2nd Edition

FINANCIAL STATEMENT FRAUD

PREVENTION and DETECTION

Zabihollah Rezaee Richard Riley

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WILEY

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:
Rezaee, Zabihollah, 1953-
Financial statement fraud : prevention and detection / Zabihollah Rezaee,
Richard Riley. – 2nd ed.
p. cm.
Includes index.
Summary: ‘‘Practical examples, sample reports, best practices and recommendations to help you deter, detect, and prevent financial statement fraud Financial statement fraud (FSF) continues to be a major challenge for organizations worldwide. Financial Statement Fraud: Prevention and Detection, Second Edition is a superior reference providing you with an up-to-date understanding of financial statement fraud, including its deterrence, prevention, and early detection. You will find A clear description of roles and responsibilities of all those involved in corporate governance and the financial reporting process to improve the quality, reliability and transparency of financial information. Sample reports, examples, and documents that promote a real-world understanding of incentives, opportunities, and rationalizations Emerging corporate governance reforms in the post-SOX era, including provisions of the SOX Act, global regulations and best practices, ethical considerations, and corporate governance principles Practical examples and real-world ‘‘how did this happen’’ discussions that provide valuable insight for corporate directors and executives, auditors, managers, supervisory personnel and other professionals saddled with anti-fraud responsibilities Expert advice from the author of Corporate Governance and Ethics and coauthor of the forthcoming Wiley textbook, White Collar Crime, Fraud Examination and Financial Forensics Financial Statement Fraud, Second Edition contains recommendations from the SEC Advisory Committee to reduce the complexity of the financial reporting process and improving the quality of financial reports’’–Provided by publisher.
ISBN 978-0-470-45570-8
1. Misleading financial statements. 2. Fraud. I. Riley, Richard, 1962- II. Title.
HF5681.B2R3997 2010
657'.3–dc22 2009025053

Printed in the United States of America
10 9 8 7 6 5 4 3 2 1

This book is dedicated to Dr. Rezaee's son Nick and Dr. Riley's parents Dick Sr. and Betty, wife Shelley, and children Connor, Andrew, and Kelsey

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Foreword

In this new century, financial statement fraud has increasingly become a serious problem for business, government, and investors. Indeed, the issue threatens to undermine the confidence of capital markets, corporate leaders, and even the venerable audit profession.

Auditors in particular have been hit hard for their seeming inability to find fraud on a massive scale. Monetary judgments in the hundreds of millions of dollars against certified public accounting (CPA) firms have become commonplace, and one of the largest auditing firms, Arthur Andersen, has completely disappeared.

Many who know say the audit process—as we have known it for generations—is doomed. But that may not be all bad. For if an audit fails to find these huge crimes, engineered at the very top of our public enterprises, what good is it?

The United States Supreme Court agreed with that premise in 1984 when it affirmed that the independent auditor was indeed the ''public watchdog.'' But in the quarter-century since that pronouncement, we've continued to see too many situations where the watchdog was asleep, toothless, or too old to chase its quarry.

To learn history's valuable lessons, we need to look at where we've been in order to know where we should be going. From recorded history until the beginning of the 1900s, the auditor's primary role was to detect and deter fraud. It was much easier to do back then: Businesses were small, financial transactions were fewer, and transnational corporations and financial conglomerates were unheard of.

But as commerce picked up speed, the auditor had to do more with less; scrutinizing each and every transaction for fraud became a physical impossibility. From the time of the stock market crash of 1929—due in no small part to rampant fraud—until the 1980s, the focus of the audit became different. During that period, the auditor spent most of his effort on reporting issues.

It didn't take financial scoundrels long to notice that the watchdog wasn't barking any more. In the 1970s, an enterprising insurance salesman named Stanley Goldblum made a mockery of the audit as it had been traditionally conducted. Right under the nose of his independent CPA firm, Goldblum's company, Equity Funding, easily managed to add 65,000 phony policyholders to its rolls, along with $800 million in fake assets.

Goldblum's scam was only the beginning of a cascade of spectacular audit failures, from the savings and loan debacle to Enron, WorldCom, and Madoff. And the refrain has only grown louder: ''Where were the auditors?''

The answer, strangely enough, is that the auditors were too busy auditing to find fraud. But don't blame them, for they were doing only what they were taught. Or, more correctly, *not* taught.

As any accounting graduate in the last 30 years will tell you, the amount of antifraud training in college is not just inadequate; it has been practically

nonexistent. Part of the reason has been the lack of authoritative texts in the field. Luckily, with books like this one, that is changing.

Zabihollah Rezaee and Richard Riley's second edition of *Financial Statement Fraud: Prevention and Detection* is bound to make a real difference. Exceptionally well researched and chocked with up-to-date case examples, *Financial Statement Fraud* not only explains in understandable language how these schemes are committed, it offers valuable advice on how to prevent and detect them.

But the authors' work goes much beyond helping educate accounting students and auditors. It is a valuable reference guide for fraud examiners, audit committees, management, and regulators; and one other important cog in this wheel: the investors who stand to lose everything.

Education is the sword needed to strike a blow against white-collar crime. And in this war, *Financial Statement Fraud* can be a powerful weapon.

Joseph T. Wells, CPA, CFE
Founder and Chairman
Association of Certified Fraud Examiners

Preface

Trust is the bedrock of the financial markets. Financial statement fraud *violates that trust.* This book empowers readers by articulating best practices in financial statement fraud prevention, deterrence, detection, and investigation. It accomplishes that goal by thoroughly examining some of the ''how it was done'' of the most notorious frauds of the last 25 years—Enron, WorldCom, Adelphia, Bernard Madoff, Stanford Financial, Satyam, and even Al Capone—by carefully examining the roles and responsibilities of the major players in the corporate governance fabric—the board of directors, audit committees, senior management, internal auditors, external auditors, and regulators—and by describing best practice tools and techniques that will help readers identify, investigate, and remediate fraud in their own organizations.

As evidenced by the catastrophic collapse of the real estate market and the financial industry's meltdown in 2008, efficiency, liquidity, safety, and robustness of financial markets are vital to the nation's economic prosperity and growth, as more than 110 million Americans directly or indirectly invest in the capital markets. Investors invest as long as they have confidence in the quality, reliability, and transparency of the financial information, including audited financial statements. Financial statement fraud is a serious threat to the market participants' confidence in financial information. The existence and persistence of financial fraud continues to be of great concern for regulators and the business and investment community. In short, the ''fraud problem'' is ever persistent and growing. Since July 2002, the Department of Justice has obtained nearly 1,300 fraud convictions. That's right; some 1,300 fraudsters are now in jail. But the tragedy goes beyond those found culpable: employees lose jobs, investors' 401(k)s are wiped out, and wealth disappears overnight. This book provides insight into how readers can help to prevent, deter, and detect fraud as early as possible.

The recent economic downturn provides incentives and opportunities for management to engage in financial statement fraud. Management is under a greater pressure to manage earnings and cooking the books is a way to achieve financial targets to meet investors' and analysts' expectations of sustained performance. Also, the opportunities to engage in financial statement fraud are higher during economic downturns, as many companies seek to reduce costs and compromise investment efforts in internal controls, governance mechanisms, and risk management. And when the ''river level drops, more rocks appear''; similarly, during difficult financial times, more frauds become apparent. During financial crises and economic meltdowns, the focus on financial statement fraud prevention and detection is more important than ever, as investors, regulators, and companies seek a better understanding of corporate malfeasance and misconduct. During the recent financial turmoil in capital markets, the Securities and Exchange Commission

(SEC) has taken several actions to combat fraud and security law violations, including initiating more than 50 pending investigations in the subprime area, charging managers of hedge funds for fraudulently misleading investors, charging brokers for defrauding customers, and examining Fannie Mae and Freddie Mac for accounting fraud. Likewise, the Federal Bureau of Investigation is experiencing an exponential rise in fraud cases, recently reporting more than 2,000 investigations regarding mortgage fraud and 566 corporate-fraud investigations.

So how does this happen? Financial fraud perpetrators are generally model citizens prior to their downfall—they are important members of the community, well-educated, often married with children and even grandchildren, exceptionally successful—and the list goes on. Boards of directors, audit committees, senior management, and regular employees should recognize that one incident of financial statement fraud can severely damage many years of investor confidence in their company's integrity. Effective corporate governance, a functioning system of checks and balances, a reinforced code of conduct, effective antifraud programs, a whistle-bower hotline, whistle-blower protections, and similar procedures can prevent, detect, and mitigate fraud. Further, the risk of collusive behavior and management override can be significantly reduced when there is an effective code of conduct, risk management, governance oversight, and whistle-blower functions.

While rules and regulations reduce incentives and opportunities for perpetrators to commit fraud, strong corporate governance and antifraud education and practice, including employee and public awareness and investor vigilance, are often most effective in preventing and detecting financial statement fraud.

The study of financial statement fraud and a book such as this are valuable primarily because the efficiency and health of companies, as well as the greater capital markets, largely depends on the quality, integrity, usefulness, and reliability of financial information. The prevention and detection of financial statement fraud are crucial to the economic growth and prosperity of the United States. This book also assesses the consequences of financial statement fraud and its impact on people—real people—and on the integrity and quality of the financial reporting process. Additionally, it suggests ways to improve prevention, deterrence, and detection. Generally, the overwhelming majority of publicly traded companies in the United States have responsible governance, use a reliable financial reporting process, and conduct their business in an ethical and legal manner; however, because "one bad apple spoils the barrel," the entire society, business community, accounting profession, and government have a vested interest in preventing and detecting financial statement fraud so as not to undermine the confidence in corporate America.

PURPOSE OF THE BOOK

High-profile cases of financial statement fraud such as HealthSouth, Phar-Mor, Tyco, ZZZZ Best, and others have raised serious concerns regarding a lack of adequate and responsible corporate governance and accountability. Fraud is everyone's

responsibility. Nevertheless, it is the top management team's responsibility to prevent it before it occurs and to design adequate and effective internal control structures to detect and correct fraudulent activities. The ''tone at the top'' set by corporate leadership, including the board of directors and its representative audit committees, to disallow any unusual business practices, aggressive accounting methods, earnings management, or violations of the company's applicable laws and regulations, as well as code of business conduct, plays an important role in preventing and detecting financial statement fraud. By focusing on the role of governance, this book provides all stakeholders, including managers, supervisors, and employees, with a better understanding of why financial statement fraud occurs and how it can be prevented and detected. This book underscores the significance of, and provides theoretical and practical guidance to recognize, prevent, detect, and correct, financial statement fraud. The contents of this book, including a brief synopsis of each chapter, are summarized to provide the reader with an overview of the upcoming themes.

As this book was going through the production process in 2009, the 111th Congress introduced several bills designed to combat white-collar crime, particularly financial statements fraud in financial institutions. These bills were introduced in response to recent financial crises and the resulting global economic meltdown and to address fraud issues in several areas, including (1) financial market fraud (the supplement Anti-Fraud Enforcement Markets Act, the Fraud Enforcement and Recovery Act), (2) mortgage lending fraud (the National Mortgage Fraud Task Force Act, the Stop Mortgage Fraud Act, the Foreclosure Rescue Fraud Act), (3) Medicare fraud (the Medicare Fraud Prevention and Enforcement Act), and (4) government spending fraud (the Whistleblower Protection Enforcement Act) and tax fraud (the Stop Tax Haven Abuse Act).

Financial statement fraud continues to be a major challenge for organizations worldwide, and the persistence of it in the post–Sarbanes-Oxley (SOX) era reflects the severity of financial statement fraud and the recognition of the urgent need for antifraud practice and education.

Financial Statement Fraud: Prevention and Detection, second edition, is a superior reference for all business professionals who need an up-to-date understanding of financial statement fraud, including its deterrence, prevention, and detection. Unlike other fraud books that focus primarily on occupational fraud, the 300+ pages of *Financial Statement Fraud* provide a clear description of the roles and responsibilities of all those involved in the financial reporting process, including the board of directors, senior executives, internal and external auditors, legal counsel, financial advisors, employees, and investors in deterring, preventing, and detecting fraud. Straightforward language illustrates theoretical and practical concepts and procedures to aid comprehension of complex financial reporting processes and exposure to a variety of fraudulent activities. Sample reports, examples, and documents promote a real-world understanding of incentives, opportunities, and rationalizations for financial reporting participants to engage in financial statement fraud. This second edition incorporates emerging corporate governance reforms in the post-SOX era, including provisions of the SOX Act, global

regulations and best practices, ethical considerations, and corporate governance principles. The emerging issues of ethics and corporate governance are integrated into all chapters. The new edition also includes features, practical examples, and refinements valuable to professionals of all levels, corporate leaders, directors, executives, and educators, without compromising the book's practical utility for auditors and practitioners. Enhancements have been made to the content, style, clarity, and presentation of materials throughout the book.

This book is helpful to the following:

Auditors. Internal and external auditors should find the chapter materials relevant, useful, and suitable to their audit functions, gearing their audit procedures toward fraud prevention and detection.

Corporations, their board of directors, audit committees, executives, legal counsel, managers, supervisors, and employees. Best practices of corporate governance, financial reporting and audit functions, provisions of SOX and related SEC implementation rules, and Public Accounting Oversight Board (PCAOB) auditing standards discussed throughout the book should help public companies and their boards of directors, executives, and legal counsel effectively discharge their responsibilities in producing high-quality financial reports, free of material misstatements caused by errors and fraud.

Business schools and training programs. The book can also be used easily in educational and training programs of business schools and professional organizations. Other professionals, such as management accountants, internal auditors, corporate legal counsel, financial institutions, and financial analysts who provide accounting, auditing, legal, and financial services to corporations, should find this book relevant and helpful to their professional services and activities.

International practitioners and students. Discussions of global corporate governance and convergence in financial reporting and auditing standards make the book attractive to corporations, business schools, and professionals worldwide. Notable coverage includes discussion of corporate governance models throughout the world, international financial reporting standards (IFRS), and international auditing and assurance standards (IAAS).

HIGHLIGHTS OF THE SECOND EDITION

- Regulatory reforms and best practices in the post-SOX era are integrated into all 14 chapters.
- Each chapter includes chapter objectives and a summary.
- Practical examples, such as Enron, WorldCom, Adelphia, Tyco, HealthSouth, and others, and sample reports and documents, are incorporated into all chapters.

- Financial statement fraud cases incurred in the post-SOX period, including Madoff, Stanford Financial, and Satyam and their deterrence are presented throughout the text.
- All chapters have been updated to address emerging initiatives affecting financial reporting and corporate governance and auditing functions (SOX- and SEC-related implementation rules, auditing standards issued by the PCAOB, technological advances, and globalization).
- Recommendations from the SEC Advisory Committee to reduce the complexity of the financial reporting process and improve the quality of financial reports are woven all through.
- Recommendations from the Treasury Advisory Committee to improve audit quality are incorporated throughout.
- Integrated audit of financial statements and internal control over financial reporting, in compliance with PCAOB Auditing Standards No. 5 and its impact in reducing fraud, are added into related chapters.
- The emerging financial reporting and auditing initiatives, including the movement toward IFRS and IAAS, as well as the use of the XBRL reporting platform, are discussed.
- Antifraud programs, procedures, and trainings are integrated throughout.
- An entire chapter is dedicated to the role of technology in financial statement fraud.

ORGANIZATION OF THE BOOK

The focus of the second edition continues to be on the importance of corporate governance in preventing and detecting financial statement fraud, including examinations of real-world frauds and practical tools and techniques for carrying out their antifraud responsibilities. The organization of the second edition provides the maximum flexibility in choosing the amount and order of materials on financial statement fraud. This book is organized into four parts, as follows:

Part	Subject	Chapters
1	Financial Reporting and Financial Statement Fraud	1 & 2
2	Financial Statement Fraud Profile, Taxonomy, and Schemes	3–5
3	Corporate Governance and Its Role in Preventing and Detecting Financial Statement Fraud	6–12
4	Digital (Computer) Approaches to Fraud and Forensic Accounting	13 & 14

Each chapter starts with an examination of a real-world fraud as a basis for further examination of the chapter's specific topics, and each chapter closes with a section titled "Anti-fraud Applications for Practice," which helps the reader further

identify how to apply the chapter's material to preventing, detecting, and deterring fraud. The 14 chapters of the second edition are organized into four parts. Part I contains two chapters, which describe the importance of financial information in our capital markets and our society as well as the persistence of financial statement fraud that continues to threaten the integrity and quality of the financial reporting process even in the post–Sarbanes-Oxley Act. These chapters examine financial statement fraud, its definition, costs, and the nature and significance as well as the financial reporting process of publicly traded companies.

Part Two, presented in Chapters 3 through 5, discusses financial statement fraud profiles, taxonomies, and schemes as well as antifraud education, programs, and practices to prevent and detect them. Chapter 3 presents profiles of several companies alleged by the SEC for engaging in financial statement fraud, reviews their alleged financial statements fraud cases, and demonstrates that "cooking the books" causes financial statement fraud, which results in a crime. Chapter 4 presents a model consisting of conditions, corporate structure, and choices (the 3Cs) in explaining and analyzing motivations, opportunities, and rationalizations for the commission of financial statement frauds. Chapter 5 identifies and discusses taxonomies and schemes of financial statement fraud in an attempt to provide a better understanding of the symptoms (red flags) of financial statement fraud and management motivations to engage in financial statement fraud.

Part Three consists of Chapters 6 through 12, which constitute the foundation of the book. Chapter 6 defines corporate governance and its participants and roles in preventing and detecting financial statement fraud. Chapter 7 discusses the role of the board of directors in overseeing corporate governance and the financial reporting process. Chapter 8 examines the audit committee's role in overseeing the effectiveness of corporate governance, integrity, and quality of financial reports, adequacy and effectiveness of internal control structure, and quality of audit function. Chapter 9 discusses the role of management in corporate governance and the financial reporting process. Management is primarily responsible for the quality, integrity, and reliability of the financial reporting process. Chapter 10 examines internal auditors' responsibility for prevention and detection of financial statement fraud. Chapter 11 discusses the responsibility of independent auditors in discovering financial statement fraud and providing reasonable assurance regarding the quality, integrity, and reliability of published financial statements. Chapter 12 discusses the role of several governing bodies (e.g., SEC, FASB, AICPA, PCAOB, IASB, NYSE, NASD) that directly or indirectly influence corporate governance and the financial reporting process of publicly traded companies.

Part Four includes two chapters. Chapter 13, titled "Fraud in a Digital Environment," examines electronic commerce strategies, changes in business environment, electronic financial reporting (including extensible business reporting language [XBRL]), and computer fraud. Chapter 14 presents forensic accounting practices, including fraud examination, litigation consulting engagements, and expert witnessing services. This chapter also discusses forensic accounting education and methods of integrating forensic accounting topics into the accounting curriculum.

Acknowledgments

We acknowledge the Public Company Accounting Oversight Board, American Institute of Certified Public Accountants, Institute of Internal Auditors, Institute of Management Accountants, Association of Certified Fraud Examiners, Securities and Exchange Commission, and Big Four Accounting Firms for permission to quote and reference their professional standards and other publications. We also recognize the quality reporting that is cited throughout the book, including the *Wall Street Journal*, *Washington Post*, *USA Today*, the *New York Times*, and others.

The encouragement and support of our colleagues at the University of Memphis and at West Virginia University are also acknowledged. The assistance of Dr. Rezaee's graduate student, Anna Anatolyevna Uboytseva, is also appreciated. We thank the members of the John Wiley & Sons, Inc., team for their hard work and dedication, including Chris Gage for managing the book through the production process, Andrew Wheeler for his marketing efforts, and Helen Cho, Tim Burgard, and John DeRemigis for their editorial guidance.

Our sincere thanks are due to our families, the Rezaee family, Soheila, Rose, and Nick; and the Riley family, Shelley, Connor, Andrew, and Kelsey. Without their love, enthusiasm, and support, this book would not have come to fruition when it did.

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