GLOBAL EDITION

Detecting Accounting Fraud

Analysis and Ethics

Cecil W. Jackson

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Detecting Accounting Fraud

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Analysis and Ethics

Global Edition

Cecil W. Jackson
University of Southern California

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To my family:
Sandra, Kate, and David

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PREFACE

ABOUT THE BOOK

Accounting fraud, or the manipulation of financial statements, has become an increasingly serious issue over the last two decades, leading to the collapse of ostensibly solid companies, exacerbating a serious global recession, and resulting in an acute lack of confidence in financial markets and in the accuracy of financial statements. This book provides an informative and invaluable analysis of the **Top 20 Methods of Fictitious Financial Reporting** that lists the most frequently used methods of overstating earnings and assets and understating debt in financial statements. The book also presents a detailed examination of the main **Signals** indicating possible fictitious reporting in financial statements. Taking the viewpoint that no book on accounting fraud would be complete without an examination of the breakdown in ethics that underlies the fraud, this text examines the three major **Theories of Ethics**, as well as ethical decision-making models that are applicable to the business world in general and to students of accounting in particular.

Detecting Accounting Fraud: Analysis and Ethics takes the following **eight-step case-study approach**:

1. Identifies the accounting fraud or method of fictitious financial reporting utilized by a specific, real-world company.
2. Presents background information about the company and its key executives.
3. Describes the fraud or scheme in detail, referencing the company's financial statements as well as primary documents such as Accounting and Auditing Releases, Litigation Releases, SEC Complaints, and Bankruptcy Reports.
4. Explains how a particular accounting scheme or fraud leads to specific signals in the company's financial statements indicating that these financial statements have been manipulated.
5. Asks students to address relevant ethical issues in the "Ethics at Work" sections throughout the book.
6. Provides short, end-of-chapter questions to ascertain that students have understood the material.
7. Provides in-depth discussion questions and exercises to encourage a more comprehensive grasp of the material.
8. Presents a new, real-world case study of another company that perpetrated an accounting fraud or scheme similar to that discussed earlier in the chapter. Students are provided with extracts from this new company's financial statements, as well as relevant excerpts from original documents such as Litigation Releases and Complaints. Students are then given the opportunity to identify signals in this company's financial statements indicating how the company has manipulated its financial statements.

Intended Audience

This book has been written for instructors and students of undergraduate and graduate courses to be used in the following areas:

- Accounting Fraud (in business schools, MBA programs, and law schools)
- Accounting Ethics and Business Ethics
- Financial Accounting Case Studies
- Auditing (in business schools and MBA programs)

Distinguishing Features of *Detecting Accounting Fraud: Analysis and Ethics*

- In addition to analyzing the more well-known case studies (Sunbeam, WorldCom, and Countrywide), the book presents a number of new and unusual real-world case studies for students to examine. These include companies such as Beazer Homes, Peregrine Systems, Buca, Inc., and TierOne Bank.
- The book is written in a lively and engaging style, with interesting background information on many of the companies and their executives.
- The material is well organized and complex material is presented in a logical, easy-to-follow manner as the chapters systematically examine the *Top 20 Methods of Fictitious Financial Reporting.*
- The book concludes with a useful Appendix summarizing the *Top 25 Signals Indicating Possible Fictitious Reporting in Financial Statements.*
- Students are presented with a variety of original, primary documents (or relevant extracts from such documents), adding a high level of authenticity to the real-world cases covered in the text.
- Students are given the opportunity to examine the ethical dimensions (or lack thereof) of a variety of the case studies.
- The wide range of end-of-chapter assignments provides students with ample opportunity to apply what they have learned.
- The new case studies presented at the end of the chapters give students the valuable opportunity to examine original documents and look for evidence of accounting manipulation in a real-world company.
- The book features an extensive list of references for each chapter, inviting further research and reading on the various topics covered.

INSTRUCTOR SUPPLEMENTS

Instructor's Solutions Manual: The Instructor's Solutions Manual provides both thought-provoking responses to all the open-ended questions and clear, concise solutions to the broad range of accounting issues and numerical questions presented in the text. To assist the instructor in guiding student discussions on ethical issues, the manual presents a range of comprehensive responses to all the questions in the Ethics at Work sections. It also contains answers to all the True/False, Fill-in-the-Blank, and Multiple Choice Questions in each chapter. It offers suggested responses to all the Discussion Questions, as well as detailed answers to all the Short-Answer Questions and Case Study Questions.

PowerPoint Presentations: Complete PowerPoint presentations are provided for each chapter. Instructors may download and use each presentation as is or customize the slides. Each presentation allows instructors to offer an interactive presentation using colorful graphics, outlines of chapter material, and graphical explanations of difficult topics.

Both the Instructor's Solutions Manual and the PowerPoint presentations are available online at www.pearsonglobaleditions.com/Jackson.

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Cecil Jackson, Professor of Clinical Accounting in the Leventhal School of Accounting at the University of Southern California, teaches courses on detecting accounting fraud and on managerial accounting for the MBA program as well as the graduate and undergraduate accounting programs. Dr. Jackson developed Leventhal's highly regarded course on "Detecting Fraudulent Financial Reporting."

Cecil Jackson's previous book, *Business Fairy Tales: Grim Realities of Fictitious Financial Reporting* (2006) received favorable reviews from publications such as *Barrons*, *The CPA Journal*, *Investor's Business Daily*, the *Motley Fool*, and *The Accounting Review*.

Dr. Jackson has appeared on a number of business news shows, including *Bloomberg Television*, *The Street.Com*, and *CNN*. He has worked for two leading public accounting firms and qualified as both a CPA and Chartered Accountant. Dr. Jackson has won several awards for his teaching and is a respected speaker and consultant on aggressive financial reporting issues. In May 2010, he was awarded the prestigious Evan C. Thompson Teaching and Learning Innovation Award by the Marshall School of Business. In May 2012, he was voted one of the best professors in the Marshall School of Business and received the Golden Apple Award.

Detecting Accounting Fraud

CHAPTER 1

Introduction to the Problem of Accounting Fraud

Learning Objectives

After studying this chapter, you should be able to:

- Identify the elements of accounting fraud.
- Recognize the pervasiveness of accounting fraud.
- Identify the major financial gatekeepers in corporate governance.
- Explain the main elements of Sarbanes-Oxley reform.
- Explain the main elements of Dodd-Frank reform.
- Identify the top 20 methods used to manipulate financial statements.

CHAPTER OUTLINE

Although gold dust is precious, when it gets in your eyes it obstructs your vision.

—His-Tang Chih Tsang, Chinese Zen Master

In July 2010, in the wake of the mortgage crisis and financial tsunami that had hit the United States in 2008, Mary L. Schapiro, then chairman of the United States Securities and Exchange Commission (SEC), described the vast damage caused by the financial crisis and went on to point out: "One of the fundamental requirements for rational investing and efficient capital formation is the availability of high quality information. One of our core functions is collecting and making publicly available financial and other relevant information from public companies." The health of our markets—and the very foundation of our financial system—relies on the production and accessibility of this "high quality" financial information.

Unfortunately, as a review of the last 15 years reveals, the financial information from a variety of public companies that were once regarded as mainstays of the U.S. economy was naïvely misleading at best and blatantly fraudulent at worst. Numerous executives have been exposed in cases of greed and betrayal, of blatant duplicity and moral bankruptcy. Central to almost every case discussed in this book is the fact that these corporate executives manipulated financial statements—or encouraged others to tamper with financial statement disclosures—and misled those who trusted them.

WHAT IS ACCOUNTING FRAUD?

Before addressing *accounting fraud*, it is helpful to briefly examine the concept of *fraud* in general. Defining *fraud* is a complex legal exercise, and definitions may differ from state to state, from federal courts to state courts, and from criminal cases to civil cases. This discussion addresses the issue in broad terms and is not meant to be taken as legal advice. The Association of Certified Fraud Examiners describes fraud as follows:

> In practice, fraud embraces all the multifarious means that human ingenuity can devise for one person to gain an advantage over another by false suggestion or suppression of the truth. No final, invariable rule can be laid down in defining fraud—according to *Black's Law Dictionary*, the act of fraud includes surprise, trick, cunning, and a range of unfair ways by which people are cheated. The only boundaries are those that limit human knavery. (*The Fraud Trial*, 2011, p. 6)

According to Lawrence and Wells (2004), "Under common law, three elements are required to prove fraud: a material false statement made with an intent to deceive…, a victim's reliance on the statement and damages." The Federal Bureau of Investigation (FBI) defines *fraud* as follows: "The intentional perversion of the truth for the purpose of inducing another person or other entity in reliance upon it to part with something of value or to surrender a legal right" (***www.fbi.gov***).

Accounting fraud (also sometimes called "corporate fraud[1]" or "financial reporting fraud") is a particular type of fraud that involves the manipulation of financial statements. In its report on *Deterring and Detecting Financial Reporting Fraud* (2010), the Center for Audit Quality defines *financial reporting fraud* as "a material misrepresentation resulting from an intentional failure to report financial information in accordance with generally accepted accounting principles" (p. i).

For criminal fraud cases, the burden of proof (or level of proof) required is generally higher than for civil fraud cases: "For civil cases that burden is a 'preponderance of evidence.' In criminal fraud the standard is 'beyond a reasonable doubt'" (Lawrence & Wells, 2004). For this reason, many cases of accounting fraud are tried in civil court or result in civil actions such as SEC enforcement actions.

Civil Accounting Fraud

The Enforcement Division of the SEC publishes "financial reporting related enforcement actions concerning civil lawsuits brought by the Commission in federal court and notices and orders concerning the institution and/or settlement of administrative proceedings" ("Accounting and Auditing Enforcement Releases"). The SEC issues its findings in the form of an Accounting and Auditing Enforcement Release (AAER) or a Litigation Release (LR) or both. In an AAER or LR, the SEC describes how a company has allegedly infringed securities law. The SEC will usually accept an "Offer of Settlement," and the respondents agree to the "Order Instituting Public Administrative and Cease and Desist Proceedings." The respondents generally do not admit or deny the findings.

After the Sarbanes-Oxley (SOX) Act was passed in 2002, SEC enforcement actions increased from 598 in fiscal year 2002 (Dickey, Sturc, & Van Lobels Sels, 2003) to 679 actions in fiscal 2003. The next few years saw a slowdown in cases, until the financial crisis hit the economy to cause another upswing in enforcement actions. As can be seen in Figure 1.1 (below), the SEC's Enforcement Actions cover a range of financial violations, such as insider trading, market manipulation, and securities offering violations in addition to financial fraud/issuer disclosure violations. The category of "Financial Fraud/Issuer Disclosure" (i.e., accounting fraud) involves violations related to financial statements and financial disclosures released by "issuers" of financial statements. These are the types of violations that we examine in this text.

The crisis of 2008 shifted the focus of SEC enforcement investigations and actions away from accounting and issuer disclosure violations for a few years. According to an article in The *Wall Street Journal*, it is expected that

[1] While not all corporate fraud is accounting fraud, accounting fraud is the most prevalent and most damaging form of corporate fraud. ("Financial Crimes Report," 2011. ***www.fbi.gov***)

FIGURE 1.1 Year-by-Year SEC Enforcement Statistics

Enforcement Actions by Fiscal Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Broker-Dealer	137	140	94	75	89	67	109	70	112	134
Delinquent Filings	n/a	n/a	n/a	91	52	113	92	106	121	127
FCPA[2]	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	20*	15
Financial Fraud/ Issuer Disclosure	199	179	185	138	219	154	143	126	89**	79
Insider Trading	50	42	50	46	47	61	37	53	57	58
Investment Adviser/ Investment Co.	72	90	97	87	79	87	76	113	146	147
Market Manipulation	32	39	46	27	36	53	39	34	35	46
Securities Offering	109	99	60	61	68	115	141	144	124	89
Other	80	50	98	49	65	21	27	35	31	39
Total Enforcement Actions	**679**	**639**	**630**	**574**	**655**	**671**	**664**	**681**	**735**	**734**

* Prior to FY 2011, FCPA was not a distinct category and FCPA actions were classified as Issuer Reporting and Disclosure.

** Prior to FY 2011, this category was reported as Issuer Reporting and Disclosure and included FCPA actions, which are now tracked separately from Financial Fraud/Issuer Disclosure actions.

Source: ***www.sec.gov/news/newsroom/images/enfstats.pdf***

new SEC Chairman Mary Jo White, who assumed leadership of the SEC in April 2013, will be more likely to shift SEC focus back to accounting fraud in future years (Eaglesham, May 27, 2013). A recent article in *Accounting Today* agrees that the SEC's emphasis will move from fraud on "Wall Street to Main Street" (Cohn, 2013).

Criminal Accounting Fraud

Sometimes, a company may also be pursued by the Department of Justice and the Federal Bureau of Investigation (FBI) and charged with criminal fraud. Since 2010, the FBI has had special agents "embedded at the SEC" to swiftly isolate securities and corporate frauds and initiate criminal investigations where necessary (Mueller, 2012). Most of the criminal corporate fraud investigated by the Financial Crimes Section (FCS) of the FBI involves financial reporting fraud:

> The majority of corporate fraud cases pursued by the FBI involve accounting schemes designed to deceive investors, auditors, and analysts about the true

[2] Foreign Corrupt Practices Act.

> financial condition of a corporation or business entity. Through the manipulation of financial data, the share price, or other valuation measurements of a corporation, financial performance may remain artificially inflated based on fictitious performance indicators provided to the investing public. In addition to significant financial losses to investors, corporate fraud has the potential to cause immeasurable damage to the U.S. economy and investor confidence. ("Financial Crimes Report," 2011)

The number of corporate fraud cases pursued by the FBI has grown steadily since 2007. At the end of its 2011 fiscal year, the FBI was investigating 726 cases of corporate fraud in the United States (Figure 1.2).

The Extent of Accounting Fraud

While there is some debate concerning the extent of corporate fraud, in their study "How Pervasive Is Corporate Fraud?" (2013), Dyck, Morse, and Zingales posit that there is an "iceberg" of corporate fraud and falsified financial statements that remains undetected and that the iceberg is "3 times bigger under the water than above the water" (p. 4).

In addition, accounting-related litigation is on the upswing. According to a recent Cornerstone Research article, "In 2012, the proportion of securities class action settlements involving accounting allegations increased to almost 70 percent from less than 50 percent in 2011" (qtd. in Wilczynski, 2013).

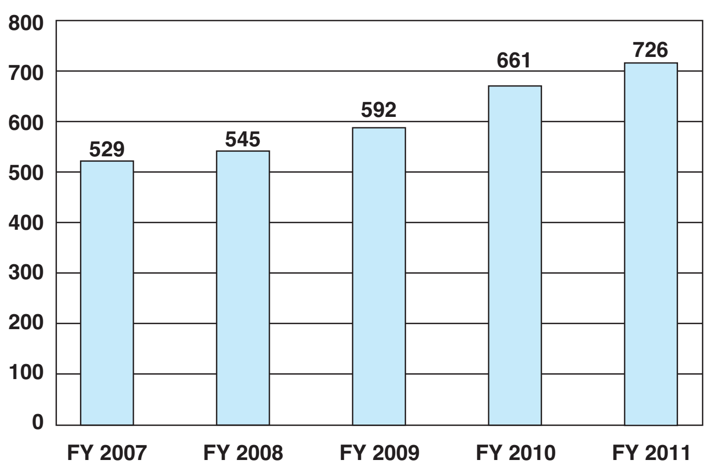

FIGURE 1.2 Corporate Fraud Pending Cases

Source: "Financial Crimes Report to the Public: Fiscal Years 2010–2011." (October 1, 2009–September 30, 2011). Federal Bureau of Investigation. *www.fbi.gov*

Increasingly, corporate frauds are also being exposed through the relatively new Dodd-Frank Whistleblower Program. According to the SEC, in 2012, the most frequent whistleblower complaints "related to corporate disclosures and financials" ("SEC Receives …," 2012). Clearly, in spite of increased regulations, accounting fraud remains a serious and persistent problem.

ACCOUNTING FRAUD AT THE TURN OF THE MILLENNIUM

At the turn of the millennium, the nation's attention was focused on the dangers of fictitious financial reports and the shortcomings of the financial reporting system as a result of the spectacular business and financial reporting failures of Enron and WorldCom.

Enron and WorldCom

In an Amended Complaint (May 1, 2003) charging Enron executives with fraud, the Deputy Director of the Enforcement Division of the SEC, Linda Chatman Thomsen, declared:

> At a point when Enron's touted groundbreaking broadband technology was little more than a concept—and its business model was not commercially viable—these defendants played important roles in perpetuating the fairy tale that Enron was capable of spinning straw—or more appropriately, fiber—into gold.

Within weeks of the beginning of Enron's meltdown in mid-October 2001, employees had lost over a billion dollars' worth of Enron stock in their 401(k) plans, stockholders had lost billions of dollars as the stock price fell from $60 per share to below $1, and debt holders were about to lose more than $3.9 billion that Enron owed them. On December 3, 2001, about 4,000 of Enron's employees were given notice to leave the company on the same day.

Unfortunately, Enron's accounting fraud was just one more case in an all-too-frequent litany of falsified financial reports that had grown in incidence over the 1990s and into the 21st century, when accounting fraud seemed to reach pandemic proportions. WorldCom's bankruptcy was soon to follow in 2002, and staggeringly, it topped Enron's[3].

In his *First Interim Report* (2002), Richard Thornburgh, WorldCom's Bankruptcy Examiner, presented a list of the gatekeepers who failed WorldCom. Thornburgh found failure by WorldCom's management and senior accounting staff and its internal control system, as well as failed checks and balances by the following gatekeepers:

- The board of directors, including general oversight failure as well as failures by the audit committee and the compensation and stock option committee
- The internal audit department
- The external auditors
- The investment banking company
- The investment banker's stock analyst

[3]However, six years later, in September 2008, Lehman Brothers became the largest bankruptcy in U.S. history and Washington Mutual became the second largest. WorldCom dropped to third place, and Enron's bankruptcy fell to sixth on the list (Ovide, 2011).