

THIS IS NOT A SYMPOSIUM ON HOW TO COMMIT
FRAUD – BUT, IF IT WERE...

*Harvey Gilmore**

INTRODUCTION	200
I. WHAT EXACTLY IS FRAUD?	200
II. A FEW SIMPLE SCHEMES	202
A. Check Misappropriation	202
B. Some Real Life & Simple (Yet Creative) Accounting.....	203
C. A Ponzi Scheme Du Jour.....	204
D. Fictitious Payee Scams	206
1. <i>Ghost Employees</i>	206
2. <i>Fictitious Payees</i>	206
3. <i>Fictitious Vendors</i>	207
E. Let’s Play Make Believe . . . Aka Padding One’s Credentials.	207
III. WHY DOES SUCH FRAUD TAKE PLACE?.....	210
A. The Fraud Triangle	211
B. Permissive Corporate Culture	212
1. <i>Dennis Kozlowski and Tyco</i>	212
2. <i>Enron and its Ballooning Revenues</i>	213
3. <i>The In Crowd</i>	214
C. Audit Failures.....	215
1. <i>Arthur Andersen’s Conflict of Interest Problem</i>	217
D. Internal Controls, Anyone?	218
1. <i>Failing To Separate The Duties</i>	219
2. <i>Fictitious Vendor Payments</i>	219
3. <i>Fictitious Receivable</i>	219
E. How Far Do Auditors Really Go To Detect Fraud?	221
1. <i>How Auditors Historically Handled The Fraud Issue</i>	221
2. <i>Then Came SOX</i>	222
CONCLUSION.....	223

*. Professor of Taxation and Business Law at Monroe College, The Bronx, New York; B.S., Hunter College of the City University of New York (1987), M.S., Long Island University (1990), J.D., Southern New England School of Law (1998), LL.M., Touro College Jacob D. Fuchsberg Law Center (2005). My thanks to Todd Jennings, Adam Kocaj, Ellen Durkee, and Sarah Lierman for their generous help and guidance with this article.

INTRODUCTION

“A lawyer with his briefcase can steal more than 100 men with guns.”¹
Don Vito Corleone

We know the names: Bernard Madoff, Kenneth Lay, Jeffrey Skilling, Andrew Fastow, Dennis Kozlowski, Phillip R. Bennett, and Bernard Ebbers. These are but a few of the biggest corporate thieves in recent memory. Similarly, the names of certain corporations will also conjure up lasting images of massive corporate frauds: Enron, World-Com, Tyco, Adelphia, Refco, Global Crossing, and Sunbeam, again, to name just a few.

The most disquieting aspect of all these financial frauds really isn't the massive amounts of money that was looted from the victimized companies. Instead, the truly unnerving fact regarding most financial frauds is that they are deceptively easy to formulate and sometimes even easier to implement.

In this piece, I will first give several definitions as to what constitutes fraud. I will next argue how and why committing certain types of financial fraud is in fact fairly simple. In doing so, I must point out that I am not deliberately giving a clinic on how to commit fraud (title notwithstanding) and live happily ever after in a nice offshore tax shelter. That said, keep in mind that in order for forensic accountants and fraud investigators to successfully detect and prevent fraud, they necessarily need to have some idea of how a financial crime might be perpetrated. This knowledge is essential in order to beat the bad guys at their own game. Or, to put it another way, in order to catch a criminal, one has to think like a criminal.

Finally, I will give my take on several factors that enable people to commit financial fraud, including weak internal controls, corporate cronyism, and negligent audits, to name a few.

I. WHAT EXACTLY IS FRAUD?

In its most generic form, fraud means that one party induces another party to enter into a transaction under false pretenses. Or, in the opinion of Susan P. Koniak, fraud is “in plain English, lying to someone to get them to give you their stuff.”² My own definition of fraud is that of separating some sucker from his money by getting him to agree to it first.

1. MARIO PUZO, *THE GODFATHER* 52 (Putnam, 1969).

2. Susan P. Koniak, *Law and Truth Roundtable: The Lawyer's Responsibility to the Truth*, 26 HARV. J.L. & PUB. POL'Y 195, 197 (2003).

Of course, there are more technical definitions as to what constitutes fraud. For example, the United States Supreme Court in *Southern Development Company v. Silva*³ defined civil fraud as follows:

First. That the defendant has made a representation in regard to a material fact;

Secondly. That such representation is false;

Thirdly. That such representation was not actually believed by the defendant, on reasonable grounds, to be true;

Fourthly. That it was made with intent that it should be acted on,

Fifthly. That it was acted on by complainant to his damage; and,

Sixthly. That in so acting on it the complainant was ignorant of its falsity, and reasonably believed it to be true.⁴

Next, the Securities and Exchange Commission's (SEC) famous Rule 10b-5⁵ describes fraud this way:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁶

Finally, the Federal Bureau of Investigation (FBI) characterizes fraud this way:

White-collar crimes are categorized by deceit, concealment, or violation of trust and are not dependent on the application or threat of physical force or violence. Such acts are committed by individuals and organizations to obtain money, property, or services, to avoid the payment or loss of money or services, or to secure a personal or business advantage.⁷

3. 125 U.S. 247 (1888).

4. *Id.* at 250.

5. 17 C.F.R. 240.10b-5 (2011).

6. *Id.*

7. *Facts and Figures 2003*, FEDERAL BUREAU OF INVESTIGATION, (2003), http://www.fbi.gov/stats-services/publications/fcs_report2005

Thus, while there is no one dominant definition as to what constitutes fraud, the SEC, FBI, and Supreme Court definitions do agree on the common elements of fraud (misrepresentation, intent, and reliance).

II. A FEW SIMPLE SCHEMES

In keeping with the general premise that one has to think like a criminal in order to catch a criminal (without becoming one of course), one has to always remember that the key to committing a successful financial fraud always lies in the details. Thus, in any financial fraud one has to start small – that is, the amount that the fraudster misappropriates in the beginning should not be a material amount.⁸

It will be necessary to plan ahead first, and account for every possible contingency in staying one step ahead. Otherwise, a potential fraudster is just inviting law enforcement into his living room if he comes up with an idea on Tuesday and tries to put it into practice on Friday.

A. Check Misappropriation

Let us assume that I work for XYZ Corporation as the accounts receivable manager. In my position, I process the payments received from vendors, record the payments in the company books, and also put together the monthly bank reconciliations. One day, the corporation receives a check from Acme Company for \$800, and, while no one is watching me, I put Acme's check in my pocket.

Now that I have the check, my immediate problem is how can I possibly cash a check payable to XYZ Corporation without anyone asking questions? Unless I somehow had signature authority with XYZ's bank, I would not otherwise be able to indorse that check under my own name. Next, the check would most likely be payable "to the order of XYZ Corporation," and the Uniform Commercial Code requires both an indorsement⁹ and delivery¹⁰ of the instrument before I could successfully negotiate an order instrument and receive payment.

Here's how I solve the problem (again, the successful fraudster would have planned this long before the actual theft): first, I will set up a shell company¹¹ in the name of "XYZ Company." My second step is to go to

8. D. LARRY CRUMBLEY ET AL., *FORENSIC AND INVESTIGATIVE ACCOUNTING* 4-4 (Kurt Diefenbach et al. eds., 3rd ed. 2007) ("[T]he measure of whether something is significant enough to change an investor's investment decision . . .").

9. U.C.C. § 3-201(b) (2010).

10. *Id.*

11. W. STEVE ALBRECHT ET AL., *FRAUD EXAMINATION* 510 (Rob Dewey et al. eds., 3rd ed. 2009) ("Dummy or shell companies are fictitious entities created for the sole purpose

Staples and simply order an indorsement stamp. The stamp would read as follows:

PAY TO XYZ COMPANY
ACCOUNT #544460
FOR DEPOSIT ONLY

Thirdly, I will then set up a bank account in the name of the fictitious XYZ Company. Why is this necessary? First, I am relying on the fact that the bank's personnel will not pay attention to the fact that I am depositing a check payable to "XYZ Corporation" into "XYZ Company's" account, and that the bank's less than diligent personnel would most likely assume that "XYZ Corporation" and "XYZ Company" are, in fact, the same business.

Then, when I am required to indorse the check, all I have to do is stamp the back of it. This serves two very important purposes. First, when Acme Company (our vendor) receives its cancelled checks with its bank statement, it will see that the \$800 liability was in fact paid (unknowingly to a different payee) and indorsed. Secondly, using an indorsement stamp will save me from writing anything on the back of any check and there would not be any handwriting samples that could be traced back to me. When the funds become available, I can withdraw the money as I see fit by going to any supermarket or gas station that has an ATM (and preferably no cameras) to make my withdrawals.

The end result, if I'm both discreet and successful, is the acquisition of several hundred thousand (or even million) dollars of the company's money before anyone realizes that anything is missing.

B. Some Real Life & Simple (Yet Creative) Accounting

It's never a good thing when someone owes you money and then stiffes you by not paying; yet, this is something that most people can relate to. Sometimes, a corporation can have a similar experience on a much bigger scale. Imagine being the Chief Executive Officer (CEO) of a corporation where the clients owe \$430 million that the company might not be able to collect. This was what Refco, and its CEO, Phillip R. Bennett, faced in late 2005, when its books showed \$430 million in bad debts.

The solution that Bennett came up with to solve the bad debt problem was astounding for its simplicity. It was nothing more than a series of well-timed, yet simple, accounting entries on Refco's books that enabled Bennett to take \$430 million of bad debts off the company's books.¹²

of committing fraud. Many times, they are nothing more than a fabricated name and a post office box that an employee uses to collect disbursements from false billings.”)

12. In re Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611 (S.D.N.Y. 2007). See also Allan Dodds Frank, *The Refco Debacle: Reporter on the Hunt*, <http://www.evesmag.com/refco.htm> (last visited Oct. 1, 2010); Paritosh Bansal, *Ex-Refco*

Every quarter, Bennett would have Refco Capital, a Refco subsidiary, lend money to a third party.¹³ The third party would then lend that money to another corporation (Refco Group Holdings, Inc., “RGHI”)¹⁴ in which Bennett himself was the sole shareholder.¹⁵ Then, RGHI would give the cash to Refco in payment of the bad debts.¹⁶ This sleight of hand gave Refco’s auditors the belief that 1) Refco’s receivables had been paid by its customers, and 2) Refco had another legitimate outstanding receivable due to its subsidiary from a third party. After Refco’s external auditing firm completed its quarterly examination of Refco’s books, Bennett would quietly reverse the transaction between RGHI and Refco and, in effect, put everything back where it was...that is, until the next quarterly audit.¹⁷

Although Bennett’s fraud resulted in \$2.4 billion in losses to shareholders and creditors,¹⁸ the real genius of the scheme was in the simple recording in the accounting records. First, by directing Refco Capital to make the loan to the third party, Bennett created an asset on Refco Capital’s books in the form of a receivable. Next, when the third party makes the same loan to RGHI, RGHI pays the money back to Refco. Now, Refco has what appears to be an additional infusion of cash as it looks like the previously uncollectible debts have been paid in full. The end result is an isosceles triangle in which money owed to Refco was in fact paid by Refco!

C. A Ponzi Scheme Du Jour

What fraud investigators commonly refer to as a “Ponzi scheme” is (dis)credited to Charles Ponzi,¹⁹ who originated the idea of creating a “pyramid scheme where investors are encouraged to invest in a ‘Great Idea’ of one sort or another.”²⁰

For example, I hold myself out as an investment broker. I send a prospectus to potential suckers, I mean . . . investors, in which I promise a 20 percent return to every client who invests \$1000 with my company within sixty days. On April 1, I get 100 investors who are willing to give

Executive Pleads Guilty, REUTERS, Dec. 19, 2007, <http://www.reuters.com/article/2007/12/19/us-refco-plea-idUSN1960240320071219>.

13. In re Refco, *supra* note 12 at 619.

14. In re Refco, *supra* note 12 at 619.

15. Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 161 (2007).

16. In re Refco, *supra* note 12 at 619.

17. *Id.*

18. U.S. v. Bennett, S3 05 Cr. 1192 (NRB), Government’s Sentencing Memorandum.

19. *Cunningham v. Brown*, 265 U.S. 1 (1924).

20. Cabot Christianson, *You can’t cheat an honest man: Everything you want to know about Ponzi schemes*, 23 ALASKA B. RAG 23, 23 (1999).

me \$1000 apiece, and I have an initial investment of \$100,000. On June 1, sixty days later, as promised I send each investor a certified check for \$200. As one of the elements of fraud is reliance, I have to make my story look good enough and sound convincing enough so that I can get my potential victims to create the contract with me based on the story I am telling them. Right now, two things happened that have convinced my initial group of investors that I am in fact the real deal.

First, since I sent each client a \$200 check, this will confirm in his mind that I am someone who is able to deliver the goods. Second, the fact that I took the time and effort (and expense) to send each client a certified check would most likely also convince each client that I am legitimate. After all, anyone who would pay good money to have that many checks certified certainly cannot be committing any fraud...can he?

Once I have delivered the “goods” to my first group of investors, two things are likely to happen next. First, my initial group of investors would likely invest even more money into my company, which I am all too happy to take. Secondly, my initial investor group will likely tell their friends about their successful venture with my firm, and this second group would also be willing to invest their money with my firm, which again, I will be very happy to take. The same thing happens with the next round of investments with my firm: I am again able to send each of my clients a certified check representing what they believe is a 20 percent return on their investment.

What really happened here? Each client gave me \$1000 as an investment, and I gave each client \$200, representing 20 percent. However, the \$200 that I gave each client is *not* a 20 percent profit on the investment. All I did was take \$200 off the top, and give that money back to the client. So, that \$200 is nothing but a *refund*, and I pocket the rest.

There's more. How can I keep doing this? According to this hypothetical, I have two groups of investors. Thus it will be necessary for me to segregate which investor belongs to which group. So when the money comes in, I will skim some of the money from Investor Group #2 in order to pay Investor Group #1. Then, with Investor Group #2, I will pay their \$200 out of whatever is left of their \$1000 investment. So, Investor Group #2 really got skimmed twice.

The more levels of investors I can get for my business, the longer I can carry out this scam. This results in the more money I can steal as I skim from Investor Group #5 to pay Investor Group #4, Investor Group #4 to pay Investor Group #3, and so on as I go further up the food chain. Unfortunately for the investors, the money that I'm using to pay the 20 percent return *has never come from any profits* from my business idea; I'm just taking money from one gullible chump to pay off another gullible chump and pocketing the difference. By the time the scheme ultimately breaks down, the last group of investors that I can bring into the fold will be

the group left holding the bag and having nothing left to show for it.²¹ Charles Ponzi's original scheme on which I based the above hypothetical is discussed at length in the Supreme Court case *Cunningham v. Brown*.²²

D. Fictitious Payee Scams

1. *Ghost Employees*

An unscrupulous payroll manager could steal a sizeable amount of money by having payroll checks issued to former employees who no longer work for the company.²³ How could this happen? Just do not remove the former employee from the payroll records. And, as an additional measure of the fraudster's covering his tracks, the fraudster could make sure that the ghost employee check has the correct amount of deductions for federal income taxes, state & local income taxes, Social Security Taxes and Medicare Taxes. And, similar to my earlier discussion of check misappropriation, I can easily have a deposit stamp created that reads "pay to (insert name), for deposit only."

2. *Fictitious Payees*

Believe it or not, under the Uniform Commercial Code, any instrument that is payable to a fictitious payee can be enforced by an innocent holder against the maker of a note or the drawer of a draft.²⁴

For example, the Jimmy Fund²⁵ is a charitable organization that supports the Dana-Farber Cancer Institute, a well known hospital in the Boston area. If I wanted to take grievous advantage of people's altruism, I could set up a scheme where I solicit donations for the Jimmy Fund. For those people who are willing to pay by check, I would have them make their checks payable to Jimmy Fund. In the meantime, I will have a bank account made up in the name of "Jimmy Fund," or even "James Fund," if I wanted to be more formal. Since "Jimmy" is generally accepted as the common

21. *Id.* ("Early investors invest, and are rewarded with huge profits. More investors invest, and then still more. After the bubble bursts, it turns out that investor #1 was paid off, not by the proceeds of the great idea, but by investor #2's investment. Investor #2 was actually paid off by investor #3. And so on. The early investors win big, and the later investors lose big.").

22. *Cunningham*, 265 U.S. at 34.

23. CRUMBLEY ET AL., *supra* note 8, at 5-18.

24. *See* UCC § 3-404(b) (2010); *see also* UCC § 3-405 (2010); Gregory C. Cook & John D. Pickering, *A Primer on Applying Articles 3 and 4 to the Ten Most Common Check Disputes*, 70 ALA. L. REV. 278, 283 (2009).

25. The Jimmy Fund, <http://www.jimmyfund.org/abo/default.html> (last visited Oct. 5, 2010).

nickname for “James,” no one would think anything suspicious about it. And, again, I can have a deposit stamp created that reads “pay to Jimmy Fund, for deposit only.” This again saves me from giving any handwriting samples on any checks that I would deposit into Jimmy Fund’s account.

3. *Fictitious Vendors*

Similar to the scams involving shell companies, ghost employees and fictitious payees, setting up phony vendors is also a relatively simple way of committing occupational fraud, the object of which is to separate an innocent person from his money and putting the money in the fraudster’s guilty pocket. In this kind of scheme, the business “makes payments for fictitious invoices to a company owned by a corrupt employee, his or her relatives, or other accomplices.”²⁶ A real life incident involving an oncology practice in Florida resulted in the office bookkeeper embezzling millions of dollars over an eight year period.²⁷

“A few months after she began working for the practice, she started opening up fictitious companies with names similar to the practice’s legitimate vendors. For example, instead of ‘Cardinal Health,’ her shell company was ‘Cardinal.’ In place of ‘McKesson Drug Company’ her fake company was ‘McKesson.’”²⁸

Unfortunately for the doctor who owned the practice, the bookkeeper’s fraud resulted in the doctor’s filing for personal bankruptcy as well as getting a divorce.²⁹

E. Let’s Play Make Believe . . . Aka Padding One’s Credentials.

As a college professor (see note 1), my tuition paying students would have an expectation (and more important, a contract right) that when I walk into the classroom, I would have the practical experience and academic training necessary to deliver the subject matter that shows my students that I actually knew what I was talking about. Instead of actually having those academic credentials, let us assume that I was someone who dropped out of grade school after the fourth grade. On top of that, my only steady job is that I dig graves. But, my dream in life was to actually teach college level taxation and business law courses, and come hell or high water, I’m going to find a way to do just that. I am not at all worried about not having

26. Lee Ann H. Webster, *Detecting Office Fraud in Your Practice*, 6 COMMUNITY ONCOLOGY 412, 413 (2009), available at <http://www.communityoncology.net/journal/articles/0609412.pdf>.

27. *Id.*

28. *Id.*

29. *Id.*

graduated from either college or law school; those are minor details – after all, I’m not actually going to spend 7-10 years actually going to college, graduate school and law school. If I can successfully pull off this charade, well, why would I go to the trouble of actually taking classes?

How could I pull this off? Part of my job is to be a good actor. I can go to websites like www.higheredjobs.com, www.chronicle.com/jobs, or any college’s website and look at the job postings for open faculty positions. I can also go online and gather information on how to conduct myself at an academic interview. Once I get that information, I can certainly rehearse and practice to the point where I might actually sound like a legitimate polished applicant for a professorship.

Next, what do I do about transcripts? If I show on my resume that I’ve graduated from the institutions shown on my resume, common sense would suggest that any potential employer would want me to furnish them with official copies of my transcripts. Since part of my fraud is misrepresenting my education, it would also be easy for me to manufacture fictitious transcripts. First, I could go to Staples or Office Max and purchase a more expensive, fancier type of paper. Next, while I’m there, I can order a special stamp that approximates the official seal of each school that I allegedly graduated from. After that, I put the special paper into my printer and I can make up a transcript showing what courses I’ve taken in which semesters, as well as the grades that I received in each course. Last, I visit the schools I “graduated” from, procure some letterhead envelopes, and I mail my transcripts from the nearest post office which will have the postmark from my school’s nearby location.

If I say that I have a Bachelor’s degree in accounting from Hunter College, I could go to the department’s website and carefully copy the sequence of courses. Again, planning ahead is a key component in committing a successful fraud. My plan would severely go up in smoke if my transcript showed that I took Principles of Accounting 1 and Advanced Accounting in the same semester. How careless is that? Finally, what were my grades in my accounting classes? ***Whatever I wanted them to be!*** Then, if I actually get hired by a college that I’ve interviewed with, I’ll be **stealing the college’s money as a salaried employee.**

Obviously, I’m being a little facetious with the above hypothetical. Unfortunately, however, not only are scams like this not at all that farfetched, but they have actually happened. A well publicized incident involved Ms. Marilee Jones, who was the dean of admissions at the Massachusetts Institute of Technology (MIT).³⁰ She began working for the school back in 1979 and over the next twenty-eight years made her way up

30. Tamar Lewin, *Dean at M.I.T. Resigns, Ending a 28-Year Lie*, N.Y. TIMES, Apr. 27, 2007, <http://www.nytimes.com/2007/04/27/us/27mit.html>.

the ranks and eventually became a dean.³¹ Ms. Jones had proven herself to be very good at the jobs she had prior to her becoming a dean³², and was beloved by her students.³³ Ms. Jones had claimed that she received degrees from Albany Medical College, Union College, and Rensselaer Polytechnic Institute.³⁴ As it eventually turned out, Ms. Jones never graduated from any of the schools that she mentioned.³⁵ In a bizarre twist to the story, Ms. Jones did receive a bachelor's degree from the College of Saint Rose, but she never listed it anywhere on her resume.³⁶

Unfortunately, this is not the only incident where someone falsified their academic credentials. A New Jersey attorney (Daniel J. Scavone) had his law license revoked after the state's disciplinary review board found that he, among other things, altered his law school transcript and failed to disclose on his bar application that he was kicked out of one law school for altering his transcript.³⁷ Scavone's first misdeed was that he applied to the University of Pennsylvania Law School as a minority student, which he was not.³⁸ In his second year, Scavone altered his first year law grades on his transcript.

"Respondent altered his transcript to show that in his first year he received three 'Excellents' and five 'Goods' whereas his true grades were two 'Goods' and six 'Qualifieds.' He submitted the altered transcript to two New York law firms which were engaged in on campus recruiting. Respondent also falsified his resume by indicating that he received a score of 705 on the LSAT whereas he had received only 564 and 539. He submitted the altered resume during the on-campus recruiting to a New York law firm."³⁹

The law school administration, after discovering Scavone's chicanery, gave him the option to either withdraw or face a disciplinary hearing likely to result in expulsion.⁴⁰ Scavone agreed to withdraw.⁴¹ After Scavone graduated from the St. Louis University School of Law,⁴² he applied for admission to the New Jersey bar.⁴³ A key question that Scavone had to answer truthfully asked the following: "Have you ever been disciplined,

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

36. Marcella Bombardieri, *Marilee Jones Did Receive Degree*, THE TECH, May 4, 2007, <http://tech.mit.edu/V127/N23/marileupdate.html>.

37. *In re Scavone*, 106 N.J. 542 (1987).

38. *See id.* at 544.

39. *Id.* at 545.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

reprimanded, suspended, expelled or asked to resign from any educational institution?”⁴⁴ Scavone answered no: “Respondent answered that question in the negative. He certified his answers were true and accurate to the best of his knowledge and belief, further stating he was aware that any willful misstatement could prejudice his admission to the bar and subject him to such penalties as provided by law.”⁴⁵ The court agreed with the review board’s findings that Scavone was not truthful in answering that specific question.⁴⁶ Consequently, the court revoked Scavone’s license to practice law.⁴⁷

These are but a few of the various ways that anyone could commit a massive fraud with a little ingenuity. Now that we have explored some of the how, the next question to tackle is . . .

III. WHY DOES SUCH FRAUD TAKE PLACE?

The answers to this question could be as numerous as the fraud schemes themselves. They could range from company culture,⁴⁸ lax internal controls,⁴⁹ personal pressure situations,⁵⁰ rationalizations,⁵¹ and audits generally not designed to specifically find fraud other than financial statement fraud,⁵² to name but a few.

44. *Id.* at 546.

45. *Id.*

46. *Id.* at 550-554.

47. *Id.* at 554.

48. Pamela H. Bucy et al., *Why do they do it?: The Motives, Mores, and Character of White Collar Criminals*, 28 ST. JOHN’S L. REV. 401, 401 (2008) (“Why do talented, bright, highly educated, successful people, who have ‘made it,’ risk it all by lying, stealing, and cheating, especially when what they’re stealing is not much compared to what they have? The simple answer is, ‘because they can.’”). *See also* Daniel J. H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, 2004 COLUM. BUS. L. REV. 773 (2004).

49. *See, e.g.*, Lawrence A. Cunningham, *A New Product for the State Corporation Law Market: Audit Committee Certifications*, 1 BERKELEY BUS. L.J. 327, 335 (2004) (“Many financial calamities that brewed during the late 1990s are attributed to internal control failure, however, including within audit committees.”).

50. *See* Bucy et al., *supra* note 48, at 408. (“For example, Walt Pavlo, Credit Collections Manager at MCI Telecommunications, Inc., who falsified MCI accounts receivables and stole \$6 million from MCI, spoke of greed, opportunity, and culture But, he also felt a lot of pressure from within MCI and did not know how to meet MCI’s mandates without cheating. His performance reviews were based entirely on how much MCI’s bad debt he collected.”).

51. *See, e.g.*, TOMMIE SINGLETON ET AL., *FRAUD AUDITING AND FORENSIC ACCOUNTING* 10 (3d ed. 2006).

52. CRUMBLEY ET AL., *supra* note 8, at 4-5.

A. The Fraud Triangle

Any discussion as to *why* individuals commit occupational fraud must include the “fraud triangle.” Criminologist Donald Cressey (1919-1987)⁵³ developed a theory that explains certain elements that are necessary for a fraud to take place.⁵⁴ Dr. Cressey’s theory became the well known “Fraud Triangle.”

Dr. Cressey’s theory establishes that there are three specific elements (like points in a triangle) that would lead a person to commit occupational fraud. The elements are (a) pressure,⁵⁵ (b) opportunity,⁵⁶ and (c) rationalization.⁵⁷

What is pressure? One might describe pressure as a deep-seated need to come up with money right away as a result of gambling, alcoholism, divorce, or a high maintenance lifestyle, to name just a few.⁵⁸

Next, what is opportunity? Opportunity is the occupational fraudster’s sensing that he has a chance to steal company funds while no one is looking and the *getting is good*.⁵⁹

Finally, what is rationalization? Rationalization is when the fraudster comes up with excuses as to why his bad act really isn’t so bad.⁶⁰ Some rationalizations include the following: I’m overworked, underpaid, and unappreciated; my 99 year old aunt needs hip replacement surgery; my bosses treat me like crap; I was only borrowing the money; this is a billion dollar company – they won’t miss \$250,000; I had to pay my bills; I had to save my family from eviction. The list goes on and on.

53. Megan Cook, *Financial Fraud 101: Understanding the Fraud Triangle*, EXAMINER.COM, JUNE 17, 2009, <http://www.examiner.com/financial-fraud-international/financial-fraud-101-understanding-the-fraud-triangle>.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. See, e.g., Kathleen Barney, *This Thing Called Forensic Accounting*, 43 ARIZ. ATT’Y 34, 38 (2007) (“First, an employee feels the pressure of a financial burden such as a divorce, a gambling problem, alcoholism or an excessive lifestyle. This becomes his or her motivation to steal.”).

59. *Id.* (“Second, opportunity exists in the loopholes of the internal controls, which allow the employee to exploit his or her position for personal gain.”).

60. *Id.* (“Finally, the fraudster must be able to rationalize the behavior. I have never met a perpetrator of fraud who considered himself a crook. The most common rationalizations are ‘I will pay it back,’ ‘The firm can afford it’ and ‘I’m not hurting anyone.’”).

B. Permissive Corporate Culture

At the corporate level, the general premise is that management's primary objective is to maximize the value of the corporation, and by extension, shareholder wealth.⁶¹ Since a corporation is owned by its shareholders,⁶² the corporation's management team is working on behalf of the shareholders, and is thus charged with the responsibility of taking a course of action that would maximize shareholder wealth.⁶³ So, if it happens that some questionable corporate ethics were instrumental in maximizing shareholder wealth with shareholders and managers making money hand over fist,⁶⁴ should one be really surprised to find after the fact that people might have been asleep at the wheel (or may have looked the other way) as to not stop the gravy train?

During his time as an MBA student at Harvard, Jeffrey Skilling responded to a question of how he would handle a situation where he knew his company sold harmful or potentially fatal products to the general public: "I'd keep making and selling the product. My job as a businessman is to be a profit center and to maximize return to the shareholders. It's the government's job to step in if a product is dangerous."⁶⁵ Consequently, during Enron's peak years, money was pouring in by the boatload. "Enron exemplified an era. At its peak, it was celebrated as a new and better way of doing business, making shareholders and employees money by the bushel while increasing the efficiency of our energy markets to everyone's benefit."⁶⁶

1. *Dennis Kozlowski and Tyco*

That said, in keeping with the premise of maximizing shareholder wealth, we have seen a number of lurid cases in the very recent past where managers have taken advantage of their positions to maximize *their own* personal wealth, at the expense of the very shareholders they were supposed

61. See, e.g., MICHAEL C. EHRHARDT & EUGINE F. BRIGHAM, CORPORATE FINANCE: A FOCUSED APPROACH 7 (3d ed. 2008); see also Edward B. Rock, Commentary, *The General Counsel of a Nonprofit Enterprise: Some Questions*, 46 HOUS. L. REV. 17, 19 (2009) ("In the for-profit corporation, the roles played by shareholders mean that, as a theoretical and practical matter, the corporation will ultimately be managed for the shareholders. Great discretion is given to the managers in how they maximize shareholder value and even, in the short term, *whether* they maximize shareholder value.").

62. See, e.g., ROGER LEROY MILLER & GAYLORD A. JENTZ, FUNDAMENTALS OF BUSINESS LAW 520-21 (8th ed. 2010).

63. EHRHARDT & BRIGHAM, *supra* note 61, at 7.

64. Greenwood, *supra* note 48, at 777.

65. Greenwood, *supra* note 48, at 777.

66. Greenwood, *supra* note 48, at 790.

to serve,⁶⁷ sometimes to the point of committing fraud.⁶⁸ Consider the now classic case of former Tyco International Inc. Chief Executive Officer Dennis Kozlowski, who is currently serving a 25 year prison sentence for looting \$600 million from the corporation.⁶⁹ Not only that, Kozlowski's larceny was taken *on top of his having earned \$332 million in salary* between 1999 and 2002.⁷⁰ Kozlowski's fraud is well known for having included a \$2 million birthday toga party for his wife, for which Tyco paid half of the cost,⁷¹ having a \$6,000 shower curtain in his Manhattan apartment,⁷² as well as his forgetting to report a \$25 million loan forgiveness from the corporation on his income tax return.⁷³

2. Enron and its Ballooning Revenues

In the last ten years, Enron has emerged as perhaps *the* poster child for corporate fraud.⁷⁴ In a nutshell, Enron's creative accounting practices resulted in untold millions of dollars of income that accrued on the books, but the resulting cash inflows never existed in fact.⁷⁵ How could this happen? It started with an accounting treatment that Enron utilized in preparing its financial statements called "mark to market accounting."⁷⁶ Mark to market accounting allows a company to record expected future earnings on its books in the current period as revenue. For example, in 2010 my law practice enters into a long term retainer agreement with a client and the client will pay me \$10 million over the ten year life of the contract. Instead of my recording a prorated amount of the contract price as revenue every year, mark to market accounting allows me to hit a home run and report the entire \$10 million on my books as revenue *this year*. In essence, mark to market accounting allows me to record non cash earnings

67. Stephen V. Arbogast, *Commentary on Legal and Managerial "Cultures" in Corporate Representation*, 46 HOUS. L. REV. 33, 36 (2009) ("In essence, it concerns firm managers, who are hired to work for shareholders, using their corporate positions to pursue personal financial agendas.").

68. *Id.*

69. See, e.g., Susan Lorde Martin, *Executive Compensation: Reining in Runaway Abuses—Again*, 41 U.S.F. L. REV. 147, 161 (2006).

70. *Id.*

71. *Ex-Tyco CEO Dennis Kozlowski Found Guilty*, MSNBC, June 17, 2005, <http://www.msnbc.msn.com/id/8258729>.

72. *Id.*

73. *Id.*

74. Greenwood, *supra* note 48, at 783-84.

75. Greenwood, *supra* note 48, at 784.

76. See, e.g., John R. Kroeger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. Colo. L. Rev 57, 75 (2005).

now with the expectation that I would realize the cash receipts in the future.⁷⁷

The catalyst that projected Enron to use mark to market accounting was that in 1991 President Jeffrey Skilling was able to convince CEO Kenneth Lay and the rest of the top management that mark to market accounting was the way for the company to go.⁷⁸ All the more amazing (in light of what eventually happened) was that Skilling was able to convince Enron's auditing firm, Arthur Andersen, as well as the Securities and Exchange Commission (SEC) that the change in Enron's accounting method was necessary and appropriate.⁷⁹

3. *The In Crowd*

A common denominator that might have been a factor with the big name corporate accounting scandals seems to be that the perpetrators were part of a powerful clique that ran the day to day operation. For example, several of Enron's key players all had MBA degrees.

The credentials for the Enron executive team were as follows:

Jeffrey K. Skilling, the former CEO of Enron, held an MBA from Harvard; Andrew Fastow, the former CFO, held a Northwestern MBA; Clifford Baxter, a former vice chairman, who killed himself shortly after the Enron revelations became a daily media event, was a Columbia MBA.⁸⁰

And Kenneth Lay, as Enron's leader, pointed the way to corporate success that his underlings were only too happy to follow.

Mr. Skilling and Mr. Fastow were so well regarded in the business community that none dared raise a question about them or their methodologies. And Mr. Lay had planted in them the goal of Enron's continuing achievement above and beyond the crowd. As a CEO a full generation older and chairman of the Enron board, Fastow and Skilling continued to perform in the manner that Mr. Lay had come to expect.⁸¹

77. *Id.* at 75.

78. HAROLD BIERMAN, JR., ACCOUNTING/FINANCE LESSONS OF ENRON: A CASE STUDY 156 (2008).

79. *Id.*

80. Marianne M. Jennings, *A Primer on Enron: Lessons From A Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 226 (2003) (citation omitted).

81. Marianne M. Jennings, *Restoring Ethical Gumption in the Corporation: A Federalist Paper on Corporate Governance – Restoration of Active Virtue in the Corporate Structure to Curb the 'YeeHaw Culture' in Organizations*, 3 WYO. L. REV. 387, 401-02 (2003) (citation omitted).

By the way, Kenneth Lay himself had a Ph.D. in Economics from the University of Houston.⁸²

Similarly, in the situation regarding Tyco, Dennis Kozlowski found an interesting method to bind his underlings to the corporation and to himself personally. Kozlowski orchestrated two employee loan programs which effectively ensured employee silence at best, or employee complicity, at worst.⁸³ The first was a loan available to Tyco employees to cover the income tax liability that triggered when their stock options vested.⁸⁴

The second loan helped Tyco employees cover their moving expenses when they relocated from Tyco's headquarters in New Hampshire to its corporate offices in New York.⁸⁵ Kozlowski had declared in no uncertain terms that these loans were available for his new hires, including Chief Financial Officer Mark Schwartz and General Counsel Mark Belnick.⁸⁶ Over time, both Schwartz and Belnick found themselves increasingly beholden to Kozlowski as they both received additional loans as well as salary increases.⁸⁷

C. Audit Failures

We all know the story of how the complicity of Enron's not-so-independent auditing firm Arthur Andersen ("Andersen") played a huge role in not only Enron's demise, but also the deterioration of Andersen's own reputation to that of a national punch line before going out of business. I'll discuss the details of Andersen's independence follies a little later. However, Andersen's role in the Enron mess does shine a bright light on the fact that it does not take much to compromise audit firm independence.

Federal law requires that a publicly traded corporation have its financial statements audited every year.⁸⁸ An auditing firm is required to be independent from the client whose financial records it is examining.⁸⁹ A corporate client hires a CPA firm to its headquarters to test samples of the company's records . . . things like bank reconciliations, journal entries, general ledgers, payroll records, and tax records, to name a few. The firm will conduct the audit in accordance with the professional auditing rules

82. WILLIAM G. FLANAGAN, *DIRTY ROTTEN CEOs: HOW BUSINESS LEADERS ARE FLEECING AMERICA* 57 (2004).

83. Jennings, *supra* note 81, at 467-74.

84. Jennings, *supra* note 81, at 474.

85. Jennings, *supra* note 81, at 474.

86. Jennings, *supra* note 81, at 474.

87. Jennings, *supra* note 81, at 467-68.

88. 15 U.S.C. § 77aa (25)-(27) (2000); 15 U.S.C.S. § 78q (e) (LexisNexis 2006).

89. Arthur B. Laby, *Differentiating Gatekeepers*, 1 *BROOK. J. CORP. FIN. & COM. L.* 119, 125 (2006).

called Generally Accepted Auditing Standards.⁹⁰ Generally Accepted Auditing Standards are the rules of the accounting profession that control how accountants perform audits. At the end of the audit, the audit partner will sign a letter in which the firm gives its opinion whether the client's accounting practices give a fair representation of its financial condition.⁹¹

The requirement of auditor independence is thus the key in the auditor being able to do his job in a dispassionate manner. "An auditor cannot be the client's advocate. The Court in the *Arthur Young* case concluded by saying that 'the public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."⁹²

Next, the auditor and client agree ahead of time how much the client will pay for the audit engagement. So, right out of the gate, an auditing firm gets paid by the very company whose financial practices the auditor is investigating. This arrangement now opens the door to the possibility that the auditor's independence might be compromised on that very basis alone. "[T]hose who defend the propriety of consulting services by auditors respond that the growth of consulting services made little real difference because the audit firm was already conflicted by the fact that the client paid its fees."⁹³

Of course, this does not necessarily mean that the auditor is automatically subject to the client's influence and power of suggestion to push the envelope, stretch the rules, or even help the client commit fraud, but this raises the specter that a client could prevail on the auditor's potential fear of losing the client to a competitor. If I'm the CEO of a publicly traded corporation and KPMG is auditing my company's books, I could conceivably suggest to the audit partner that if things are not "just so" at the end of this year's engagement, I may take my business to Price Waterhouse Coopers next year. So, I could subtly (or not so subtly) maneuver the auditing firm into doing my bidding simply by using their competition as my leverage.

Put as bluntly as possible, the audit partner of a major client (such as Enron) is always conflicted by the fact that such a partner has a 'one client' practice. Whoever is the gatekeeper—attorney, auditor, or analyst—a 'one client' practice compromises the agent. Should the partner lose that client for any reason, the partner will not easily find a

90. See, e.g., *United States v. Arthur Young & Co.*, 465 U.S. 805, 811 (1984).

91. *Id.*

92. Laby, *supra* note 89, at 124.

93. John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 322 (2004).

replacement client and may need to find employment elsewhere.⁹⁴

1. *Arthur Andersen's Conflict of Interest Problem*

Let us go back to the Enron debacle and how Andersen's chummy relationship with its favorite client ultimately led to the spectacular failure of both firms. If we accept the proposition that the auditing firm is to be independent from its client, then common sense might suggest that the auditor should not do any non-audit (tax, consultation, financial statement preparation, etc.) work for the client.

a) Who did what? In addition to being Enron's external auditor, Andersen also did management consulting and tax work for Enron, for which Enron paid \$25 million for the auditing work and another \$27 million for the non-audit work.⁹⁵

b) Who worked where? Quite a few members of Andersen's staff had permanent offices in the Enron headquarters and were eventually hired to work for Enron.⁹⁶ In addition to that, "Andersen performed and reviewed both the internal and external audit functions."⁹⁷

c) Who was close with whom? David Duncan, who was Andersen's audit partner in the Houston office (where Enron was located), was a golfing buddy of Rick Causey, who was Enron's Chief Accounting Officer and himself a former Andersen partner.⁹⁸ Thus, it became easier over time for Andersen to acquiesce to Enron's additional demands over time.⁹⁹

While Andersen's "misadventures" with Enron have now become legendary, it is worth noting here that several of the biggest corporate accounting frauds in recent history have the same common denominator: *Arthur Andersen was the auditor*.¹⁰⁰

The investor losses tied to fraud by Arthur Andersen's clients are enormous. Three hundred billion dollars is the total loss in market capitalization, *i.e.*, stockholder value, for only the following six fraud-

94. *Id.* at 322.

95. Jennings, *supra* note 80, at 214. See also Deborah Solomon, *After Enron, a Push to Limit Accountants to . . . Accounting*, WALL ST. J., Jan. 25, 2002, at C1.

96. Jennings, *supra* note 80, at 214. See also Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 868 (2003).

97. Jennings, *supra* note 80, at 214.

98. Flynn McRoberts, *Ties to Enron Blinded Anderson*, CHI. TRIB., Sept. 2, 2010, <http://www.chicagotribune.com/news/chi-0209030210sep03,0,7490166.story?page=2>. See also Jennings, *supra* note 80, at 214.

99. McRoberts, *supra* note 98.

100. John Freeman, *Ethics Watch: Lawyers and Corporate Disgrace*, 14 S.C. LAW. 9, 9 (2003).

tainted firms: Sunbeam, Waste Management, WorldCom, Qwest, Global Crossing and Enron. These wayward firms have more in common than staggering losses due to financial fraud: They all shared Arthur Andersen as their auditor.¹⁰¹

That said, I do not mean to suggest that Arthur Andersen is the only big accounting firm that was ever in bed with a client to the point of committing massive fraud. As of this writing, Big Four accounting firm Ernst and Young is currently under investigation for its work with the now bankrupt investment firm Lehman Brothers.¹⁰² Similarly, PricewaterhouseCoopers, another Big Four accounting firm, is under scrutiny for giving American International Group (AIG) a clean bill of health before AIG nearly collapsed.¹⁰³

D. Internal Controls, Anyone?

The ease with which one can perpetrate a financial fraud also depends on the quality of the company's internal controls (or lack thereof). What exactly are internal controls? Generically speaking, internal controls are defensive mechanisms a business puts in place to maintain the integrity of its financial reporting, as well as protecting itself from financial fraud. "Internal control consists of all of the related methods and measures adopted within an organization to safeguard its assets, enhance the reliability of its accounting records, increase efficiency of operations, and ensure compliance with laws and regulations."¹⁰⁴

Typically, a company's internal control policies will have specific principles that the responsible employees must adhere to in order to conduct its operations (financial and otherwise with reliability and integrity). "The six principles of control activities are as follows: establishment of responsibility; separation of duties; documentation procedures; physical controls; independent internal verification; and human resource controls."¹⁰⁵

How can an unscrupulous, enterprising individual circumvent his company's control devices? Similar to my hypothetical regarding check

101. *Id.*

102. *See, e.g.*, Kevin Reed, *E & Y Investigated over Lehman Brothers*, THE ACCOUNTANCY AGE (Oct. 4, 2010), <http://www.accountancyage.com/accountancyage/news/2270880/y-auditors-investigated-lehman>; Emily Chasan, *Could Lehman Be Ernst & Young's Enron?*, REUTERS, Mar. 12, 2010, available at Factiva, Doc No. LBA0000020100313e63d0000r; John Carney, *Will Ernst and Young Survive the Lehman Fiasco?*, BUS. INSIDER, Mar. 12, 2010, <http://www.businessinsider.com/will-ernst-and-young-survive-the-lehman-fiasco-2010-3>.

103. Joseph Weber et al., *Tough Questions for AIG's Auditors*, BUS. WK., Apr. 11, 2005, http://www.businessweek.com/magazine/content/05_15/b3928047_mz011.htm.

104. JERRY J. WEYGANDT ET AL., ACCOUNTING PRINCIPLES, 348 (9th ed. 2009).

105. *Id.* at 349.

misappropriations, a common possibility can arise from the fact that if an individual does all of the accounting functions from start to finish, the temptation to take advantage of the situation can be more than the individual can withstand. For example:

1. *Failing To Separate The Duties*

Angela Bauer was an accounts payable clerk for Aggasiz Corporation. She prepared and issued checks to vendors and reconciled bank statements. She perpetrated a fraud this way: She wrote checks for costs that the company had not actually incurred (e.g., fake taxes). A supervisor then approved and signed the checks. Before issuing the check, though, she would 'white-out' the payee line on the check and change it to personal accounts that she controlled. She was able to conceal the theft because she also reconciled the bank account. That is, nobody else ever saw that the checks had been altered. Total take: \$570,000.¹⁰⁶

2. *Fictitious Vendor Payments*

As discussed previously, in a fictitious vendor situation, I could create a shell company, have its address as a post office box, and have my employer mail checks to the phony address, and I'm off and running.

Lawrence Fairbanks, the assistant vice chancellor of communications at Aesop University was allowed to make purchases for his department of under \$2,500 without external approval. Unfortunately, he also sometimes bought items for himself, such as expensive antiques and other collectibles. How did he do it? He replaced the vendor invoices he received with fake vendor invoices that he created. The fake invoices had descriptions that were more consistent with the communication department's operations. He submitted these fake invoices to the accounting department as the basis for their journal entries and to accounts payable as the basis for payment. Total take: \$475,000.¹⁰⁷

3. *Fictitious Receivable*

If I run a legitimate business, I provide goods or services for my clients, and they pay me. For example, I prepare a client's tax return and

106. *Id.* at 351.

107. *Id.*

charge him \$200. If the client pays me up front, I will prepare a journal entry in my books showing two things. First, my accounting records will show that my cash account balance increased by \$200. Second, my accounting records will show that my revenue account balance also increased by \$200 because I did the actual work, and thus earned the money. Or, if my client is to pay me at the end of the month, instead of my cash balance increasing by \$200, my receivables balance will instead increase by \$200 because my client owes me the money and will pay me later. My revenue balance will also go up by \$200 because, again, I did the work. My having done the work now fixes my right to receive payment as well as the client's contract obligation to pay me. Either way, this transaction increases both my assets and more importantly, my earnings.

On the flip side, if I am not legitimate and I wanted to inflate both my assets and my revenues simultaneously, I could make simple accounting entries on my books (using the methodology explained above) to show that I provided tax preparation services for 100 additional clients at \$200 per return, on credit. This results in an additional \$20,000 in both revenues and receivables. In actuality, I never did any work, and my 100 additional "clients" are nothing more than 100 made up names.

Now that I have misrepresented \$20,000 in both assets and earnings, how can I use this to my additional advantage? If I wanted to borrow \$15,000 from a bank, I could show the loan officer my (albeit inflated) financial statements that my business is both solvent and profitable (irrespective of the true financial condition of my business). Thanks to my inflated receivables, I have an asset on my books that I can give the bank as collateral to secure the loan. If I default on the loan, the bank will simply notify my "customers" to pay the bank instead of paying me, pursuant to the terms of the loan contract between myself and my bank.

And, if I need to carry the charade one step further, I can show the loan officer my ledger showing my legitimate customers who have previously paid me on a timely basis. Assuming that the loan officer does not find anything out of the ordinary, and therefore approves my \$15,000 loan, I am now off and running as I can pull off this same scam at more than one bank.

A well-known incident involving a fictitious revenue scam was perpetrated by an entity called Equity Funding.

Equity Funding was an insurance company, to be specific, a reinsurer. To create fictitious revenues, the CEO simply created phony insurance policies. After seven years, the fraud was finally exposed in 1973 by a recently fired and

disgruntled employee. At that time, \$2 billion of the \$3 billion in Receivables was phony.¹⁰⁸

E. How Far Do Auditors Really Go To Detect Fraud?

Unfortunately, not all that far. After the recent creative accounting scandals involving Enron, Tyco, et. al., the most popular question was: *where were the auditors?* As we know with Arthur Andersen, as discussed above, the auditors *were in bed with at least one client (Enron)*. As I've mentioned elsewhere, Andersen was not the only CPA firm that was ever in bed with one or more of its clients.¹⁰⁹

Unfortunately, the single biggest problem with an external audit is this: an external audit is not generally designed to be a forensic fraud investigation. The typical external audit is conducted by an outside certified public accounting (CPA) firm "to obtain reasonable assurance as to whether the financial statements are free of any material misstatements."¹¹⁰

1. How Auditors Historically Handled The Fraud Issue

Prior to 2002, , the American Institute of Certified Public Accountants (AICPA) was the professional governing body responsible for setting auditing standards. Consequently, the AICPA (through its Auditing Standards Board (ASB)) issued several Statements of Auditing Standards (SAS) that control how external accountants perform their audits.

a) SAS No. 16: "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities," issued in 1977, says the following:

The independent auditor's objective in making an examination of financial statements in accordance with (GAAS) is to form an opinion on whether the financial statements present fairly financial position, results of operations, and the changes in financial position in conformity with (GAAP)...). Consequently, under (GAAS), the independent auditor has the responsibility within the inherent limitations of the auditing process...to plan his examination to search for (material) errors and irregularities.¹¹¹

108. SINGLETON ET AL., *supra* note 51, at 109.

109. Greg Burns, *Accounting's Power Slips Into Loss Column*, CHI. TRIB., Nov. 10, 2002, http://articles.chicagotribune.com/2002-11-10/news/0211100536_1_accounting-oversight-board-accounting-lecturer-accounting-industry/4.

110. Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097, 1148 (2007).

111. ALBRECHT ET AL., *supra* note 11, at 644.

b) SAS No. 53: In 1987, the AICPA issued SAS 53, “The Auditor’s Responsibility to Detect and Report Errors and Irregularities.” SAS 53 “modified the auditor’s responsibility to require the auditor to ‘design the audit to provide reasonable assurance of detecting errors and irregularities.’”¹¹²

c) SAS No. 82: Ten years later, the AICPA instituted SAS 82, “Consideration of Fraud in a Financial Statement Audit.” SAS 82 gave the auditor the responsibility to detect and report any material misstatements due to fraud.¹¹³ SAS 82 now gave auditors some guidance on how to consider the possibility of fraud¹¹⁴ in terms of exercising due professional care,¹¹⁵ planning the audit,¹¹⁶ evaluating the company’s internal controls,¹¹⁷ and getting supportive evidence for the audit opinion.¹¹⁸

d) SAS No. 99: Finally, the AICPA issued SAS 99, “Considerations of Fraud in a Financial Statement Audit,” effective December 15, 2002. SAS 99 gave auditors additional guidance regarding the specific issue of fraud. SAS 99 now gives a description of fraud and its characteristics, requires auditors to discuss amongst themselves the risks of material misstatements due to fraud, and conferring with the client’s management team and other employees about the risks of financial statement fraud among others.¹¹⁹

2. Then Came SOX

After the train wreck that was the accounting fraud scandals in the early 2000’s, Congress responded by enacting the Sarbanes-Oxley Act of 2002 (SOX), which President George W. Bush signed into law in July 2002.¹²⁰ This statute was based on legislative concerns that the accounting profession, self-regulating as it was, was doing a rather poor job as a financial watchdog in auditing publicly traded companies.¹²¹ In fact,

112. ALBRECHT ET AL., *supra* note 11, at 645.

113. Barbara R. Farrell & Joseph R. Franco, *The Role of the Auditor in the Prevention and Detection of Business Fraud: SAS No. 82*, W. CRIMINOLOGY REV. (1999), <http://wcr.sonoma.edu/v2n1/farrell.html>.

114. ALBRECHT ET AL., *supra* note 11, at 646.

115. ALBRECHT ET AL., *supra* note 11, at 646.

116. ALBRECHT ET AL., *supra* note 11, at 646.

117. ALBRECHT ET AL., *supra* note 11, at 646.

118. ALBRECHT ET AL., *supra* note 11, at 646.

119. AMERICAN INSTITUTE OF CPAS, AU § 316: CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT 169, *available at* <http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00316.pdf> (last updated April 2007).

120. Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, Jul. 31, 2002, at A1, *available at* Factiva, Doc. No. nyt000020020731dy7v00039.

121. ALBRECHT ET AL., *supra* note 11, at 389.

Congress' SOX legislation kicked the AICPA out of the job of setting auditing standards. SOX created an administrative agency called the Public Corporation Accounting Oversight Board (PCAOB) and gave the PCAOB that responsibility. As such, the PCAOB is the entity now legally recognized to develop "Professional Auditing Standards' that must be followed by registered public accounting firms for audits of public companies."¹²²

CONCLUSION

As shown above, in order to commit a financial fraud, the three main ingredients are a well-planned idea, some ingenuity, and good acting skills. Again, just because these pages show a kind of a blueprint as to how to commit certain fraud, that does not mean that I'm giving any future Bernie Madoff inspiration for the next great mass swindle. That is not my intention.

The focus of this note is to reinforce the understanding that in order know how to detect and investigate fraud, one has to know what to look for in order to prevent the fraud. Finally, I would like to pass along some professorial advice to any accounting students (including my own) and future fraud investigators who may read this piece: Knowledge is power. Therefore, take the information in these pages and be sure to use it as agents for the forces of good.

122. ALBRECHT ET AL., *supra* note 11, at 1147.