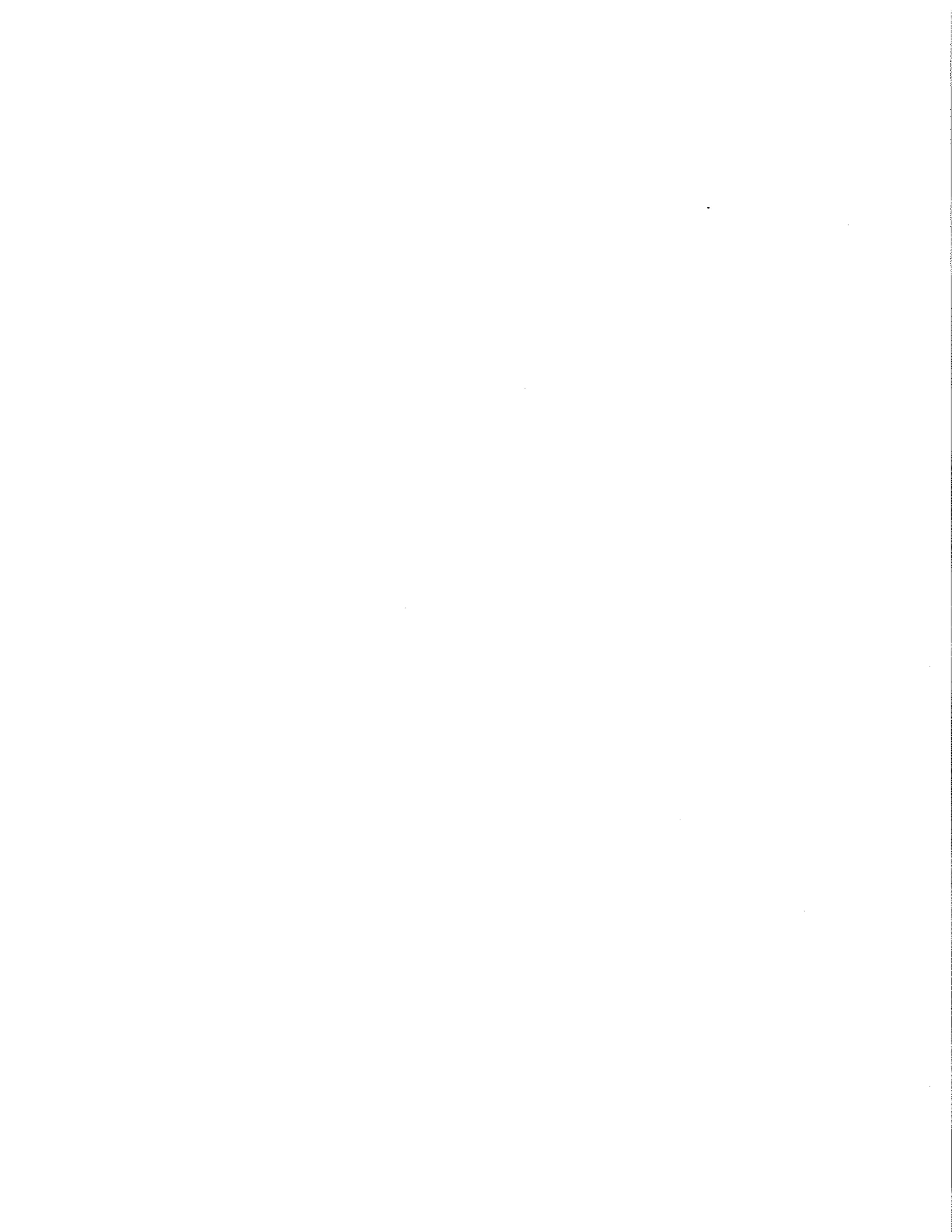

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FINANCIAL STATEMENT FRAUD: THE SAGA CONTINUES

Introduction

Financial statement fraud slammed its way into public awareness with hurricane force in 2002. Reacting to a need to shore up public confidence in financial markets, the Congress and President of the United States acted swiftly to pass legislation known as the Sarbanes-Oxley Act. The Act imposed rigid procedures on corporate officers and on the accounting profession for improving the reliability of the financial statements of public corporations. Penalties for noncompliance were increased to what many saw as draconian levels.

It will be interesting to observe, in ten, twenty or fifty years, whether the public looks back on 2002 as a watershed year in corporate governance and reliability of financial statements. Will current legislation have the desired effects? One way of predicting the future is to revisit the past. In this article, we will take a bird's eye view of five studies over the past fifty years that have dealt with the issue of corporate crime including financial statement fraud. We will conclude by comparing some findings of those studies with relevant provisions of the Sarbanes Oxley Act in order to predict the likelihood of the Act's effectiveness in combating financial statement fraud.

Edwin H. Sutherland

In 1949, Edwin H. Sutherland, well-known sociologist and political economist, published his monograph entitled White Collar Crime[i], a work that remained in print for more than thirty years and was translated into several languages.[ii] The monograph was an analysis of law violations, including financial fraud and violation of trust, by seventy large U.S. corporations. The sources for his study included decisions of federal, and state

and municipal courts, as well as published decisions of several federal administrative agencies, including the Securities and Exchange Commission.

Under pressure from his publisher, who feared legal reprisals, Sutherland deleted from the original publication the names of the target corporations. A complete and uncut version of the study, including the names of those corporations, was published in 1983.

Sutherland coined the term "white collar crime" to mean "violations of law by persons in the upper socioeconomic class....by a person of respectability and high social status in the course of his occupation."[iii] Sutherland seemed to be particularly disturbed by the damage these kinds of crime caused to social relations, in that they "violate trust and therefore create distrust, and this lowers social morale and produces social disorganization on a large scale."[iv]

In his study of the seventy large corporations over their life careers, Sutherland highlighted financial manipulations, including, among other things, "stock market manipulations, fraud in sale of securities, enormous inflation of capital, inadequate and misleading financial reports, and other manipulations." He indicated that 150 charges had been made against 59 of the 70 largest corporations.[v]

Under the heading of "violation of trust", Sutherland noted a total of 64 accusations against executives of 41 of the 70 large corporations. Various violations included using corporate funds for personal purposes, using corporate positions for the purpose of making a profit at the expense of the corporation, and paying themselves enormous salaries and bonuses. In some cases, "not even the directors knew the salaries of the executives."[vi]

Forty of the seventy large corporations studied were accused of public misrepresentation of corporate financial affairs, ranging from technical misrepresentation to intentional fraud.[vii]

Sutherland likened white collar crime to organized crime, noting that:

> Among the 70 largest industrial and commercial corporations in the United States, 97.1 percent were found to be recidivists in the sense of having two or more adverse decisions. *None of the official procedures used on businessmen for violations of law has been very effective in rehabilitating them or in deterring other businessmen from similar behavior.*[viii] (Emphasis added)

Sutherland observed that businessmen who violated laws designed to regulate business did not usually lose status among business associates. "Prestige is lost by violation of the business code, but not by violation of the legal code...."[ix], and, "even when they violate the law, they do not conceive of themselves as criminals."[x]

The public does not consider the businessman as a stereotypical criminal, according to Sutherland, based on the public conception of 'status', which seems to relate to power. In order to maintain their public status, "the policy of corporations is general public adherence to the law and secret defections from the law."[xi]

Noting that the corporate form acts as a unit, Sutherland opined that:

> Responsibility is divided among directors, executives, subordinates, and stockholders. A director loses his personal identity in this corporate behavior and in this respect, but in no other respect, *corporate behavior is*

like the behavior of a mob. Persons do not act in these situations as they would act if segregated from each other.[xii] (Emphasis added)

Sutherland offered a theory of white collar crime based on the hypothesis of differential association:

> (C)riminal behavior is learned in association with those who define such criminal behavior favorably and in isolation from those who define it unfavorably, and … a person in an appropriate situation engages in such criminal behavior if, and only if, the weight of the favorable definitions exceeds the weight of the unfavorable definitions.[xiii]

To demonstrate his theory, Sutherland related the personal stories of several well-educated and idealistic young men who were induced into illegal behavior during their first few years in the working world. From these stories, Sutherland postulated that a young man develops a general ideology, partly based on orders from superiors, partly based on techniques learned from successful co-workers, and partly from hearing such rationalizations as "We are not in business for our health", and "Business is business."[xiv]

Sutherland offered as further evidence of his theory of differential association the diffusion of illegal practices. Noting that businesses have the objective to maximize profits, he said, "when one firm devises a method for increasing profits, other firms become aware of the method and adopt it."[xv]

Sutherland found several segments of society that he believed protected the practice of white collar crime. He faulted newspapers, motion pictures and radio for failing to define white collar crime in a critical manner because they feared losing advertising income. In addition, he pointed out that these public agencies of

communication, themselves, engaged in white collar crime through "restraint of trade, misrepresentation in advertising and unfair labor practices."[xvi]

Sutherland further observed that "Businessmen are shielded against harsh criticisms by persons in governmental positions."[xvii] He believed this was the result of several relationships:

- Persons in government are…culturally homogeneous with persons in business…
- Many persons in government are members of families which have other members in business…
- Many persons in business are intimate personal friends of persons in government…
- Many persons in government were previously connected with business firms…
- Many persons in government hope to secure employment in business firms when their government work is terminated…
- Business is very powerful in American society and can damage or promote the governmental programs in which the governmental personnel are interested…
- The program of the government is closely related to the political parties, and for their success in campaigns these political parties depend on contributions of large sums from important businessmen...[xviii]

Sutherland offered this insight:

> The statutes…have little importance in the control of business behavior unless they are supported by an administration which is intent on stopping the illegal behavior. In turn the political administration has little force in stopping such behavior unless it is supported by a public which is intent on the enforcement of the law. [xix]

Marshall B. Clinard and Peter C. Yeager

Published in 1980, the Clinard/Yeager book entitled Corporate Crime[xx] chronicles the results of their research that began in 1976. Using materials from a variety of sources, especially from the Securities and Exchange Commission[xxi], the authors said, "government inquiries have … shown that corporate violations are exceedingly difficult to discover, to investigate, or to develop successfully as legal cases because of their extreme complexity and intricacy."[xxii]

The authors further delineated Sutherland's term, white collar crime, into to the sub-categories of "occupational" and "corporate". They observed that corporate crime, rather than being limited to the United States, appeared to be extensive elsewhere in the world.[xxiii]

The study revealed that "1553 federal cases were begun against all 582 corporation during 1975 and 1976 (and)….60.1 percent had at least one federal action brought against them…".[xxiv] These included a range of illegal activities, including financial.

Interestingly, the authors found that:

> (I)n only 1.5 percent of all enforcement actions was a corporate officer convicted for failure to carry out his legal responsibility to the corporation. Of the 56 executives convicted, 91 percent were convicted of federal antitrust violations, 5 percent of financial or tax violations, and 4 percent of violations of federal food and drug laws.[xxv]

The authors concluded that while corporate executives are largely insulated from consequences of their socially harmful actions, the strong argument to be made for criminal sanctions against them is the effect that unequal justice has on the rest of society. They also say, "*evidence appears to show that criminal sanctions can be an effective deterrent when applied in a forceful manner.*[xxvi] (Emphasis added)

Clinard and Yeager summarized their research in the final chapter of their book. Here are just a few of their observations:

- The larger corporations commit a disproportionate number of violations of law.
- Corporations that do violate and those that largely do not are distinguished by "corporate cultures," or ethical climates.
- The measures designed to deal with corporate crime are distinct from those used to control ordinary crime or even other types of white-collar crime.
- The inculcation of ethical principles forms the basis of crime prevention and control…it is impossible to control complex corporate violations solely by enforcement measures.

Report of the National Commission on Fraudulent Financial Reporting (The Treadway Commission Report)[xxvii]

Fast-forward to October 1987 and the Treadway Commission Report. Sponsored and funded by the leading accounting professional organizations, the Commission, from October 1985 to September 1987, studied the financial reporting system in the United States in order "to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." Focusing on public companies, the Commission set out to learn, among other things, the extent, nature, and effects of fraudulent financial reporting, the role of the independent public accountant in detecting fraud, and attributes of corporate structure that might contribute to fraudulent financial reporting.[xxviii]

The Commission reviewed 119 enforcement actions against public companies or associated individuals and 42 cases against independent public accountants or their firms brought by the SEC from 1981 to 1986.[xxix] These are just some of their findings:

Opportunities for fraudulent financial reporting arise from:

- Absence of a vigilant board of directors or audit committee
- Weak or nonexistent internal accounting controls
- Unusual or complex transactions
- Accounting estimates requiring significant subjective judgment by management
- Ineffective internal audit staffs[xxx]

Most cases against Independent Public Accountants alleged:

- Failure to conduct the audit in accordance with Generally Accepted Auditing Standards

- Failure to recognize "Red Flags" or to pursue them with skepticism
- Ignoring weak internal controls.
- Failure to train and supervise the audit staff adequately[xxxi]

Here are highlights of the Commission's Summary of Recommendations:

- Top management must identify and assess the factors that could lead to fraudulent financial reporting.
- All public companies should maintain internal controls including written codes of corporate conduct.
- The audit committee of the board of directors should be composed entirely of independent directors.
- Management should take steps to better inform users of financial statements about the roles of management and the audit committee in the financial reporting process.
- Changes in auditing standards to enhance audit quality are recommended. Auditors need to improve the likelihood of detecting fraudulent financial reporting.
- Recommendations are made for new SEC sanctions, greater criminal prosecution, improved regulation of the public accounting profession, adequate SEC resources…
- The business and accounting curricula should convey a deeper understanding of the function and importance of internal controls and the overall control environment…

- The ethical dimension of financial reporting should receive more emphasis in the business and accounting curriculum.[xxxii]

Fraudulent Financial Reporting: 1987-1997 - The COSO Report[xxxiii]

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) sponsored a study covering the eleven years following the Treadway Commission Report. COSO analyzed Accounting and Auditing Enforcement Releases (AAER) issued by the Securities and Exchange Commission (SEC) from 1987 to 1997. They focused on alleged violations of SEC Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the 1933 Securities Act that represented the primary antifraud provisions relating to financial statement reporting.[xxxiv] COSO identified 300 companies involved in alleged fraudulent financial reporting during the period. From those they used 200 as a final sample .

Here are highlights of the COSO study findings:

- Companies committing fraud generally were small, and most were not listed on the stock exchanges.
- The frauds went to the very top of the organizations.
- The audit committees and boards of the fraud companies appeared to be weak.
- A significant portion of the companies was owned by the founders and board members.
- Severe consequences resulted when companies committee fraud, including bankruptcy, significant changes in ownership, and delisting by national exchanges.

- Cumulative amounts of frauds were relatively large in light of the relatively small sizes of the companies involved.
- Typical financial statement fraud techniques involved overstatement of revenues and assets.
- External auditors included all sizes of audit firms.
- All types of audit reports were issued during the fraud period.
- Financial statement fraud occasionally implicated the external auditor.[xxxv]

Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002[xxxvi]

The Sarbanes-Oxley Act was signed into law by the President on July 30, 2002 in response to massive financial statement restatements by prominent corporations with resultant losses to investors in the billions of dollars.

Pursuant to Section 704 of the Act, the Securities and Exchange Commission studied 515 enforcement actions for financial reporting and disclosure violations arising out of 227 Division of Enforcement investigations during the study period July 31, 1997 through July 30, 2002. The actions included 869 named parties, consisting of 164 entities and 705 individuals.[xxxvii] Of these, the SEC charged 82 entities and 511 individuals with fraud in connection with reporting violations. The majority of these were for improper revenue recognition. Most of the individuals held responsible for the accounting violations were members of issuer senior management.[xxxviii]

Independent auditors were charged in 57 of 227 enforcement matters. This involved 89 individuals and 18 auditing firms. Twenty-four individual auditors were charged with fraud under Section 10(b) of the Exchange Act for participating in their

client's reporting violations, while only one firm was so charged.[xxxix] Of the 57 enforcement matters, 16 involved one of the five largest public accountings or an individual associated with one of the five largest firms, while 41 involved smaller firms. Reporting violations were as likely to occur when a large firm was involved as when the audit was conducted by a smaller firm. In 140 enforcement matters, the issuer was audited by one of the five largest firms.[xl]

Most audit failures were caused by auditors' failures to verify management statements, by failing to use proper procedures and verification techniques, or by failing to exercise professional skepticism.[xli]

The Sarbanes-Oxley Act as Remedy

How does the Sarbanes-Oxley Act affect accountants? The Securities Exchange Commission has created a Public Company Accounting Oversight Board (PCAOB). Audit firms must now register with PCAOB. PCAOB is required to establish audit quality, ethics and standards, as well as to investigate and discipline firms and individuals. Limitations are placed on certain non-audit services by accounting firms to audit clients. Lead and concurring audit partners must rotate off the audit after five years and stay off the audit for at least one year. Foreign auditors of U.S. public companies are also subject to the provisions of the Act.

How does the Act affect public companies? Officers must now certify financial statements. Officers may not fraudulently influence or otherwise mislead an auditor. Officers must assess internal controls. A code of conduct must be established for officers in public companies. Restrictions are placed on bonuses, loans and trading company

stock. Audit Committees must take a stronger role, with independent members and more financial expertise.

How is the Securities Exchange Commission enforcement ability affected? The SEC budget is increased. New criminal enforcement tools and increased penalties are established.

Predicting the Future from the Past

Will the increased regulation and potential punishments deter financial crimes? As noted earlier in this article, Sutherland thought that official procedures had not been very effective in rehabilitating business criminals or deterring others from committing similar crimes.

On the other hand, Clinard and Yeager thought that criminal sanctions could be effective deterrent when applied in a forceful manner. They observed that the differences between corporations that violate the laws and those that don't is the corporate culture, and recommended the inculcation of ethical principles to prevent and control crime.

The Treadway Commission Report observed that it was "the tone set by top management that influences the corporate environment within which financial reporting occurs."[xlii] The Commission included among its recommendations that the ethical dimension of financial reporting receive more emphasis in the university curriculum.

Various U.S. laws have been passed to curtail financial crime, beginning with the 1933 and 1934 Securities Acts and continuing with the Sarbanes-Oxley Act of 2002; and yet financial statement fraud continues to plague our world. The observations of Edwin H. Sutherland in 1949 are still relevant today.

Perhaps more than regulations, laws and penalties are needed. Perhaps we should heed the words of William Donaldson in his nomination hearing for the chair of the SEC"[xliii]

> (L)egislation and vigorous regulation can accomplish only so much. There must be a conscious decision to make honesty, integrity and regard for the good of the shareholders, the motivation of all business decisions...Corporate American and Wall Street [must be called on] to restore these principles in their proper place."

[i] Edwin H. Sutherland, White Collar Crime, 1983, Yale University Press, New Haven and London, 1983
[ii] Ibid;, xi, Introduction by Gilbert Geis and Colin Goff
[iii] Ibid, p. 7
[iv] Ibid, p. 10
[v] Ibid, p. 153
[vi] Ibid, p. 160
[vii] Ibid, p. 163
[viii] Ibid, p. 227
[ix] Ibid, p. 229-229
[x] Ibid, p. 230
[xi] Ibid, p. 232
[xii] Ibid, p. 235
[xiii] Ibid, p. 240
[xiv] Ibid, pp 240- 245
[xv] Ibid, p. 246
[xvi] Ibid, pp. 250-251
[xvii] Ibid, p. 251
[xviii] Ibid, p. 251-252
[xix] Ibid, p. 256-257
[xx] Marshall B. Clinard and Peter C. Yeager, Corporate Crime, Free Press, New York and London, 1980
[xxi] Ibid, p. xi
[xxii] Ibid, p. 6
[xxiii] Ibid, p. 18-19
[xxiv]Ibid, p. 113
[xxv]Ibid, p. 272
[xxvi] Ibid, p.297
[xxvii] Report of the National Commission on Fraudulent Financial Reporting, October 1987. Chairman, James C. Treadway, Jr. Executive Vice President and general Counsel, Paine Webber, Incorporated. (The Treadway Report)
[xxviii]Ibid, p. 2
[xxix] Ibid, p. 23
[xxx] Ibid, p. 24
[xxxi] Ibid, p. 25
[xxxii] Ibid, p. 11-16
[xxxiii] Fraudulent Financial Reporting 1987-1997, An Analysis of U.S. Public Companies, Research Commission by the Committee of Sponsoring Organizations of the Treadway Commission. Research Report Prepared by Marck S. Beasley, North Carolina State University; Joseph V. Carcello, University of Tennessee; and Dana R. Hermanson, Kennesaw State University. (COSO)

[xxxiv]Ibid, p. 4
[xxxv] Ibid, pp. 1-7
[xxxvi] Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002, Securities Exchange Commission.
[xxxvii]Ibid, p. 1
[xxxviii]Ibid, p. 2
[xxxix] Ibid, p. 37
[xl]Ibid, p. 39
[xli]Ibid, p.40
[xlii] The Treadway Report p. 11
[xliii] U.S. Senate Committee on Banking, Housing and Urban Affairs, Hearing on Nomination of William H. Donaldson, at www.senate.gov (Feb. 5, 2003).