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**Financial Statement Fraud: Some Lessons from US and European Case Studies**

**Niamh M. Brennan and Mary McGrath**

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## **Abstract**

This paper studies 14 companies which were subject to an official investigation arising from the publication of fraudulent financial statements. The research found senior management to be responsible for most fraud. Recording false sales was the most common method of financial statement fraud. Meeting external forecasts emerged as the primary motivation. Management discovered most fraud, although the discovery was split between incumbent and new management.

*“An ounce of prevention is worth a pound of cure. In few other business contexts is that as true as with financial statement fraud”* (Young 2000, p. 211).

## **INTRODUCTION**

The term “red flags of fraud” is frequently found in books and articles on fraud (see, for example, Brennan and Hennessy 2001, ch. 3). Fraud is generally a hidden activity and fraudulent financial statements do not always come to light. This type of fraud can have very serious consequences for organisations: although the Association of Certified Fraud Examiners has found fraudulent financial statements to be the least commonly reported fraud, it had the highest median loss at \$US1 million (ACFE 2004). Financial statement fraud can be difficult to detect, is motivated by many different factors and is achieved in many ways. This paper attempts to identify “red flags” associated with reported cases of financial statement fraud. The research focuses on 14 case studies from the US and Europe.

Australia has not been free from financial statement fraud. In the case of HIH, one of the biggest business failures in Australian history, material misstatements of assets were not included by Arthur Andersen in the year-end proposed adjusting entries, and therefore were not included in their assessment of the truth and fairness of the financial statements. In National Australia Bank, staff concealed foreign-exchange trading losses through false transactions and systems’ manipulations which were not picked up by external auditors, resulting in misleading financial statements. KPMG’s 2004 survey of fraud in Australia found seven instances of financial statement fraud out of 206 usable responses (KPMG 2004a). KPMG was unable to quantify the losses from these frauds.

While Australian cases are not included in this paper, insights from the US and Europe may add knowledge in an Australia context. Sharma (2004), for example, found results for the relationship between fraud and governance variables in Australian companies similar to studies in the US, and that US research evidence was generalisable to an Australian environment.

### **Financial statement fraud**

Most jurisdictions do not have a specific crime of financial statement fraud. Perpetrators are charged with theft or the improper keeping of books and records depending on the nature of the fraud. Guy and Pany (1997) state that financial statement fraud differs from other frauds in that “fraudulent financial reporting is committed, usually by management, to deceive financial statement users while misappropriation of assets is committed against an entity, most often by employees” (p. 4).

This research uses the Treadway Commission’s definition of financial statement fraud (AICPA 1987): “Financial statement fraud is any intentional act or omission that results in materially misleading financial statements” (p. 8). While it could be argued that this definition is out of date, more recent definitions are not much different. For example, the definition of fraudulent financial reporting in paragraph 08 of Australian auditing standard (AUS) 210 is “. . . intentional misstatements including omissions of amounts or disclosures in the financial report to deceive financial statement users” (AARF 2004a).

It is often difficult to classify an act or omission as fraud, as the motivation behind the action must be considered. Brennan and Hennessy (2001, p. 61) point out: “The classification of an action as being fraudulent may depend on the motivation behind it (eg, was it deliberate or accidental?)” Similar to Beasley (1996) and Persons (2005), this research assumes that US firms subject to Securities and Exchange Commission (SEC) enforcement actions under Rule 10(b) have been involved in financial statement fraud in which the acts or omissions resulting in the fraud were intentional. While this is a simplification it is necessary, as intent is difficult to prove. This assumption is also applied to the European cases in this paper.

Young (2000) suggests that fraudulent financial reporting does not start with dishonesty; rather, it may begin with pressure to meet financial targets and a fear that failure to meet these targets will be viewed as unforgivable. Alternatively, the perpetrator of fraud may be driven by dishonesty and personal gain (for example, to protect bonuses) rather than by pressure from the organisation. This resonates with Cressey’s (1953) fraud triangle, which identifies three factors: private non-sharable incentives or pressures, contextual opportunities to commit fraud and ability to rationalise fraud. Cressey’s research was based on interviews with embezzlers, and without further research cannot be extrapolated to financial statement fraud.

Financial statement fraud tends to start small (KPMG 2004b). It begins in areas of generally accepted accounting practices (GAAP) which contain ambiguities (except for jurisdictions with very prescriptive accounting standards). Managers may exploit the ambiguities and available choices to present the financial picture that meets their financial targets. The dividing line between “earnings management” and “earnings manipulation” is narrow. Paragraph 10 of AUS 210 specifically comments on this pattern of starting out small, with pressures and incentives heightening the activity. Burns (1998) asked: “At what point does sharp practice become fraud?” (p. 38).

Once financial statement fraud has been committed it is difficult to stop, as most fraud techniques involve “borrowing” from one period and “loaning” to another period. With the passage of time, the amounts and number of people involved grow and the perpetrators can only continue to try to hide the fraud.

### **Justification for the research**

Research into fraud, and financial statement fraud in particular, is difficult as fraud is usually a hidden activity. Higson (1999) found management reluctant to report suspected fraud because of its imprecise definition, vagueness over directors’ responsibilities and confusion about the reason for reporting fraud. The Committee of Sponsoring Organisations of the Treadway Commission report found that most audit reports issued in the year prior to the fraud coming to light were unqualified (COSO 1999); therefore, qualified audit reports do not adequately quantify the impact of financial statement fraud. Fraud Advisory Panel (1999) figures suggest that UK fraud involving false accounting peaked in the early 1990s, falling until 1996 when reported cases of false accounting rose again, though not to the same level. Similar data available for Australia suggest that financial statement fraud peaks in times of recession (Fraud Advisory Panel 1999, p.18).

Despite the lack of quantitative evidence, consideration of the qualitative aspects of financial statement fraud can enhance our insights. This research will be useful to practitioners by highlighting management and organisational characteristics

associated with financial statement fraud and may help in early detection and prevention of fraud. Cases are evaluated by reference to the number of fraud factors present in official reports of the financial statement fraud and interrelationships of fraud factors for each case studied are analysed. Most previous case studies are based only on US cases. This paper contributes to the literature by including a sample of European as well as US cases. Clarke *et al* (2003) include case studies of Australian accounting scandals.

## **LITERATURE REVIEW**

### **Perpetrators of financial statement fraud**

A survey by the Association of Certified Fraud Examiners (ACFE 1997) found that 83% of the fraud losses studied involved owners or executive directors. Using the phrase “watch the insider”, Ernst & Young (2003) found that more than half of the perpetrators were from management.

While many individuals within companies have committed financial reporting fraud, most of the cases studied involved the CEO, president or chief financial officer (CFO) as the principal perpetrators (AICPA 1987). The COSO (1999) investigation of 200 companies in which financial statement fraud had been found showed that 72% of occurrences involved CEOs and 42% involved CFOs. The Auditing Practices Board (1998) also points to senior management involvement and states (p. 9) that most material fraud involves management.

### **Methods of financial statement fraud**

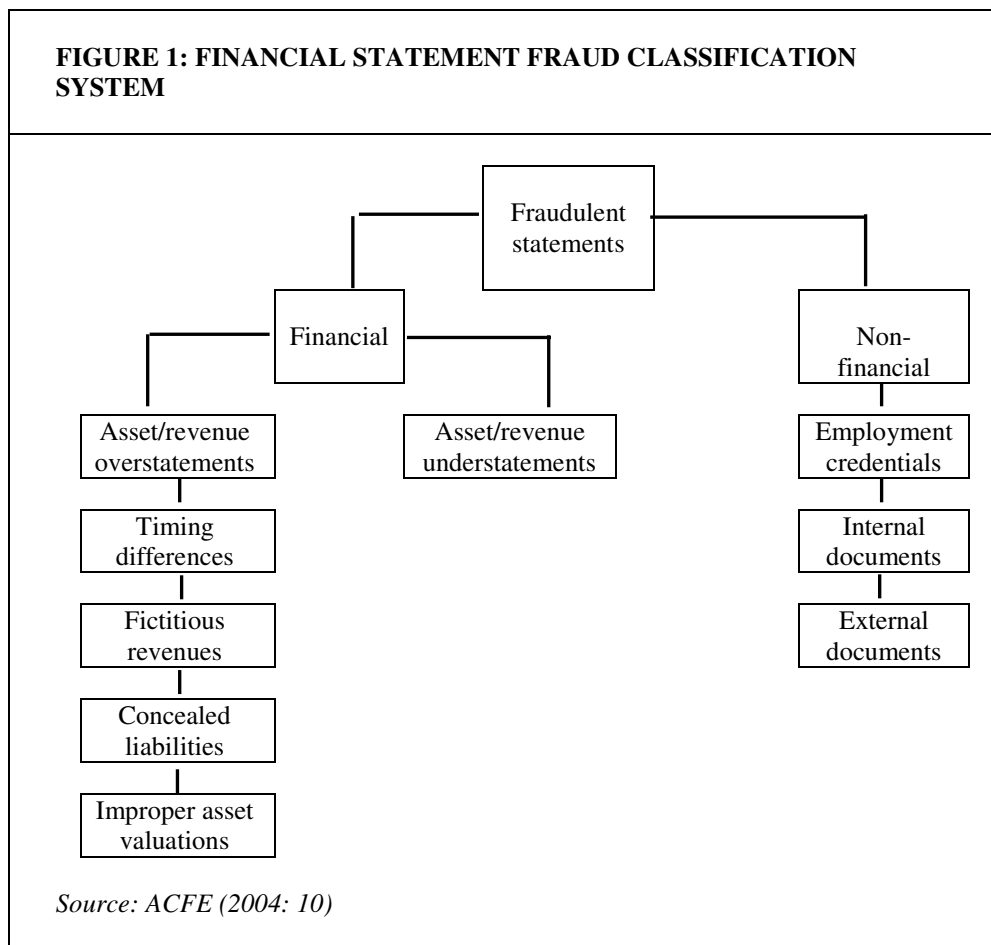
ACFE (2004, p. 10) has developed an occupational fraud classification system, shown in Figure 1.

Spathis (2002) identifies three methods of committing financial statement fraud:

- changing accounting methods;
- altering managerial estimates; and
- improper recognition of revenue and expenses.

Beasley *et al* (2000) investigated fraudulent financial reporting in the technology, healthcare and financial services sectors. The study found the most common types of fraud to be:

- improper revenue recognition; and
- asset overstatement.



### Motivations for financial statement fraud

Motivating factors cited for the involvement of management in fraudulent financial reporting include:

- compensation packages based on reported earnings. There is support in the literature for management compensation as a significant motivator of fraudulent financial reporting (eg, Watts and Zimmerman 1990, AICPA 1987), although there have also been contrary findings (Dechow *et al* 1996);
- desire to maintain or increase share prices;
- need to meet internal and external forecasts. When a firm is failing to achieve targets, there is incentive for management to falsify financial reports to meet them and protect share prices (Feroz *et al* 1991, Dechow *et al* 1996);
- desire to minimise tax liabilities (Spathis 2002);
- need to avoid violations of debt covenants. Dechow *et al* (1996) found that firms committing financial statement fraud had higher leverage than control firms. Spathis (2002) mentions the need to meet unrealistic commitments made to creditors as a motivation to commit fraud. The Treadway Report (AICPA 1987) found that the desire to postpone dealing with financial problems (and thus violating debt covenants) was a frequent incentive for fraudulent financial reporting; and
- desire to raise external capital cheaply.

Albrecht *et al* (2004) examine financial statement fraud from the perspective of four prevailing theories of management. They identify nine factors which together create the “perfect fraud storm”: a booming economy (which hid the fraud), moral decay,

misplaced executive incentives, unachievable expectations of the market, pressure of large borrowings, US rules-based accounting, opportunistic behaviour of audit firms, greed on the part of a wide variety of groups of people and educator failures. These nine factors are analysed by reference to the fraud triangle of pressure to commit fraud, opportunity to commit fraud, and inclination to rationalise fraud. They are also examined against agency and stewardship theories. Albrecht *et al* conclude from their analysis that managers who identify with a stakeholder perspective rather than with an agency theory perspective are less likely to commit fraud.

### **Organisational factors related to financial statement fraud**

Loebbecke *et al* (1989) designed a fraud prediction model based on conditions in the entity, manager motivation and manager attitude. Bell and Carcello (2000) used the same fraud sample as Loebbecke *et al* and contrasted it with a non-fraud sample in order to consider the presence or absence of “red flags” as assessed by auditors. Some organisational factors identified as likely contributors to fraudulent financial reporting include:

- weak control environment;
- rapid growth;
- inadequate or inconsistent profitability;
- management placing undue emphasis on meeting earnings forecasts; and
- ownership status (public or private companies).

Fama and Jensen (1983) hypothesise that the internal control function of the board of directors is increased by the inclusion of outside directors, who have an incentive to develop reputations as experts in decision control. Jensen (1993) argues that outside directors have a greater incentive to monitor top management when they hold substantial amounts of shares. Beasley (1996) found that certain characteristics of outside directors, such as the percentage of equity held, help reduce the incidence of financial statement fraud.

Audit committees form an important part of the internal control environment. Young (2000) describes the audit committee as the vanguard in the prevention and detection of financial statement fraud. However, Beasley (1996) found that the existence of audit committees does not significantly affect the likelihood of the occurrence of financial statement fraud. This may be attributed in part to the number of times the audit committee meets. Beasley found that in 35% of fraud firms and 11% of non-fraud firms in the research an audit committee had not met during the year. Dechow *et al* (1996) found that firms subject to fraud are less likely to have an audit committee.

Beasley *et al* (2000b) investigated corporate governance differences in a sample of fraud and non-fraud firms. They found that fraud firms were less likely to have an audit committee. Where one existed in a fraud firm, it tended to be less diligent and less independent; non-fraud firms had more outside directors on the audit committee than fraud firms. They also found that internal audit departments were less common in fraud firms.

### **Detection of financial statement fraud**

APB (1998) concedes that management fraud is difficult to detect during a financial audit because of management’s unique ability to conceal the fraud. Auditors discovered 84% of the fraud cases examined by Loebbecke *et al* (1989). Financial statement fraud may be discovered when the auditor becomes suspicious about false



accounting or a lack of management explanation regarding transactions and balances. However, it is often discovered because of the company's difficult financial circumstances, which may ultimately bring about the firm's failure. Johnson *et al* (1993) examine what kinds of knowledge help the successful detection of financial statement fraud. Summers and Sweeney (1998) found auditors could increase the likelihood of detecting fraudulent financial reporting by including insider trading in their detection model. Also taking an auditor perspective, Chen and Sennetti (2005) try to develop a model to predict fraudulent financial reporting. They identify common fraud characteristics in a group of 52 computer companies accused of financial statement fraud. They find fraud firms have larger stock-option tax benefits and, compared with sales, lower research and development expenditures, lower marketing expenditures and smaller changes in free cashflow.

#### *Time to discovery*

The average length of time taken to discover financial statement fraud varies among studies. Summers and Sweeney (1998) found the average period from fraudulent actions to discovery was three years. Table 1 shows that the time taken to discover fraudulent financial statements varies with each individual case.

<b>TABLE 1: TIME TO DISCOVERY OF FINANCIAL STATEMENT FRAUD</b>	
<b>Number of firms</b>	<b>Time to discovery</b>
19	3 months
50	1 year
10	2 years
<i>Adapted from Dechow et al (1996)</i>	

#### *Management and the reporting of financial statement fraud*

Higson (1999) found that there was a distinct reluctance to report fraud and that few companies had policies for dealing with discovered fraud. The main motivation for reporting financial statement fraud was to deter others. Disciplinary action was found to be the most popular deterrent, as prosecution or loss recovery was expensive and troublesome.

#### **Outcomes arising from fraud**

Outcomes arising from fraud or its discovery are considered from the perspectives of the victim firm, the perpetrator, actions of official investigators and of the external auditor.

#### *Effect of fraud on the firm*

The immediate result for the company is a serious drop in share price once the financial statement fraud becomes public. Dechow *et al* (1996) found an average share-price drop of about 9% when allegations of financial statement fraud were first announced. Not all firms can survive once the financial statement fraud is discovered. The COSO report (1999) found that consequences for the company included bankruptcy, significant changes in ownership, financial penalties and delisting by stock exchanges. More than 50% of the sample firms went bankrupt or experienced

significant changes in ownership. Twenty-one percent of the firms were delisted by a national stock exchange.

#### *Effect of fraud on the perpetrator*

Consequences for the individuals involved in the fraud are also severe. When accounting irregularities come to light in the US, class-action suits and investigation by the SEC may follow. COSO (1999) reports that individual senior executives of the sample firms were subject to class-action legal suits and SEC actions resulting in personal financial penalties. A large number were sacked or forced to resign. Few, however, admitted guilt or were jailed.

#### *Official investigations into fraudulent financial reporting*

In the US, allegations of fraud can be investigated by the SEC where the companies involved come under the Commission's supervision. Feroz *et al* (1991) point out that the SEC has more targets than it can cope with and, because investigations are costly and highly visible, undertakes investigations only where there is a high probability of success.

In contrast to the US, class-action suits are not common in the UK, where financial statement fraud is more likely to result in criminal prosecution. The Serious Fraud Office (SFO), which is part of the UK criminal justice system, investigates and prosecutes cases of serious or complex fraud, including financial statement fraud. As in the US, the SFO investigates cases only where there is a high probability of success and, because of the cost and time involved, only where the fraud results in a loss of more than £1 million; "smaller" cases will not be officially investigated.

#### *External auditor and fraud*

Palmrose (1987) studied the relationship between business failures or management fraud and legal actions brought against auditors. The findings show that nearly half the cases of alleged audit failure relate to the economic climate — auditor litigation increases with economic recession. Actions against auditors are more likely in cases of audit failure when management fraud is involved, possibly because auditors are seen to represent deep pockets from which investors and creditors can recover their losses.

## **RESEARCH QUESTIONS**

The purpose of the research is to consider documented cases of financial statement fraud and to note any commonalities. Six questions are addressed:

1. Who is committing financial statement fraud?
2. How is financial statement fraud perpetrated?
3. What are the motivations for financial statement fraud?
4. Are there any organisational factors related to financial statement fraud?
5. How and why is financial statement fraud detected?
6. What was the outcome for the perpetrators and their victims?

## RESEARCH METHODOLOGY

### Case selection

Fourteen companies are analysed in the research — nine US and five European.

The nine US companies were selected following a search of the SEC's Accounting and Auditing Enforcement Releases (AAER) relating to violations of Rule 10-b of the Securities and Exchange Act 1934 and Section 17(a) of the Securities Act 1933. These are the main rules relating to financial statement fraud. The AAER are available on-line at [www.sec.gov](http://www.sec.gov).

The European cases are UK companies with the exception of Lernout and Hauspie (L&H), a Belgian company. The main source for the European cases was the financial press. The SFO website, [www.sfo.gov.uk](http://www.sfo.gov.uk), provided a summary of the results of successfully prosecuted cases.

Table 2 lists the official names of the companies used as case studies.

TABLE 2: COMPANIES USED IN THE RESEARCH
<b>US cases</b> Livent Inc Sunbeam Corporation Cendant Corporation Kurzweil Applied Intelligence Inc Automated Telephone Management Systems Inc (ATM) Waste Management Inc Aura Systems Inc Xerox Corporation Cypress Bioscience Inc
<b>European cases</b> Wickes Group MTM Plc Powerscreen International Lernout and Hauspie Speech Products (L&H) Azlan Group
<i>A detailed appendix which is available on request contains a summary of each of the 14 cases.</i>

### Steps in assessing case studies

The approach to assessing the case studies is that suggested by Ryan *et al* (1992). Cases were deemed suitable for inclusion in the research where information about methods and motives was on the public record and where persons involved in the fraud had been publicly identified. The main source was documented evidence from SEC and SFO reports. Secondary evidence such as newspaper reports and articles was also used.

Each case was analysed for recurring results, using the six research questions. The results were brought together in Table 7, which shows the interrelationship of all factors relating to financial statement fraud for each of the 14 case studies. Using

totals to summarise the evidence, the companies were ranked by the number of factors found.

## RESULTS

Results for each of the six research questions are presented separately in Tables 3-6 and 8-10. The results are brought together in Table 7, ranking the cases according to the number of fraud factors. This shows that factors relating to financial statement fraud are inter-linked, and that fraud does not occur in a vacuum.

### Perpetrators of financial statement fraud

As Table 3 shows, senior management was responsible for the financial statement fraud in most cases. This is due to senior management's ability to override controls and direct others to commit and conceal the fraud. Others responsible included sales director, trading director, finance director, chief operating officer and a managing director who was also one of the company founders. These are all senior positions in the control structure of the firms. Most of the senior accounting staff held responsible were qualified accountants.

<b>TABLE 3: PERPETRATORS OF FINANCIAL STATEMENT FRAUD</b>		
<b>Perpetrator</b>	<b>Number of cases</b>	<b>Percentage of 14 cases studied</b>
<b>Internal perpetrators</b>		
<u>Senior management</u>		
CEO/Vice-president	12	86%
Chairman/President	9	65%
CFO/Finance director	7	50%
Entire senior management	4	29%
Senior legal officers	2	14%
<u>Accounting staff</u>		
Senior accounting staff	9	64%
Middle accounting staff	2	14%
Junior accounting staff	1	7%
<u>Non-senior staff</u>	3	21%
<u>Others</u>	5	36%
<b>External perpetrators</b>		
Auditors	2	14%
Other outsiders	2	14%

In two cases the auditors were held responsible for not detecting the fraud or for not taking appropriate action in relation to the fraud. On one occasion, the audit partner alone was deemed responsible as he knew (or should have known) of the fraud. In the other case the entire audit firm was held responsible, as all those involved in the audit knew of the fraud and yet the auditors gave an unqualified audit report. It has long been the view that auditors are watchdogs, not bloodhounds, and are not expected to detect fraud (*Kingston Cotton Mill Company (No. 2)* (1896) Ch 279, at 288–9). More recent case law suggests that auditors take into account the circumstances of the individual business (eg, *Pacific Acceptance Corporation Ltd v. Forsyth* (1970) 92 WN

(NSW) 29), and the possibility of fraud (*WA Chip & Pulp Pty Ltd v. Arthur Young & Co.* (1987) 12 ACLR 25) (Tomasic 1992). AUS 210 now requires auditors to conduct audits so as to have a reasonable expectation of detecting material misstatements arising from fraud or error.

In each case, more than one individual was involved, which is why the number of cases in Table 3 is greater than the number of cases researched.

### Methods of financial statement fraud

Table 4 shows the most common method of financial statement fraud to be the inflation of revenue. Different methods of revenue inflation were used, the most popular being forging sales, used in 57% of cases. Asset-intensive firms such as Xerox manipulated depreciation provisions, while revenue-rich firms such as Wickes and Cypress falsified sales. Results suggest that each firm will commit fraud however and wherever it is easiest to commit and conceal. Other methods used include:

- recording false profits on disposals;
- side agreements relating to sales;
- entering sales agreements which produce no profit, solely to increase revenue;
- offsetting gains against losses not previously recorded; and
- manipulating lease agreements.

TABLE 4: METHODS OF FINANCIAL STATEMENT FRAUD		
Methods	Number of cases	Percentage of 14 cases studied
<b>Inflating revenue</b>		
False/forged sales	8	57%
Recognition of incomplete sales	4	29%
Misclassifying sales	3	21%
Early recognition of rebates from suppliers	2	14%
<b>Others</b>		
Deleting expenses from the books	2	14%
Creating secret reserves through restructuring charges	2	14%
Incorrect valuation of stock	2	14%
Under-providing for depreciation	3	21%
Others	5	36%

In some cases more than one method was used, which is why the number of cases in Table 4 is greater than the number of cases researched.

### Motivations for financial statement fraud

As shown in Table 5, influencing share prices to meet external forecasts, or for personal gain, was the most common motivation for the fraud. Where personal gain is cited, it was the overriding motivation for the fraud. In every such case, the perpetrators gained from their actions, whether it be promotion, keeping a job, gaining favour with senior personnel or receiving increased bonuses. However, in 43% of cases, personal gain was the sole reason for the perpetrators' publishing misleading financial reports. Even where the pressure to meet external forecasts was cited as the motivation, it is not clear that personal gain was not also involved. It would be

interesting to study share dealings by directors and executives before the fraud came to light, to test whether individuals made personal gains.

Most of these individuals were found guilty of insider trading or of obtaining bonuses unlawfully and were forced to repay their gains. The motivation for the fraud was not explicit in some cases and where this occurred the motivation was deduced from the perpetrator's gains and the outcome of the official investigation.

In some cases there was more than one motivation, which is why the number of cases in Table 5 is greater than the number of cases researched.

<b>TABLE 5: MOTIVATIONS FOR FINANCIAL STATEMENT FRAUD</b>		
<b>Motivations</b>	<b>Number of cases</b>	<b>Percentage of 14 cases studied</b>
<b>Influence stock prices</b>		
Meeting external forecasts	6	43%
Personal gain	6	43%
Success of Initial Public Offering (IPO)	2	14%
Increase value of firm by inflating stock prices	2	14%
<b>Others</b>		
Loyalty to the organisation	1	7%
To make new strategy succeed	1	7%

### **Organisational factors related to financial statement fraud**

Each company had a weak control environment, as shown in Table 6. The presence of this factor is necessary for any type of financial statement fraud to occur. Details of audit committee activity were not available for every case. Further research into the composition of the board of directors could enable a more detailed analysis of organisational factors relating to financial statement fraud. The research did not uncover evidence on the independence of the board of directors in every case. Individuals were classified as having too much power when they held more than one senior position in the organisation, such as vice-president and CFO. Boards of directors and audit committees were classified as weak where they were not independent or were controlled by one or a few individuals.

In each case, more than one organisational factor was related to the fraud, which is why the number of cases in Table 6 is greater than the number of cases researched.

<b>TABLE 6: ORGANISATIONAL FACTORS RELATED TO FINANCIAL STATEMENT FRAUD</b>		
<b>Organisational factors</b>	<b>Number of cases</b>	<b>Percentage of 14 cases studied</b>
Weak internal control	14	100%
Culture of meeting targets	6	43%
Too much power held by one person	5	36%
Weak audit committee	4	28%
Weak board of directors	3	21%

### **Case analysis summary**

The 14 cases have been analysed individually. However, it is important to extract a broader picture by analysing all 14 cases together. All factors relating to the fraud (shown in Tables 3 to 6) were summarised and listed by company in Table 7. For each of the 14 cases, a mark is recorded where the fraud factor was present. In all cases, the fraud involved the presence of a large number of fraud factors, ranging from 14 in Livent, Sunbeam and Cendent to six factors in Azlan.

Generally, the more people involved in the fraud, the greater the number of methods employed and the greater the number of outcomes. Livent emerges as having had the worst case of financial statement fraud. US cases tended to have more fraud factors than European cases. The worst European case (Wickes) ranked only seventh. The three cases with the least number of fraud factors were all European. It is difficult to know whether this is due to differences in the business environments or the regulatory regimes (there may be differences in enforcement strategy between the SEC and the SFO), or due to the thoroughness of reporting of fraud in the US compared with Europe.

**TABLE 7: RANKING OF CASES BASED ON FRAUD FACTORS**

	Livent	Sunbeam	Cendant	Kurzweil	ATM	Waste Mgt	Wickes	Aura Systems	Xerox	MTM	Cypress Bioscience	Powerscreen	L&H	Azlan	Total
<b>Perpetrators of financial statement fraud (Table 3)</b>															
CEO/vice-president	•	••	••	•	•	•		•			•	•	•		12
Chairman/president	•	•	••		•		•	••		•					9
CFO/finance director		•	•	•			•			•	•			•	7
Entire senior management	•			•		•			•						4
Senior legal officers	•	•													2
Senior accountants		•	•	•	•	•	•	•			•	•			9
Middle accounting staff	•			•											2
Junior accounting staff	•														1
Non-senior staff							•		•					•	3
Others			•	•	•		•						•		5
Auditors		•				•									2
Other outsiders					•			•							2
	6	7	7	6	5	4	5	5	2	2	3	2	2	2	58
<b>Methods of financial statement fraud (Table 4)</b>															
False/forged sales	•		•	•	•			•		•		•	•		8
Recognition of incomplete sales		•		•	•						•				4
Misclassifying sales			•						•			•			3
Early recognition of supplier rebates		•					•								2
Deleting expenses from books	•					•									2
Creating secret reserves through restructuring charges			•						•						2
Incorrect valuation of stock		•												•	2
Under-providing depreciation	•					•			•						3
Others	•				•	•		•		•			•		5
	4	3	3	2	2	3	1	2	3	2	1	2	2	1	31
<b>Motivations for financial statement fraud (Table 5)</b>															
Meeting external forecasts			•						•	•	•	•		•	6
Personal gain	•		•		•		•			•			•		6
Success of IPO				•	•										2
Inflate stock prices		•				•									2
Loyalty to the organisation				•											1
Success of strategy								•							1
	1	1	2	2	2	1	1	1	1	2	1	1	1	1	18
<b>Organisational factors related to financial statement fraud (Table 6)</b>															
Weak internal control	•	•	•	•	•	•	•	•	•	•	•	•	•	•	14
Culture of meeting targets		•	•	•					•			•		•	6
Too much power by one person	•			•						•	•		•		5
Weak audit committee	•				•	•	•								4
Weak board of directors		•				•	•								3
	3	3	2	3	2	3	3	1	2	2	2	2	2	2	32
<b>Total</b>	<b>14</b>	<b>14</b>	<b>14</b>	<b>13</b>	<b>11</b>	<b>11</b>	<b>10</b>	<b>9</b>	<b>8</b>	<b>8</b>	<b>7</b>	<b>7</b>	<b>7</b>	<b>6</b>	<b>139</b>



### Discovery of financial statement fraud

As shown in Table 8, the length of time to discovery varied between one and five years, with only one fraud incident discovered within one year and three not discovered for more than five years. The person discovering the fraud did not bear any relation to the time taken to discover it, contrary to expectations.

TABLE 8: TIME TO DISCOVERY		
Time period	Number of cases	Percentage of 14 cases studied
< 1 year	1	7%
1 – 5 years	9	64%
≥ 5 years	3	21%
unknown	1	7%

Table 9 shows that management discovered the fraud in five cases. In 21% of cases, the fraud was uncovered when new management was appointed. Incumbent management who became aware that other members of management were “cooking the books” uncovered 14% of the frauds. In most of these cases, junior staff involved confessed to management that they had participated in the fraud scheme.

TABLE 9: DISCOVERY OF FRAUD		
Discovery of fraud	Number of cases	Percentage of 14 cases studied
<b>Internal discovery by:</b>		
New management	3	21%
Incumbent management	2	14%
<b>External discovery by:</b>		
Public allegations of fraud lead to internal investigation	3	21%
Auditors	3	21%
Failed rights issue	1	7%
SEC notice discrepancy between press release and filed accounts	1	7%
Unknown	1	7%

Only in 21% of cases was the fraud discovered by the external auditor. In 3 cases (21%) the fraud was highlighted by allegations in newspapers and other public forums. These public allegations led to internal investigations into the possibility of financial statement fraud, followed by public admission that the financial reports were fraudulent. Pizzani (2004a and 2004b) has analysed some of these public allegations. In the case of Sunbeam, the fraud was first stumbled upon by a journalist, with the assistance of an academic. In the case of Xerox, the SEC launched an investigation into rumours of irregularities, possibly started by an internal whistleblower. The *Wall Street Journal* brought the Lernout and Hauspie case to public attention (Carreyrou and Maremont 2000). In the case of ATM, how the fraud was discovered is not clear from the SEC reports.

### **Outcome for the victims and perpetrators**

Only cases where the fraud had been proved by an official body, either the SEC or the SFO, were used in the research (see Table 10). The Belgian company L&H was prosecuted by the Belgian courts and its US division and at the time of the research was still under investigation by the SEC. Most perpetrators were ordered by the SEC/SFO not to violate anti-fraud laws again. Those perpetrators who were also accountants were prevented from appearing in front of the SEC again as practising accountants for between three to five years. Prison sentences were imposed in only four cases. Monetary penalties imposed mainly related to the repayment of illicit gains such as profits from insider trading or bonuses received due to fraudulently increased earnings.

All companies except one (which closed soon after the discovery of the financial statement fraud) issued re-stated financial reports for the fraud periods. Three companies filed for bankruptcy protection as a direct result of the fraud. Others would have been forced to do the same had not their bankers refrained from foreclosing lines of credit.

Although auditors were held responsible in two cases of financial statement fraud, at the time of the research only one audit firm had been fined. Arthur Andersen was fined \$7 million for unprofessional conduct in the case of Waste Management. At that time, this was the largest penalty to be awarded against an auditor in a case of fraudulent financial reporting. In the second case, KPMG was held responsible in respect of the audit of Xerox. In April 2005 (after the conduct of this research), KPMG arrived at the largest-ever settlement with the SEC of \$22 million. (Subsequently, in August 2005 KPMG settled with the SEC for \$456 million in respect of tax-shelter fraud.) In 86% of cases, the auditors were deceived by their clients yet only two auditors took action against their clients. In both of these cases the auditors themselves are being sued by shareholders.

Only in the case of Cendant Corporation was the shareholders' lawsuit against the auditors completed at the time of the research.

In each case there was more than one outcome as a result of the fraud, which is why the number of cases in Table 10 is greater than the number of cases researched.

### **IMPLICATIONS AND CONCLUSIONS**

Financial statements are the responsibility of company directors. In 71% of cases studied the CEO or chairman was responsible for the fraud. Prevention of financial statement fraud must therefore begin at board level, and especially at executive director level.

#### *Tone at the top*

The "tone at the top" refers to the attitude of top management towards the financial reporting process. The Australian Stock Exchange (2003) makes it clear that boards of directors are responsible for setting the tone at the top. The correct tone is an unrelenting insistence that the numbers are truthful and are never massaged for any purpose. Once such an attitude is established at the top it must be communicated to every division, every department and every individual throughout the organisation.

Without the right attitude, internal controls are less effective. Maintaining the right attitude in the control environment requires continuous vigilance, as fraud generally starts small, within the grey areas of accounting rules. While the tone required at the top is one of unrelenting truthfulness, the specifics of achieving this vary among firms.

**TABLE 10: OUTCOME FOR PERPETRATORS AND THEIR VICTIMS**

<b>Outcome</b>	<b>Number of cases</b>	<b>Percentage of 14 cases studied</b>
<b>Perpetrators</b>		
Perpetrators prosecuted by the SEC/SFO	11	79%
Case investigated by SFO but no charges brought	1	7%
Investigation by SEC not completed at time of research	2	14%
Perpetrators receive prison sentences	4	29%
Company disciplined staff members involved	3	21%
Perpetrators receive monetary penalties	3	21%
<b>Company</b>		
New management employed as a result of fraud	10	71%
Company taken over as a direct result of the fraud	2	14%
Company bankrupt due to fraud	3	21%
Company no longer in existence	1	7%
Company closed but re-formed under new name	1	7%
<b>Auditors</b>		
Auditors sue company for concealing fraud	2	14%
Auditors are held responsible for the fraud and fined	1	7%
<b>Shareholders</b>		
Sue company, auditors and perpetrators for loss of investment.	4	29%

#### *Audit committee and internal audit*

Most stock exchanges now require listed companies to have an audit committee (eg, US SEC Section 10A(m)(1) of the Securities and Exchange Act 1934, Principle C3.1 UK Combined Code (Financial Reporting Council (FRC) 2006), Principle 4 Australian Stock Exchange 2003). However, the composition and operation of audit committees is often not prescribed. Research shows that existence of the committee alone is not sufficient to prevent fraud, although fraud is less likely where there is an audit committee (Beasley 1996). To be effective, the audit committee must be independent, meet regularly and have financial expertise (Farber 2005). Many stock exchanges require audit committees to be composed of non-executive directors only. The committee should have a written charter, outlining its duties and responsibilities. To be effective, the audit committee must have the technical knowledge to identify when things are going wrong. The UK Combined Code requires at least one member of the audit committee to have financial expertise (FRC 2006). The Australian Stock Exchange suggests in its guidance (but does not explicitly require) audit committee members to possess appropriate technical competence. Finally, the audit committee must be willing to give as much time as is necessary to their duties. There need be no set number of meetings in a year; rather, the financial reporting process of the firm will determine how much effort is required from the audit committee.

The internal audit, like the audit committee, needs to be able to function without interference from management. Detailed guidance on internal audit standards is provided by the Institute of Internal Auditors in Australia (<http://iia.asn.au>). Internal audit has an advantage over external auditors, being continuously present in the organisation and thus better able to form a judgment about the control environment. Good communication between internal audit and external auditors is expected.

#### *Capability of accounting department*

The accounting department should be adequately staffed to enable the division of duties. Staff should have the technical knowledge necessary to fulfil their tasks. The accounting department does the work and preparation behind the financial statements; if it lacks the necessary skills, the likelihood of fraud occurring increases dramatically. The issue of human resources, training and competence is referred to in AUS 402 in relation to external auditors' assessments of risk (AARF 2004b). Many corporate governance regulations require the audit committee to ensure the internal audit function is adequately resourced, but the requirement tends not to extend to the accounting staff generally.

#### **Implications for external auditors**

Auditing standards have been strengthened and auditors carefully assess the risks of fraud, taking into account the control environment and the general quality and the independence of the board of directors and audit committee. Auditors nowadays also spend more time examining the control environment and focus on areas which can easily be manipulated, such as revenue recognition. In the light of the findings of this study, auditors should consider any unusual revenue patterns in their efforts to detect fraud. Revenue increases before the end of a quarter, or revenue patterns that do not fit the business cycle, could be an indication of something untoward. The auditor should also consider any unusual or unjustified reserve movements, not just at year-end but also throughout the year. Reserves that are based on subjective judgments alone warrant extra consideration.

When deciding whether adjusting errors are material, auditors need to consider the qualitative, as well as quantitative, aspects of materiality (see Brennan and Gray 2005 for a review of the concept of materiality). An abuse of the concept can lead to "nonmaterial adjustments" not being made, leading to misleading financial statements

#### **Implications for regulators**

##### *Legislation*

Much recent regulatory change, such as Australia's Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (CLERP 9), the Australian Stock Exchange's corporate governance principles and the US Sarbanes-Oxley Act 2002, has been aimed at improving the integrity and transparency of financial reporting (KPMG 2004b). The bar has been significantly raised from a regulatory point of view in many jurisdictions. This has led to many complaints from business that it is over-regulated. The collapse of Refco in the US in October 2005 perhaps illustrates the truism that no amount of regulation can prevent fraud. Some argue that the substantial extra cost of Sarbanes-Oxley exceeds its benefits to society (eg, Zhang 2005) but the evidence is mixed on this point (Leuz *et al* 2004).

### *Enforcement*

In many of the cases studied in this paper, there were numerous warning signs. Many with responsibilities for reacting to or dealing with red flags chose not to do so. This may suggest that regulations are not taken seriously enough by responsible parties. Regulators may need to re-focus their attention away from imposing further regulatory burdens on companies, and towards ensuring that the regulations on the books are actually enforced. It could be argued that passivity by regulators and other responsible parties could amount to collusion in cases of fraud.

### *Continuous disclosure*

Young (2000) suggests that the current financial reporting process, by producing information only quarterly or annually in some jurisdictions, is failing to meet the needs of the financial markets. The markets demand instantaneous non-stop information, and the gap is filled by financial analysts whose earnings predictions are based on their knowledge of the firms' activities. The financial markets respond to quarterly or annual results only when they fail to coincide with the analysts' predictions. Given that the research found meeting external analyst's forecasts to be a motivation for fraud in 43% of cases, there is support for his argument. Perhaps regulators need to consider ways to reduce the pressure on companies to match analysts' targets.

Continuous disclosure rules were introduced in 1994 by The Australian Stock Exchange, requiring the immediate announcement of material price-sensitive information known to the directors. Enactment of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act on 30 June 2004 significantly enhanced the enforcement of these continuous disclosure rules by introducing on-the-spot fines of up to \$1 million and extending liability beyond listed entities to include individuals involved in breaches of the rules. It would be naive to expect these rules to eliminate the management of earnings in attempting to meet analysts' forecasts, but they may restrain the degree of aggressiveness applied in doing so.

### **Limitations and further research**

This research is subject to a number of limitations. First, the findings are based on a small number of cases. Research could use a greater variety of case studies from different countries to provide a greater contrast of financial statement fraud incidents, methods and motives in various financial markets. The use of more cases would produce results capable of greater generalisation. Second, the research is based only on published data. Interviews with market participants could yield enhanced insights.

It would be interesting to research in greater detail the organisational factors influencing financial statement fraud. Since each company studied was registered on a stock exchange, it would be possible to obtain detailed information on the directors' tenure, experience, personal connections with the company and compensation. This could be investigated in connection with the independence of the board of directors and the audit committee.

Most previous research is based on US data. This study included European cases. The relationship between regulation and financial statement fraud in different jurisdictions requires more careful analysis. Such research might assist in answering the common question from business: Are companies over-regulated?

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