Financial fraud: Accounting theory and practice
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ESSAY

FINANCIAL FRAUD: ACCOUNTING THEORY AND PRACTICE*

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SECURITIES INVESTMENT MODEL

Investors purchase equity securities in the expectation that their investments will increase in value two ways – through dividends and through appreciation in the market value of the securities. Market value can be influenced by many factors, but in the main the value of equity securities is based upon the profitability of the enterprise. Value may be measured and predicted by: (a) consideration of past (i.e., historical) performance; (b) assessment of current results of operations and financial condition; and (c) evaluation of likely future results. Some metrics of corporate performance – past, present, and future – are accounting measures, such as:

- Revenue and revenue trends
- Profit margins
- Earning and earnings trends
- Cash flows from operations and expected future cash

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flows

Other indicators of potential value may include: known or anticipated market success of products and services; market share; competitive factors (such as intellectual property rights, management quality, customer base, channel of distribution, or effectiveness of supply chain and manufacturing resources); and technological advantage. These value indicators are proxies for operating results, in that they are expected to result in increased value of equity securities because of their inherent ability to create revenue growth, control costs and expenses, achieve supererogatory profit margins, and – ultimately – obtain increased profitability.

Risk is a factor in all equity investments. The most basic risk is that future outcomes – in terms of results of operations, profitability, and share value – will not meet expectations. Risk also may be associated with volatility of revenues or any other accounting metric, or of underlying stock value, or with uncertainties relating to: exogenous economic factors; markets, market share, and competitive behavior; liquidity and the ability to produce and sustain necessary cash flows (and obtain necessary financing); management judgment; and changes in technology and in customer preferences.

Investors use financial information to assess operating results, make judgments about probable future performance, and evaluate non-accounting factors within the framework of a microeconomic and financial model of the enterprise in which an investment might be made. Thus one of the greatest risks to investors is the risk that the financial information upon which they rely is materially misstated. Financial information may be misstated erroneously or intentionally. When such financial information is misstated by any scheme, artifice, or device with the intent to mislead investors, this is a form of financial fraud.

OVERVIEW OF FINANCIAL INFORMATION

The basic form of financial information used in U.S. capital markets is general purpose financial statements, which include balance sheets (or statements of financial condition); profit and

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loss statements (also known as "P&Ls", or statements of operations); statements of changes in equity; statements of cash flows; and footnotes that provide additional information concerning: (a) accounting policies and procedures used to prepare the financial information contained in the financial statements; (b) the nature and composition of balances shown in the financial statements; and (c) other significant matters requiring disclosure in order for the financial statements to *present fairly* the results of operations and financial condition of the reporting entity. Most U.S. securities registrants are required to file certain financial information with the Securities and Exchange Commission ("SEC") in various annual, quarterly, and periodic filings, including Annual Reports on Form 10-K and Quarterly Interim Reports on Forms 10-Q.[1] A company's Annual Report on Form 10-K also is required, by SEC rules and regulations, to include additional and supplemental information in the nature of: (a) certain statistical information; (b) descriptions of the company's business, products and services, plant and properties, major operating units and their locations, and significant risk factors; (c) management's discussion and analysis of operations (also known as "MD&A"); (d) an assessment of liquidity and liquidity risks; and (e) certain supplementary schedules (e.g., a schedule of valuation reserves and loss accruals). Quarterly Interim Information on Forms 10-Q contain condensed financial information and abbreviated footnote disclosure, and they are presented to be used in conjunction with the more detailed disclosure set forth in an entity's Annual Report. Any other material financial disclosures – typically those that might occur during periods between annual and quarterly reporting dates – may be reported in the form of press releases (e.g., preliminary earnings releases) or on Form 8-K.

Generally accepted accounting principles ("GAAP") represent a body of authoritative guidance, promulgated by one or more of the following:

- Financial Accounting Standards Board ("FASB")
- Accounting Principles Board ("APB"), which was the predecessor to the FASB

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1. *See* 17 C.F.R. 240.13a-1 (2000); 17 C.F.R. 240.13a-13 (2000).

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- American Institute of Certified Public Accountants, usually through its AICPA Accounting Standards Executive Committee ("AcSEC")
- Emerging Issues Task Force ("EITF") of the FASB

Such authoritative guidance may be in the form of FASB Statements of Financial Accounting Standards ("SFAS"); APB Opinions ("APB"); AICPA Statements of Position ("SOP"); EITF Issues ("EITF"); APB Interpretations ("AIN"); FASB Interpretations ("FIN"); FASB Technical Bulletins ("FTB"); or FASB Statements of Financial Accounting Concepts ("CON"). Also, SEC guidance, usually in the form of Staff Accounting Bulletins (or "SABs"), provides insights on the SEC Staff's interpretation of GAAP. AICPA Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, correlates the concept of *present fairly*, in respect of financial statements, with GAAP, as follows:

> [J]udgment concerning the "fairness" of the overall presentation of the financial statements should be applied within the framework of generally accepted accounting principles. Without this framework, the auditor would have no uniform standard for judging the presentation of financial position, results of operations, and cash flows in financial statements.[2]

SEC Financial Reporting Practices ("FRP") Section 101 (Accounting Series Release, or "ASR" 4, April 25, 1938) states:

> In cases where financial statements filed with the Commission pursuant to its rules and regulations under the Securities Act or the Exchange Act are prepared in accordance with accounting principles for which there is *no substantial authoritative support*, such financial statements will be *presumed to be misleading or inaccurate* despite disclosures contained in the certificate of the accountant or the footnotes to the statements provided the

2. THE MEANING OF PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IN THE INDEPENDENT AUDITOR'S REPORT, Statement on Auditing Standards No. 69 (Amer. Inst. of Certified Pub. Accountants 1992).

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> matters involved are material [emphasis added].[3]

And SEC FRP Section 150 (ASR 150, December 20, 1973) states:

> In the exercise of its statutory authority with respect to the form and content of filings under the Acts, the Commission has the responsibility to ensure that investors are provided with adequate information. *A significant portion of the necessary information is provided by a set of basic financial statements (including the notes thereto) which conform to generally accepted accounting principles* [emphasis added].[4]

Thus, by definitions of both the AICPA and the SEC, financial statements that do not conform to GAAP are not *presented fairly* and are presumed to be misleading or inaccurate.

OVERVIEW OF FRAUD IN FINANCIAL STATEMENTS

Fraudulent financial information typically takes the form of material misstatements intentionally (or recklessly) made in one or more of the above types of reports. The most common media are the annual and/or quarterly financial statements. Such misstatements generally involve: (1) overstatement of revenues; (2) understatement of expenses; (3) overstatement of assets; (4) omission of liabilities; (5) mischaracterization of, or failure to disclose, transactions, accounting events, or other information material to a fair presentation of the reported results of operations; and/or (6) materially misleading disclosures in respect of: (i) MD&A; (ii) liquidity and liquidity risks; (iii) products and services (and their efficacy, market success, etc.); and/or (iv) supplemental information.

Financial statements that are intentionally (or recklessly) misstated, so that they are misleading or inaccurate, and so that they do not conform to GAAP, are a fraud upon investors and, possibly, capital markets. In this respect, the most common species

3. Substantial Authoritative Support, Fed. Sec. L. Rep. (CCH) ¶ 10,501 (1938).

4. Fed. Sec. L. Rep. (CCH) ¶ 10,081 (1973).

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of financial statement fraud involves overstatements of revenues and earnings, and/or understatement of costs and expenses – so as to inflate the profitability (or minimize the losses) of an entity. Concomitantly, such misstatements of the P&L also result in overstatements of assets and/or understatements of liabilities. Such fraud also is known as an *inclusive* fraud. A subspecies of fraud may involve the intentional omission of liabilities and obligations from the financial statements of a company. Such a fraud is known as an *exclusive* fraud. Most typically, *inclusive* frauds involve the following combinations of misstatements:

Assets or Liabilities	Revenues or Expenses
Accounts Receivable [Overstated]	Revenue [Overstated]
Allowance For Sales Returns [Understated]	Revenue [Overstated]
Doubtful Accounts Allowance [Understated]	Bad Debt Expense [Understated]
Inventory [Overstated]	Cost of Goods Sold [Understated]
Inventory Res. (For Lower-of-Cost-Or-Market Impairment) [Understated]	Cost of Goods Sold [Understated]
Inventory [Overstated]	Direct Expenses [Understated]
Prepaid or Deferred Assets [Overstated]	Direct, Indirect or Selling, General and Administrative ("SG&A") Expenses [Understated]
Accounts Payable, or Accrued Liabilities, Or Other Obligations [Understated]	Expenses [Understated]

These types of *inclusive* frauds may involve either the creation of fictitious assets, or the omission of actual liabilities (or both), or they may involve the "timing" of transactions – so as to improperly reflect, for example:

- Revenues and receivables prematurely recognized before they are earned and realized or realizable.
- Costs of goods sold deferred beyond when such costs should have been accrued – either by improperly overstating the value of inventories, or by deferring the recognition of purchases, or costs (materials, labor,

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and/or supplies), or indirect expenses and overhead expenses.

- Contingencies – in the form of doubtful accounts allowances, sales returns allowances, warranty and product liability reserves, litigation reserves, etc. - not recognized timely (when such were first *probable* and *estimable*), thus resulting in delayed recognition of associated provision expenses.
- Accruals of accounts payable and other liabilities not recognized timely, when the obligations actually were incurred, thus deferring recognition of the related expenses.

In the case of creation of fictitious assets, the two most common frauds involve: (1) recording fictitious revenues and associated fictitious receivables; and (2) recording fictitious inventory, and thus understating cost of goods sold. However, any balance sheet account for which a fictitious "debit" can be created can be used to create an equal and inapposite fictitious "credit" to either a revenue or an expense account in the P&L – thus overstating earnings.

Exclusive frauds typically involve the exclusion of liabilities or other obligations (e.g., commitments, guarantees, or contingencies) from a company's balance sheet. The effects of such exclusions can include:

- Associated understatement of an expense, such as:
  - Environmental clean-up expenses and related litigation expense provisions, associated with a failure to properly record environmental liabilities;
  - Litigation expense provisions, associated with a failure to properly record litigation reserves and judgment liabilities;
  - Losses associated with debts and other long-term liability obligations that inure to a company as a result of undisclosed guarantees, commitments, or other debt-related contingencies;
  - Reserves (or direct charge-offs) associated with

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impairments of unconsolidated assets (e.g., equity investments, joint ventures, partnerships, etc.), the failure to record such also resulting in understatement of investment losses or impairment charges to earnings;

- o Allowances or loss accruals, related to – among others: doubtful accounts allowances; loan loss allowances; inventory reserves; warranty and product liability reserves; or self-insurance reserves, that are intentionally excluded and thus result in understatement of the associated expense provisions.

- Associated overstatement of liquidity measures (e.g., debt-to-equity or current ratios) and understatement of the true balance of a company's total liabilities.
- Associated understatement of interest expense.

Some frauds involve the intentional mischaracterization of the nature of transactions and/or misleading disclosure dealing with: (a) the accounting policies and procedures used to account for such transactions or events; (b) the effects of *accounting changes*; (c) the classification of transactions; or (d) how such transactions affect reported results of operations. Among the most common examples are:

- Failure to properly disclose the effects of material changes in *accounting estimates* – on both current and, possibly, future operations.
- Misclassification of operating expenses and costs (or losses) as "non-recurring," when in fact such expenses should be reflected as "operating" in nature.
- Creation of reserves – most typically associated with "pre-acquisition" liabilities, "restructuring charges," and other so-called "one-time charges" – intentionally done in excess of *probable* and *estimable* liabilities expected to be incurred; and subsequent release of such reserves in order to offset expenses (or increase revenues) for which such reserves were not provided. (In many cases the provisions of such reserves are reflected as "non-operating" charges, while their

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subsequent release – in whole or in part – are reflected improperly as "ordinary course" results of continuing operations.)

- Misstatement of, or failure to include, key accounting policies (and/or their effect upon reported results of operations).

Another type of financial fraud involves the intentional creation of "cookie jar" reserves (i.e., "general" reserves of the kind that are prohibited under FASB SFAS No. 5, *Accounting for Contingencies*[5]) – usually in times when a company is enjoying "excess" earnings (i.e., earnings that exceed the company's profit plan and the markets' consensus earnings expectations) – that are kept for a "rainy day" (when release of such reserves helps the company to achieve earnings targets, absent which the company's results of operations would not meet market expectations). Just about any allowance, loss accrual, or reserve account will do as a "cookie jar"; the only common denominator of such is the intentional provision (and/or maintenance) of reserves in excess of contingent liabilities that are specifically identifiable, and are both *probable* and *estimable* under the criteria set forth in FASB SFAS No. 5.[6]

ACCOUNTING IRREGULARITIES AS AN ELEMENT OF FINANCIAL FRAUD

AICPA SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, defines financial fraud, involving accounting irregularities, as follows:

Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve acts such as the following:

- Manipulation, falsification, or alteration of accounting

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5. ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5 (Financial Accounting Standards Bd. 1975).

6. *Id.*

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records or supporting documents from which financial statements are prepared;

- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information;
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.[7]

Generally, "badges" of financial fraud include:

- Reported results that do not comport with GAAP.
- Pressures or incentives to commit fraud – including pressure to achieve unrealistic operating results, and incentive in the form of performance-based compensation (e.g., stock options, bonuses or other forms of performance-based compensation, the value of which is tied to achieving such unrealistic operating results).
- Opportunity to commit fraud – resulting from lack of adequate controls, insufficient segregation of duties, or dominance – by one or more individuals – over critical elements of the accounting and reporting process.
- Concealment, through falsification, alteration, destruction, or the hiding of documents and other accounting evidence.
- Collusion – because major financial frauds rarely are perpetrated by just one person; instead, major financial frauds typically involve, and require, the acts – by commission or omission – of a number of individuals.
- Misrepresentations about, among other things: (a) control activities having been performed properly, when in fact they have not; (b) the true nature of transactions or accounting events; (c) management's true intent in respect of transactions being entered into; (d) the reasonableness and support for management's

7. CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT, Statement on Auditing Standards No. 82 (Amer. Inst. of Certified Pub. Accountants 1992).

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judgments and estimates, when such are – in fact – known to be unreasonable, or are lacking in valid support; or (e) false evidence, misrepresented to be true and valid, regarding: absence of "side-letters," authenticity of documents (known to have been falsified or otherwise altered), relationships with counter-parties (including concealment of related party arrangements), the dating of documents (e.g., back-dating) and actual timing of transactions, and the true nature of arrangements (e.g., concerning rights of return, contingent arrangements, consignment arrangements represented to be completed sales, undisclosed rebates and other price concessions, etc.).

COMMON FINANCIAL FRAUDS

When it comes to financial fraud, human imagination is capable of inventing myriad combinations of accounting irregularities with which to deceive investors. However, there are some financial frauds that occur with greater frequency and that have – in their basic structures – many similarities by which they may be identified. The following are some of these regularly recurring common frauds.

Revenue Recognition Involving Timing Manipulation

The situation usually involves: (a) pressure to meet revenue targets as the accounting period (i.e., quarter) comes to a close; (b) a known or expected short-fall of sales transactions actually consummated through period-end; (c) the potential existence of sales that are expected to be consummated shortly after the period-end; and (d) opportunity – either unilaterally or in collusion with the customers (i.e., counter-parties) – to alter the dating of these post period-end transactions in order to make such transactions appear to have been consummated prior to the period-end close of business. Falsification or alteration of documents may be required, including back-dating of delivery or shipping documents; back-dating or alteration of the dates of invoices; and alteration or

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falsification of other dating evidence that might reveal the true date(s) – post period-end – of the arrangement, or of delivery of the products sold or services rendered. Some examples of other dating evidence that may require alteration include: (i) facsimile dates (e.g., on copies of signed contracts or other documents); (ii) management information system transaction record dating; (iii) sales registers or sales journals transaction dates; (iv) purchase order dates (because it might be incongruent and hard to explain that the date of the purchase order was later, i.e., after the period-end, than the purported dates falsely entered on contracts, invoices, and delivery documents); and (v) dating of correspondence associated with negotiation and consummation of the transaction. A necessary result of any such "timing" accounting irregularity is that the current accounting period "borrows" revenues from the next period or periods, thus starting off these subsequent periods "in the hole." If these next periods also are beleaguered by flat or declining actual sales (thereby exacerbating the revenue shortfall already created by the "timing" irregularity), then even more premature revenue recognition accounting irregularities will be needed at such subsequent accounting period-ends, in order to: (a) make up the shortfall caused by "lending" revenues to the prior period; (b) cover the effects of any real decline in sales; and (c) achieve the expected level of sales growth. As one can see, in a time when real sales are declining (e.g., due to market or economic conditions) and such a "timing" accounting irregularity is taking place – each period can require more and more fraudulent premature revenue recognition, in order to keep up the appearance (and fiction) that revenues are growing.

Revenue Recognition Involving the Creation of Fictitious Sales

When no real sales are available to manipulate, some financial fraudsters resort to making up sales transactions out of thin air. This fraud has the benefit of simplicity but the problem of concealment. Recording a fictitious sale in a company's books and records is as simple as posting to the general ledger:

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Dr. Accounting Receivable	**$1,000,000**	
Cr. Sales		**$1,000,000**
To record 3-31-02 sale of software products to ABC Corp.		

However, if the ABC Corp. never actually purchased $1,000,000 of software products, then it is unlikely that the account receivable will be *realized* through any subsequent cash receipt from ABC Corp. of said $1,000,000. Eventually this uncollected account receivable will "age" (i.e., grow older and become 30-, then 60-, then 90-, and eventually 120-days – and over – past due). And long past-due receivables attract attention; therefore, they need to be concealed. One way is simply to write off the receivable in some future period. This method is based upon the fraudster's expectation that future revenues and profits will be sufficient to permit such a write-off; thus, it is a form of "timing" irregularity.

However, evidence of the original, fictitious transaction, as well as of the subsequent write-off, still remains in the books and records; and the reason for such a subsequent write-off may be questioned. Thus, another way to conceal the fraudulent transaction is to charge it to the account "Sales Returns Allowance" (with the explanation that the customer returned the products for some plausible reason). However, this concealment approach requires that: (a) the allowance balance is sufficient to absorb such a charge (permitting re-provision of the allowance over future periods); (b) the effect of the charge does not raise questions about the adequacy of the allowance and sales returns provisions recorded in prior periods; and (c) no one challenges the circumstances of the transaction or the subsequent product return. Yet another way to conceal the transaction is a form of "kiting," wherein collections from a legitimate customer transaction are diverted and misapplied to "pay off" the fictitious receivable balance. Of course, this then exposes the legitimate receivable to non-collection (because it is unlikely that the legitimate customer will pay twice for the same purchase); therefore, subsequent diversions and misapplications of collections must be done – over, and over, and over again.

Like all forms of "kiting," the latter approach is plagued by complexity, and it usually requires the notorious "second set of books" (to keep track of all of the diversions and misapplications

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and keep a record of which legitimate receivables need to be covered by which misapplied collections). Unless a future reckoning is made – by eventually writing off some receivable balance(s) in the amount of the original fictitious receivable, then this type of scheme takes on the nature of a perpetual motion device, which one knows cannot exist. Compounding this obvious problem is the tendency of these kinds of frauds to grow, through more and more fictitious entries that will require more and more deceptions to conceal their existence.

One more problem with this type of fraud is that, should anyone ask the purported customers whether they actually made the fictitious purchase, the answer would be "no," and eventually the fraud could unravel. Thus, such frauds are subject to discovery if receivables were to be confirmed properly and in sufficient numbers and scope. This brings to mind the adage, "inside every can of worms is another can of worms waiting to get out." In order to prevent detection of such a fraud by auditors (external and/or internal) who might attempt to confirm with customers their recorded accounts receivable balances, the fraudsters also may have to tamper with and corrupt the receivables confirmation process, in one or more of the following ways:

- Talk the auditors out of confirming receivables at all – by arguing:
  - The response rate is too low (so why not just review subsequent collections, or perform some kind of "overall analysis" of receivables aged balances, or just review documentation of sales transactions, i.e., invoices, purchase orders, etc.).
  - Confirmations bother our customers.
  - Customer ABC Corp. is unable to confirm overall balances; they only can confirm individual invoices (and it is difficult – or impossible – for us to match our invoices to their invoice references, so let's call the whole thing off).
- Falsify the population records (e.g., accounts receivable subsidiary ledger) to exclude the fictitious balances –

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therefore preventing them from being confirmed. This approach also requires manipulating the data file so that "totals" include the amounts of the balances that were excluded, which in turn must depend upon the auditor not "footing," i.e., totaling, the subsidiary ledger's individual line items – either manually or by use of an automated test program.

- Intercept either the confirmations or the responses (and, in the latter case, alter the response), which in turn requires: (a) collusion with someone at the party being confirmed; (b) inattention, negligence, and/or failure to follow proper auditing procedures by the auditor; (c) theft of, or tampering with, the mail (outgoing or incoming); and/or (d) dissembling with the party being confirmed (e.g., by contacting such party, alerting them to the confirmation request being sent, and telling a lie, such as: "The balance was inadvertently stated as $1,000,000 when in fact it should have been $-0-, just ignore the confirmation and don't respond to it or any subsequent inquiries; and, if you have any questions, don't call the auditors, just call me.").
- Lie to the auditors, after the fact (that the customer *does* respond to the confirmation and *does* repudiate the fictitious balance), by misrepresenting: (a) the customer is wrong (here is all of our documentation of the transaction), they obviously made a mistake; (b) the customer is right, because they *paid* that balance, and we inadvertently mis-posted the collection to the wrong account (this requires undoing some other misapplication of collections and hoping that the auditors do not follow up, by confirmation, *that* customer balance); or (c) the customer is right, because we mis-posted the original sales transaction, which should have been recorded to customer XYZ Corp. and not the ABC Corp. This also depends upon the auditor not following up by confirming *that* balance with the XYZ Corp.

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Obviously the least problematic way to corrupt the confirmation process is to alter the population from which any confirmation audit sample is to be drawn. Equally obviously, maintaining the fiction surrounding the original falsified revenue and receivable entries recorded in the general ledger also requires creation of accompanying fraudulent documents and records, including fictitious: (a) invoices; (b) purchase orders; (c) shipping documents; (d) delivery receipts; (e) correspondence (e.g., documenting negotiation of the fictitious arrangement); (f) entries to the general and subsidiary ledgers, any applicable sales journal, any inventory stock ledger if applicable, and any shipping record; (g) collections records; and (h) if necessary, aged accounts receivables schedules and reports. As one can see, this could be hard work for just one person, so any serious fraud scheme of this type usually requires collusion by others (e.g., revenue accountants and/or the manager in charge of revenue accounting, the general ledger and/or accounts receivable subsidiary ledger accountants, the accountant responsible for cash collections and their application to receivables balances, etc.).

Revenue Recognition Involving Irregularities Concerning Rights of Return

"Rights of return" refers to circumstances, whether as a matter of contract or of existing practice, when a product may be returned after its sale – either for: a cash refund, a credit applied to amounts owed, or to be owed, for other products, or, in exchange for other products. Authoritative guidance under GAAP is set forth in FASB SFAS No. 48, *Revenue Recognition When Right of Return Exists*. Basically, FASB SFAS No. 48 requires that recognition of revenue should be deferred when one or more of the following sales conditions exist: (a) the price to the buyer is not fixed or determinable; (b) the buyer (if a reseller) is not obligated to pay the seller until the product is sold to an "end-user"; (c) the buyer is not obligated to pay the seller in the event of theft, destruction, or other loss of the product; (d) the buyer acquiring the product does not have economic substance apart from that provided by the seller; (e) the seller has continuing, significant obligations to bring

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about directly the resale of the product by the buyer; and/or (f) the amount of future returns cannot be reasonably estimated. Should one or more of these conditions exist, revenue cannot be recognized until either the return right has expired or none of these conditions obtain. Thus, frauds in connection with rights of return typically involve concealment of the existence of the right – either by contract or arising from accepted practice – and/or the aforementioned conditions (a) through (f). Concealment usually takes one or more of the following forms:

- Use of "side-letters," confected and maintained separate and apart from the sales contract, that provide the buyer with a right of return;
- Obligation by oral promises, or some other form of understanding between seller and buyer, that are honored as a customary practice, but that are arranged covertly and are hidden;
- Misrepresentation designed to mischaracterize the nature of arrangements, particularly in respect of:
  - Consignment arrangements made to appear to be final sales;
  - Concealment of contingencies, under which the buyer can return the products, including failure to re-sell the products, "trial periods," and product performance conditions;
  - Failure to disclose the existence (or extent) of stock rotation rights or price protection concessions.
- Arrangement of transactions with "straw" counter-parties, agents, related parties, or other special purpose entities in which the true nature of the arrangements are concealed or obscured; but, ultimately, the counter-party does not actually have any significant economic risk in the "sale."

Sometimes, the purchaser is complicit in the act of concealment (e.g., the negotiation of a "side-letter"), and this makes detection of the fraud even more difficult. Also, such frauds often involve collusion among a number of individuals within an organization (e.g., sales persons, their supervisors, and possibly

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both marketing and financial management). This species of fraud takes the form of recognizing revenue before it actually has been earned or is realized (or realizable), in violation of both FASB CON No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*,[8] and SEC SAB No. 101, *Revenue Recognition in Financial Statements*.[9]

Legitimate rights of return can and do exist; and – assuming all of the revenue recognition conditions set forth in FASB SFAS No. 48 are met – sales involving such rights of return may be recognized in the ordinary course. The most significant condition is that the amount of future returns must be reasonably estimable. Estimates of "sales returns allowances" result in provision for such future returns by a charge (i.e., contra-entry) against revenues and the related accrual of an allowance (i.e., reserve), as follows:

Dr. Sales Returns Provision	**$100,000**		
	Cr. Sales Returns Allowance		**$100,000**
	To record estimated provision for sales returns.		

The "debit" side of this type of accounting entry is reflected as a reduction of total sales, while the "credit" is accrued to the balance sheet account, "Sales Returns Allowances," against which any subsequent returns can be charged. This accounting treatment affords one other opportunity for fraud – by intentionally *under*-providing for *probable* and otherwise reasonably *estimable* future returns of products. Usually this type of fraud involves ignoring known, or reasonably foreseeable, events that are likely to result in product returns, such as: introductions of new products (that can be expected to result in returns of old products by resellers); "channel stuffing" (that is, intentionally over-selling product in excess of the capacity of distribution channels); and anticipated price reductions (that likely will lead to claims for "price protection" from resellers).

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8. RECOGNITION AND MEASUREMENT IN FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES, Concepts Statement No. 5 (Financial Accounting Standards Bd. 1984).

9. REVENUE RECOGNITION IN FINANCIAL STATEMENTS, 17 C.F.R. 211, SEC Staff Accounting Bulletin No. 101 (Securities and Exchange Commission 1999).

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"Roundtrip Revenue" Frauds

Basically, this kind of fraud involves the arrangement of a transaction that appears to be an arms-length sale, but that has no real economic substance for one or more of the following reasons:

- The funds used by the "purchaser" actually were advanced – either directly or indirectly – by the seller, typically in the form of a loan (that subsequently is forgiven) or an "investment" (e.g., in stock of the counter-party, or in a joint venture or partnership arrangement with that party).
- The arrangement involves *quid pro quo*, reciprocal, transactions – in which both parties sell to each other equivalent amounts of products or services.
- The arrangements are barter transactions wherein realizability depends upon subsequent transactions in which the bartered goods must be sold to third parties.
- The "buyer" has no real economic substance other than that provided by the seller.
- The "buyer" incurs no real risk in the transaction, because the "seller" has guaranteed third-party financing on behalf of the "buyer," or otherwise caused the funding – through intermediaries – of the arrangement.

Indicia of "roundtrip revenue" frauds are: (a) their apparent complexity – in structure of, and rationale for, the transaction; (b) concealment of the true sources and uses of funds exchanged in the arrangement; (c) attempts to dissociate the subject transaction(s) from other transactions upon which the subject transaction(s) actually are dependant; and/or (d) mischaracterization of the true relationships, rights, and obligations among the parties.

Improper Allocation of Value in Multiple-Element Revenue Arrangements

Multiple-element revenue arrangements are common in the software industry and in other industries where sales of products are combined with sales of services. For example, a multiple-

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element arrangement might include the sale of computer software along with the sale of a software maintenance agreement and the sale of services relating to installation and integration of the software products. Accounting rules may call for different revenue recognition treatments for each of these elements, as follows: (1) revenues allocated to the software product might be recognizable upon delivery, assuming that the seller had no significant product-related continuing obligations; (2) revenues allocated to the maintenance agreement usually would be recognizable ratably over the term of the maintenance contract; and (3) revenues allocated to services should be recognized as such services are provided. Thus, the timing and amounts of revenues recognizable depend upon identifying the respective elements and understanding their accounting implications, and then upon properly allocating the total sales price of the arrangement to such elements. AICPA SOP 97-2, *Software Revenue Recognition*,[10] and SEC SAB No. 101 both set forth rules for the allocation of revenues among the elements of a multiple-element arrangement. Essentially, such allocations must be made based upon the respective fair values of these elements, and these fair values estimates must be supported by verifiable objective evidence ("VOE"). The accounting rules do not permit mere reliance upon stated (i.e., "list") prices, or upon the prices agreed upon by the parties to the multiple-element arrangement, because – to quote from SEC SAB No. 101:

> Prices listed in a multiple-element arrangement with a customer may not be representative of fair value of those elements because the prices of the different components of the arrangement can be altered in negotiations and still result in the same aggregate consideration.[11]

Fraud can be introduced into the process of allocating fair values among elements within multiple-element arrangements in one or more of the following ways:

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10. SOFTWARE REVENUE RECOGNITION, Statement of Position 97-2 (Amer. Inst. of Certified Pub. Accountants 1997).

11. *Id.*

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- Fabricating, altering, or otherwise manipulating VOE data;
- Mischaracterizing the terms or nature of the elements which require deferred or ratable recognition of their allocated revenues (usually by attempting to minimize the significance – and related values – of such elements, thereby increasing the value assigned to elements for which revenues can be recognized immediately);
- Bifurcating the arrangement to make it seem as though the maintenance and/or services components were sold separately, at "arms-length" negotiated prices stated in their bifurcated transactions – when in fact, all of the subject elements were negotiated as a single deal (and are interdependent);
- Misstating prices at which elements were planned to be sold (in the case of new products where VOE is not yet available);
- Concealment of, or mischaracterization of the nature of, "up-front" fees associated with deals (because, under GAAP, many of such fees are required to be recognized ratably over the term of the arrangement).

Improper Measurement of the Percentage of Completion in Long-Term Construction or Certain Long-Term Production Arrangements

"Percentage-of-completion" accounting is required under GAAP for many long-term contractual arrangements (e.g., construction of buildings or major capital assets such as plants, ships, aircraft, large equipment items, etc.). Basically, the sales price of the arrangement is recognized over the term of the contract in percentages based upon the degree of completion achieved through each respective measurement date. Accounting irregularities in this area involve: (a) misstatement of the percentage of completion, either by intentionally mis-measuring such or by falsifying or manipulating engineering and/or cost accounting records; (b) hiding cost overruns (which might require accrual as contingent losses and thus reduce profits relating to the

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contract); and/or (c) misrepresenting the nature and collectibility of cost overruns (by falsely stating that such are "add-ons," or contract amendments, that will be realized as additional revenue – when in fact they are not, or they are subject to dispute with the customer).

Inventory Accounting Irregularities

"Cost of sales" is computed as:

Purchases + (Direct Labor + Overhead Costs) + Beginning Inventory – Ending Inventory

Accordingly, by overstating the value of ending inventory one can understate "cost of sales," and thereby fraudulently overstate gross margin and profits. There are three ways to fraudulently overstate inventory: (1) by overstating the count of goods on hand; (2) by overstating the value assigned to such goods; and/or (3) by intentionally understating the amount of reserves or write-downs of obsolete, slow-moving, and damaged goods in stock. "Count" frauds typically are perpetrated by: (a) falsifying the stock counts, either on the inventory count sheets or during the summarization of inventory counts; (b) simply listing false counts (usually done for inventory locations where physical counts were not observed by internal or external auditors); and/or (c) counting (and treating as valuable) obsolete, scrapped, or even non-existent inventory items (the latter by counting empty boxes, crates, bins, tanks, etc., as if they contained valuable inventory). "Costing" (i.e., price extension) frauds involve overstating the cost of finished goods (or work-in-process, or raw materials) by: (a) simply mis-pricing the items; (b) misallocating the values of higher-priced inventory items to high quantity items in the inventory on hand; and/or (c) overstating amounts associated with overheads or other costs and expenses absorbed as part of the value of inventory. Frauds involving understatement of inventory write-downs and reserves usually entail: (a) misrepresenting the estimated market value of goods on hand in inventory; (b) concealing the true nature of goods that are (or will soon become) obsolete or slow-moving; and/or (c) intentionally understating the quantities (and/or values) of goods on hand that might be deemed obsolete or slow-moving.

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Overstating ending inventory in order to understate costs of goods sold for the period has one main drawback – that period's ending inventory becomes the next period's beginning inventory balance; and thus, any such overstatement will cause the next period's cost of sales to increase by that amount. This usually means that inventory frauds must be recurring and must grow in size, unless their purpose was just to shift costs from one accounting period to the next.

At their simplest, inventory frauds can be accomplished merely by recording a fictitious entry:

Dr. Inventory $200,000
Cr. Cost of Goods Sold $200,000
To record ending inventory on hand.

But such a simple fictitious entry, lacking any back-up or support – in the form of subsidiary ledger entries, inventory records, count-sheets, inventory costing extension worksheets, or inventory summarization records – might be easily discovered. Therefore, inventory frauds often involve the falsification of some or all of these supporting records. On the other hand, by simply altering recorded counts – to be used in costing extensions and the summarization of inventory – one might avoid the need to create entire sets of fictitious records. However, this method of fraud, to be successful, usually depends upon: (i) no one checking the "audit trail" of counts from the inventory count sheets, to the inventory extension sheets, and into the inventory summarization records; and (ii) keeping a "second set of books," in order to keep track of the altered count entries.

In any inventory fraud it helps to know where and when physical inventory observations will be attended by internal or external auditors. This is so that fraudulent activities can be undertaken only for the inventory locations where no such physical inventory observations will occur. Alternatively, false counts or improper valuations of goods can be recorded buried in the detail of voluminous intermediate accounting extensions and summarizations of inventory – in the hope that such detail will not be examined (or that the fictitious entries will not be detected).

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<u>*Unrecorded Liabilities Accounting Irregularities*</u>

Simply put, liabilities or commitments, contingencies or other obligations are kept off the books. This can be done either by delaying their accrual (a type of "timing" fraud) or by concealing their existence. But, no matter how well concealed, most liabilities eventually come due and require settlement – typically in cash. Thus, unrecorded liabilities frauds usually face a "day of reckoning," at which time new unrecorded liabilities and/or "off-balance sheet" obligations must be found to take the place of the amounts coming due. Some examples of such frauds include the following:

- "Cut-off" irregularities, involving the intentional non- or under-recognition of liabilities (e.g., accounts payable or accrued liabilities) at period-end;
- Concealment of commitments, guarantees (e.g., loan guarantees) and/or contingencies that – if known – would require accrual as liabilities;
- Creation of fictitious (or improperly manipulated) transactions that purport to achieve "off balance sheet" financing or the defeasance of debt; but, that in fact do not, because:
    - The structure, nature, or substance of the transaction violates the accounting criteria set forth in FASB SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*;[12]
    - "Side-letters," or other extra-contractual agreements conceal other forms of obligations (e.g., guarantees or commitments);
    - Funding of defeased transactions, which purportedly was provided by third parties, actually was provided, or guaranteed, by the entity effecting the defeasance of debt;

12. ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000).

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  - The necessary condition of loss of control over the transferred (and apparently off-balance sheet) asset is misrepresented by the transferor; and, in fact, the transferor continues to maintain effective control over the asset.
- Improper avoidance of recognition of loss contingencies (e.g., in respect of impairments of investments, equity interest, joint venture holdings, or some kinds of long-lived assets) by purporting to effect their transfers to special purpose entities ("SPEs") when, in fact, the transfers are shams, or they violate the criteria for de-recognition set forth in FASB SFAS No. 140.

In any of the above cases, the intent of the accounting irregularity usually is to: either (a) improperly reflect a "gain on sale" (of the asset purportedly transferred); (b) avoid recording an impairment loss (in respect of the asset purportedly transferred); or (c) avoid recognizing a liability (and with it a contra-entry loss or expense).

Accounting Irregularities Involving Estimates

Accounting estimates are required to be made for many contingent amounts, the realization of which will occur in one or more future periods. Because estimates involve judgments and measurements of future outcomes, they are inherently more subjective and more susceptible to improprieties. Among the most common accounting estimate frauds are the following:

- Intentional underestimation of loss contingencies and loss accruals, including:
  - Allowance for doubtful accounts;
  - Allowance for loan losses;
  - Litigation reserves;
  - Inventory reserves and "lower-of-cost-or-market" write-downs;
  - Warranty reserves;
  - Product liability reserves;
  - Self-insurance (e.g., workers' compensation)

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reserves; or
    - Impairments of long-lived assets.
- Intentional overestimation of fair values, particularly in respect of "gain-on-sale" calculations; purchase price allocations; "mark-to-market" computations for investments in non-traded securities; and in connection with allocations of values in multiple-element revenue arrangements.
- Failure to recognize, and make proper allowance for, known contingencies that are *probable* and *estimable*.
- Creation and improper use of general (i.e., "cookie jar") reserves – usually to fraudulently "manage" earnings.
- Misuse of specific reserves, by the release and improper application for some purpose other than for which the reserve was intended (e.g., a release of reserves to increase revenues or decrease costs and expenses which are unrelated to the purpose for which the reserve was established) – again usually as a means of "managing" earnings.
- Failure to properly disclose material changes in certain types of estimates, in violation of APB No. 20, *Accounting Changes*.[13]

<u>*Improper Use of Impairments and Restructuring Charges*</u>

Ordinarily, taking an impairment charge (typically associated with the write-down in value of inventory, investments, or long-lived assets) or recording a restructuring charge would not seem to be fertile grounds for fraud. However, when such charges are intentionally *over*stated, with the intent to improperly lower the asset's carrying value in anticipation of then recognizing an overstated gain on the subsequent sale of the asset (e.g., inventory), then such over-impairment can be a form of fraudulent earnings management. In the case of restructuring charges, a

13. ACCOUNTING CHANGES, Opinion No. 20 (Accounting Principles Bd. 1983).

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variant of this kind of accounting irregularity is to recognize the restructuring charge as a non-operating, "one-time" item, create a restructuring reserve, and then misuse such reserve – in future periods – to offset operating (i.e., recurring) expenses. Another variant is to overstate assumed liabilities, particularly "pre-acquisition contingencies" associated with a business combination transactions, in which the "credit" is to some kind of contingency reserve, and the "debit" is recorded to "Goodwill." Then, in subsequent periods, when the fictitious contingency does not materialize, the reserve can be released into income (while the "goodwill" remains on the books, unless impaired).

"Ponzi" Schemes

In 1919 and 1920, Charles Ponzi operated an investment scheme, through his business, the Securities Exchange Company, that promised investors returns of up to fifty percent, purportedly to be earned from investing in, and arbitraging, "International Postal Union" reply coupons. In reality, after some initial success in his venture, Ponzi sustained losses; and – in order to keep his scheme going – Ponzi began repaying old investors with funds provided by new investors. Although Ponzi was exposed, jailed, eventually exiled back to Italy, and died penniless, his name lives on in describing a kind of financial fraud that depends upon: (a) claims of astonishing profits to investors; (b) attracting more and more new investors to provide the funds repaid to old investors; and (c) a pyramid structure in which only the initial investors (and the sponsor of the scheme) recover their investments and earn profits thereon. Modern versions of "Ponzi" schemes may involve multiple-pledging of assets claimed to be security for the investors' loans or other investments, commingling of funds and diversion of cash collateral, and fraud in the inducement to invest by:

- Mischaracterizing the nature of, and risks associated with, the investment;
- Overstating anticipated returns, and misstating the security backing up the investment;
- Misstating financial statements – by overstating investment returns and operating results and/or

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understating losses;
- Misrepresenting the success of the product, service, or financial scheme upon which the investment is to be based; and,
- Concealing losses and the failure of the scheme – at least for a time – by paying out later investors' monies to earlier investors.

BANK FRAUDS

Although not usually investors in equity securities of entities, banks invest in loans to entities that are made – at least in part – on reliance upon the financial statements and other financial information provided by the borrower. Thus, fraudulent financial statements may be used to defraud lenders just as they defraud equity investors – usually by overstating a company's financial condition and results of operations. Several additional forms of fraud also may affect lenders; and these types of fraud involve overstating the value of collateral, pledging fictitious collateral, multiple-pledging assets as security, and fraudulently conveying assets – against which loans were made – to related parties, third parties, or other lending institutions.

In the special case of "floor-plan" loans, often a fraud can be committed by manipulating asset identification records, misrepresenting improperly converted assets as "in transit," and "kiting" cash collateral, to use proceeds from borrowing on new securitized assets to pay off loans made against old assets (another form of "Ponzi" scheme).

FRAUDS ON AUDITORS

Since the purpose of an independent audit is to determine whether financial statements do, in fact, *present fairly* the financial condition and results of operations of a company, if reported results contain accounting irregularities and do not comport with GAAP any intentional failure to disclose such a condition represents a fraud upon the auditors. This type of fraud has, as its purpose, obtaining from the auditors an unqualified audit opinion

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and keeping the auditors from knowing about, and disclosing, the accounting irregularities. Usually, elements of a fraud on the auditors include the following:

- Misrepresentations by management and/or employees concerning the nature of transactions, the accounting applied, the absence of accounting irregularities (when, in fact, such accounting irregularities exist), and the adequacy of disclosure.
- Concealment of fraudulent transactions by falsification, alteration and manipulation of documents and accounting records.
- Subornation of collusion to defraud among management and/or employees, taking the form of: (a) silence, when in fact these persons have knowledge of the fraudulent activities but do not disclose their knowledge to the auditors; (b) active participation in the fraud, by corroborating misrepresentations and/or assisting in the falsification of books and records; and (c) assistance in the circumvention of internal controls designed to prevent or detect fraud.
- Collusion with third parties or related parties, in which such parties are aware of irregular transactions but do nothing to prevent them and/or do nothing to bring them to the attention of either their auditors or the counter-party's auditors.
- Deceptions, including planning the fraud to take advantage of known (or anticipated) patterns of auditing (i.e., scope of testing or audit locations) and providing false information to auditors in response to their audit inquiries.
- Destruction of evidential matter and/or hiding key documents (e.g., "side-letters").

ENVIRONMENTAL RISKS OF FINANCIAL FRAUD

Financial fraud is more likely to occur in an environment in which one or more of the following "red flags" exist:

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Risk Factors Relating to Management Characteristics and Influence

- Compensation that is significantly affected by results of operations, including stock options, bonuses, and other incentives, the value of which is tied to the entity's performance.
- Excessive interest in maintaining or increasing the company's stock price or earnings trend, coupled with the use of overly aggressive accounting practices to do so.
- Unrealistic earnings targets established by management.
- A tendency by management to engage in "earnings management" - motivated transactions, related party transactions, and structured deals whose purpose is entirely (or predominantly) to "game" the accounting rules.

Risk Factors Relating to Management's Attitudes Toward Internal Controls and Adherence to GAAP

- Expressions of disdain for (if not outright hatred of) specific GAAP pronouncements that affect the company's accounting for transactions.
- Failure to display and/or communicate an appropriate attitude concerning internal controls and the need for compliance therewith.
- Domination over key controls and accounting procedures by a few persons in management.
- Inadequate monitoring of key controls.
- Failure to take appropriate remedial action in response to violations of established controls and procedures.
- Failure to correct known reportable conditions (of internal controls weaknesses) on a timely basis.
- Display of significant disregard for SEC authority and the Commission's rules and regulations.
- Management continuing to employ ineffective accounting personnel and/or surrounding themselves

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with "yes" persons, lackeys, and sycophants.

Risk Factors Associated with Industry and Market Conditions

- Fierce competition.
- Declining profit margins.
- Rapid technological change.
- Distribution channels that are highly dependent upon resellers (e.g., distributors and major retailers).
- Industry in decline, accompanied by eroding customer base.
- Significant changes in accounting rules, regulation, and/or laws affecting the industry.

Risk Factors Relating to Operating Characteristics, Liquidity and Financial Stability

- Inability to generate sufficient cash flows to sustain operations and repay debts.
- Significant pressure to obtain additional capital.
- Assets, liabilities, revenues, and/or expenses based upon the use of significant estimates that are subjective in nature and are inherently subject to manipulation.
- Significant related party transactions.
- Significant unusual or highly complex (e.g., structured) transactions, particularly those occurring at or near the end of accounting periods.
- Significant transactions whose principal justification appears to be to circumvent accounting rules.
- Unusually rapid growth in revenues or profits, especially when compared to comparable companies.
- Unrealistically aggressive sales or profitability targets and related incentive programs.
- Overly complex organizational structures, the creation and use of numerous special-purpose subsidiaries, reliance upon partnerships and joint ventures to effect "off-balance sheet" financing, and/or the creation of legal entities in tax havens (the purpose of which

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appearing to be primarily for tax avoidance).

- Contractual arrangements with no apparent, substantive, business purpose (other than to cause a favorable accounting result).

The above "red flags" are set forth in more detail in AICPA SAS No. 82.[14] After-the-fact analysis of virtually every major financial fraud that has occurred in the past several decades has identified the existence of many of these "red flags." However, their identification, and the application of appropriate responses to prevent or detect financial fraud, depends upon the following internal control (and/or audit) attributes:

- "Tone at the top" – if senior management does not set a good example and establish a proper "tone" of corporate ethics and behavior that is inimical to accounting irregularities, then such irregularities are more likely to occur.
- Effective governance and oversight by a financially literate, well-informed, and *active* Board of Directors and their Audit Committee.
- Sufficient "professional skepticism" on the part of auditors.
- Adequate audit budgets and scope of audit examinations.
- Effective, well-designed, and properly monitored internal controls.
- Appropriate and conservative choices in accounting policies, procedures, and practices that are designed to comply fully with the spirit (and not just the letter) of GAAP authoritative pronouncements.
- Audit planning that specifically targets for close examination: (a) large or unusual transactions; (b) significant transactions occurring at or near the end of accounting periods; (c) structured and otherwise complex arrangements; (d) deals with SPEs; (e) related party transactions; (f) the basis and support (including sufficient documentary evidence) of significant

14. *See supra* note 7.

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estimates, particularly for loss accruals and reserves, as well as for any material changes therein; (g) long-established (and apparently dormant) reserves, allowances, and accruals that might be maintained as "cookie jars"; and (h) transactions (e.g., multiple element revenue arrangements, or "mark-to-market" impairments of investments; or impairments of long-lived assets) that depend upon evidence of fair values.

- More extensive compliance testing of internal controls and substantive testing of significant transactions by both internal and external auditors.

SOME OBSERVATIONS REGARDING FINANCIAL FRAUD

Based upon statistics for private securities class actions and SEC investigations, from 1991 through 2001, the incidence of allegations of financial fraud among SEC registrants is less than three percent in any year. However, as the recent events associated with certain major financial frauds have demonstrated, even as few as – on average – 220 financial frauds per year (out of over 14,000 SEC registrants) is shocking to U.S. capital markets and to investors. Preventing financial fraud is like preventing sin; there always will be malefactors. However, financial fraud can be minimized and reduced in its effects – upon capital markets and investors – if it is properly looked for and recognized in the early stages. It is axiomatic that all financial frauds start small, and then grow bigger and bigger, until they cause significant harm. Application of sufficient vigilance and professional skepticism can serve as a deterrent to financial fraud and the attendant financial losses suffered by investors and other users of financial information. Experience, based upon investigation and analysis of over one thousand cases of alleged financial fraud, demonstrates that adequate internal controls, proper "tone at the top," effective auditing, and being on the *qui vive* for fraudulent activities can make a significant difference.

In the current financial accounting and reporting environment, the temptations to commit accounting irregularities are too great. The value of performance-based compensation, especially the

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value of options, bonuses, and other variable compensation awards for Chief Executive Officers ("CEOs"), Chief Financial Officers ("CFOs"), and other senior management, is a great temptation to manage earnings, set unrealistic revenue and profit targets, and manipulate accounting to achieve results in line with market expectations. Particularly in certain sectors, such as software, electronics, and high technology, the pressures of competition, technological change, and need for capital cause some people to do crazy things, including committing financial fraud. Also, with the recent explosion of IPOs and the significant growth of middle-market firms, the accounting "bench" of properly trained, suitably experienced, and ethically aware financial officers has become lean. The old "factory" system of training, development, supervision, and progression of accountants often has given way – in some respects – to "instant accountancy" by inexperienced accountants and younger MBAs and others who lack the appropriate knowledge, experience, and professional discipline to perceive properly the difference between what is right and what is wrong in respect of accounting judgments. And some of these people are more easily swayed by senior management to act in ways that place company performance before ethical values.

A "sea change" is needed in the entire area of financial accounting and reporting, to include:

- Less complex, more understandable, and more common sense accounting rules and GAAP authoritative pronouncements. Presently, GAAP includes 144 FASBs, 30 APBs, 44 FINs, 7 CONs, and myriad EITFs, AINs, FTBs, and SEC SABs. Many of such GAAP read like stereo (or "DVD") instructions. Fewer would be better, and less formulaic would be preferable.
- Better auditing standards, particularly in the areas of auditing revenue recognition, loss accruals and allowances and reserves, and accounting estimates.
- Improved effectiveness of Audit Committees, particularly in respect of: (a) accounting and auditing literacy and basic knowledge; (b) independence (both *de jure* and in fact) from management; (c) greater

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activism – in terms of number of meetings held, consideration and understanding of key accounting policies and accounting procedures and accounting practices, and inquiry into the propriety of significant transactions; (d) better oversight of management; and (e) more emphasis on the establishment and monitoring of internal controls designed to prevent fraud.

- Corporate policies, and management actions, that establish and maintain a proper "tone at the top," which allows no place in a company (and its management and employees) for accounting irregularities or violations of established accounting policies or internal controls.

The SEC and the U.S. Justice Department, as well as many state regulatory agencies and judicial departments have increased their focus on, and activities involving, financial fraud. The penalties – both civil and criminal – for financial fraud are severe, and recent investigations and prosecutions of alleged financial frauds have been tenacious and thorough. Likewise, the auditing profession has experienced a "wake-up call" regarding financial fraud, and has become even more sensitive to, and vigilant for, any instances that smack of irregularities or improper accounting. Although it usually is true that some people do not get the message, that message still is clear – most financial frauds are caught and the perpetrators are punished.

They say that one bad apple can spoil the bunch. Likewise, just a few financial frauds – especially those that are spectacular in terms of size, audacity, and harm done – can do enormous damage to investor confidence in financial markets and the reliability of financial statements of SEC registrants. Even though financial frauds are small in number – relative to the total number of companies with shares traded on U.S. and foreign exchanges – the economic losses attributed to just these few financial frauds have, of late, been enormous and shocking to investors, financial analysts, accounting professionals, and regulators. More needs to be done to prevent, or detect and expose, such financial frauds; and what needs to be done must be done now – in order to restore

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confidence in the system of financial reporting and audit assurance that underpins U.S. capital markets.

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