

PART ONE

Origin

COPYRIGHTED MATERIAL
<http://www.pbookshop.com>

<http://www.pbookshop.com>

The Origin of Financial Fraud

WHY DO BUSINESS EXECUTIVES COMMIT financial fraud? Viewed from almost any perspective, it simply makes no sense. Once engaged in a fraud, an executive's otherwise fulfilling career can be transformed into stress-filled days and sleepless nights. Every new day can present the risk of exposure by whistleblowers, the SEC, the internal auditors, the outside accounting firm, or innumerable others. The downsides of exposure can include ruined reputations and public condemnation. The downsides can also include decades in prison.

Why do executives do it? To get rich quick? Because they view themselves as above the law? Because they are dishonest and utterly lacking a moral compass?

Those are all logical explanations. But the underlying reason has little to do with any of them. The fact is that business executives often commit financial fraud without really thinking about it. Rarely do they plan for it to happen. And it's not that the guilty executives are necessarily corrupt or dishonest. For that matter, the level of individual honesty typically has little to do with it.

And that is one of the great tragedies. The perpetrators of financial fraud are often decent and honest individuals who have lived decent and honest lives. They have done well in school and earned college and graduate degrees.

They have worked hard to achieve success and respect within their companies and communities. They are admired by almost all who know, or know of, them. They are well regarded by business associates, friends, and families alike.

And yet, one day, they come to the realization that they are participants in a massive financial fraud. And with the office door closed, and the emails piling up and the phone going unanswered, the executive asks himself: How did this ever happen?

That is the topic at hand. How does fraudulent financial reporting start? How does it grow? How do we prevent and detect it? And the toughest question of all: How do fundamentally decent people at a public company get caught up in such massive wrongdoing?

WHAT IS FINANCIAL FRAUD?

Before taking on such questions, we need to establish some basics. In particular, we need to nail down what we mean by “financial fraud.”

The key point is that financial fraud involves much more than whether reported financial results are right or wrong. If the numbers are wrong, but those pulling them together tried to get them right, there is no fraud and often not even a violation of the federal securities laws. If, in contrast, those pulling together the numbers tried to manipulate things, or did so with a level of recklessness that amounted to the same thing, the situation is completely different. The law can come down on the perpetrators like a ton of bricks.

This distinction between wrong numbers innocently prepared, and equally wrong numbers prepared less innocently, has long bedeviled those involved with financial reporting. Historically, the accounting literature went so far as to put in place technical terms to capture the distinction. An accounting *error* meant an innocent mistake. An accounting *irregularity* meant a deliberate one (Exhibit 1.1).

Why did the literature distinguish between the two? Because the difference between an innocent mistake and a deliberate one is comparable (to paraphrase one U.S. jurist) to the difference between a dog that has been stumbled over and a dog that has been kicked. Where a company finds an accounting error, it does its best to fix it and move on. Where the wrong numbers qualify as fraud, however, the situation is completely different. When financial statements are misstated because of fraud, someone has not made an innocent mistake. Someone has deliberately lied. And the resulting concern is that somebody or a group of people is dishonest and is lying to everyone about financial performance.

EXHIBIT 1.1 Statement on Auditing Standards No. 53's Definition of "Errors and Irregularities"

The term *errors* refers to unintentional misstatements or omissions of amounts or disclosures in financial statements. Errors may involve:

- Mistakes in gathering or processing accounting data from which financial statements are prepared
- Incorrect accounting estimates arising from oversight or misinterpretation of facts
- Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure

The term *irregularities* refers to intentional misstatements or omissions of amounts or disclosures in financial statements. Irregularities may include fraudulent financial reporting undertaken to render financial statements misleading and misappropriation of assets. Irregularities may involve:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation or intentional omission of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

So, the company is not in a position in which it can just fix the numbers and move on. Some level of corporate housecleaning is going to be involved.

None of this means that "fraud" implies that everyone in an organization was in on it. Unfortunately, fraud can be brought about by just one bad apple. But when we see the label *fraud*, we know that someone within the organization has deliberately misstated some aspect of financial performance, and that misstatement has seeped into the company's publicly reported results.

HOW DOES FINANCIAL FRAUD COME ABOUT?

Financial fraud can surface almost anywhere. Companies that are big, small, old, new, manufacturing, service—all of them are at risk. Intriguing is that, regardless of the industry or nature of the company, fraudulent financial reporting almost always seems to get its start the same way.

As mentioned earlier, financial fraud typically does not start with dishonesty. It typically does not start with a dishonest CEO or CFO. Nor does it start because the company had the misfortune to hire a dishonest CPA in the accounting department.

Similarly, financial fraud typically does not start pursuant to a grand conspiracy or plan. It does not start with the chairperson of an executive meeting declaring, “Next item on the agenda: Let’s perpetrate a massive fraud.”

The sad fact is that participants in fraudulent financial reporting typically wanted to do their best to stay honest, decent, and honorable. Rather than with dishonesty or a plan, deliberate financial statement misstatements typically begin with a certain type of corporate *environment* in which fundamentally honest people are put under pressure to do fundamentally dishonest things.

This is not a particularly original insight. It harks back to the findings of the Treadway Commission in October 1987. What we’ve seen since then is that, where financial fraud surfaces, two influences are commonly present in the corporate environment. The first is an overly aggressive target of financial performance. The second is a “tone at the top” that views the failure to achieve that overly aggressive target as unforgivable. The key to understanding the origin of financial fraud—and the key to its prevention—is accordingly to understand that environment and the way it influences individual conduct.

Consider a situation that many will recognize as all too familiar. Hypothesize a manufacturing company that went public at a time when the market was hitting new highs and an economic expansion was surpassing all records. Accordingly, management has been able to announce a series of record-breaking quarters. In the meantime, management has struggled to attract the attention of Wall Street analysts whose attention is, management believes, necessary if the company’s laudable earnings history is to be fairly reflected in the stock price. Several analysts are following the company’s stock, and among the company’s stockholders are momentum investors who are investing based on anticipation of a continuing upward trajectory to ever-increasing heights.

There is, though, a problem. The company’s industry—which, quarter after quarter, had enabled continued expansion and double-digit earnings growth—is starting to slow down. Management perceives this slowdown in growth, moreover, before its potential effects are fully appreciated by the investment community. In particular, the slowdown largely seems to escape the notice of the Wall Street analysts following the stock.

Therefore a mismatch exists. Wall Street is expecting a new record quarter (and the analysts have got it nailed down to the exact penny). But management sees that a new record quarter is not likely to happen. For the first time, the company is facing the specter of a failure to attain analyst expectations.

The more seasoned members of the business community might recognize that it’s time for the company to take its lumps and move on. But this company is somewhat lacking in seasoned managers—it’s been public for only a few years.

For management, the thought of missing analyst expectations—and the specter of momentum investors fleeing the stock—is more terrifying than it can endure. So what happens? Executives' feet are to be held to the fire. The word goes out to all division heads: Pull out the stops. Specific earnings targets are distributed to various divisions. Along with the targets comes an admonition: There is to be no slippage. A failure to attain the target will be viewed as unforgivable.

Now the key elements of a certain kind of corporate environment are in place. There is pressure. There is an aggressive earnings target. And there is the vivid recognition that one way or another that earnings target must be attained.

Let's shift our attention to someone who is on the receiving end of all this—a division president, a graduate of the finest schools, and an individual whose personal integrity has heretofore been unchallenged. He is now facing the most difficult crisis of his career.

For it is plain to our division president that, excruciating pressure or no, he cannot meet his earnings target. The business simply isn't there. He has already cut expenses to the bone. He has already admonished his sales force to make every effort. But, as he comes to the end of the quarter, he sees he is just not going to make it.

Our division president has one of two choices. One, of course, is that he can report up the chain-of-command that he has failed. Admitting failure, though, is never an attractive option, especially in an environment in which failure is unforgivable. So our division president looks for an alternative. Among other things, he takes a hard look at his numbers to see if there's enough flexibility in his division's financial reporting system to find a way to come up with the specified earnings.

What can he do? Because the president works for a manufacturing company, he sees a simple solution. He realizes that during the last few days of the quarter he can bring in overtime help and accelerate shipments. He does the math and sees that shipment acceleration would give him a couple of extra pennies in earnings. And he doesn't think he's planning to do anything wrong. His understanding is that, under generally accepted accounting principles (GAAP), if you ship the goods, you are actually entitled to recognize the revenue. (He views it as sort of a hazy area of financial reporting.) And he figures that this is only going to be a one-quarter thing. He's confident that next quarter he'll have enough business to more than make up for what he is borrowing for this quarter.

So that's what he chooses to do. As the quarter comes to a close, he brings in overtime help. He accelerates shipments. He generates a couple of extra pennies in earnings. He meets his earnings target. And in the company he's a big hero.

But—now he's got a new quarter. And with the new quarter comes a new earnings target. He finds that the business has not bounced back the way he hoped it would. Now the president has twice the problem. First, he's got to meet his earnings target for this new quarter. Second, he has to make up for what he borrowed out of the new quarter for the previous quarter.

Again, he decides to accelerate shipments. This time, though, he sees that shipment acceleration by itself won't be enough. So he thinks this might be a good time to take a look at some of his reserves. His gut tells him that his reserve, say, for returns is too big, and if he can reduce his reserve for returns, that can translate into a couple of extra pennies in earnings.

So that's what he does. In addition to again accelerating shipments, he reduces his reserve for returns. And, again, he meets his earnings target.

But—now he's got a new quarter. Now the problem is three times as bad. He's got a new earnings target. Plus he's got to make up for what he's borrowed out of this quarter for the previous two quarters. And what makes it a little worse is that this happens to be the fourth quarter. Soon the auditors of the financial statements are going to show up.

Still, the division president isn't overly concerned. It's far from clear to him that he's done anything wrong. He figures you're allowed to second-guess reserves. He figures you're allowed to ship early. Besides, at this point everything is very small, and the real issue isn't asset values as much as quarterly timing, so there is little likelihood that the outside auditors are going to pick it up. He's pretty confident of that, by the way, because he used to be a manager at the accounting firm that audits his company's financial statements. He basically knows how the firm goes about its audit. More than that, audit fees have been under some pressure lately, and there is no reason to think that this year the auditors will undertake more than their standard audit steps.

So he makes it through the audit without a problem. In fact, reported earnings for the year are terrific. Stock analyst expectations have been met. The stock price is up. He gets a nice bonus. And a complimentary article appears in *BusinessWeek*.

But—now he's got a new quarter. Now he's got a bunch of quarters from the previous year to make up for. And it's becoming increasingly clear that the business is not going to bounce back. Now little beads of sweat appear. Soon he is sitting at his desk staring at spreadsheets with earnings on one side and Wall Street expectations on the other. For the president, the preoccupation of financial reporting is no longer fairly reflecting the operations of the business. It has become: How are we going to meet this quarter's expectations?

EXHIBIT 1.2 Treadmill Effect

- Shipments accelerated
- Quarters kept open
- Reserves reduced
- Revenue recognized on anticipated orders
- Consignment sales improperly recognized
- Bill-and-hold sales improperly recognized
- Accounts receivable manipulated
- Expense recognition delayed
- Intercompany credits used
- Acquisition reserves adjusted
- False inventory “in transit” recorded
- Phantom inventory created
- Phony shipments recorded
- Unsupportable general ledger revisions made
- Unsupportable top-side adjustments made

So he goes through the year. As the quarters proceed, he finds himself keeping bad accounts receivables, delaying the recognition of expenses, and altering inventory levels. At one point, dispensing with all formality, he finds himself directing his accounting staff to cross out real numbers and insert false ones. More and more he feels like he's on a treadmill on which he has to run faster and faster just to stay in place (Exhibit 1.2).

Now it's audit season again. Now there's reason to be a little nervous. The word goes out to others within the division who have to deal with the auditors: Extra caution is to be used in providing the auditors with certain kinds of information. Supporting documentation for questionable entries comes to be manufactured by people within the accounting department to try to respond to questions that the auditors will inevitably raise. Members of the accounting department convene meetings for the sole purpose of devising a plan to survive the audit.

Now a fair question would be: What's the president's exit strategy? The answer is: He hasn't got one. He didn't intend for this to happen. This was supposed to be a little glitch in the numbers that came and went away in a single quarter. But somehow it got away from him. And now, quarter to quarter, the president is scrambling for his life.

Let's pause to look at what's happened. At this point, the physical implementation of what's going on, and in particular the need to deal with the outside auditors, has broadened participation beyond one or two people. By the

time a fraud surfaces, it's not unusual to find that a large percentage of the entire accounting department has gotten involved. It's not that these people are fundamentally dishonest or evil. In fact, typically, very few people see the whole picture.

But as the quarters proceed, ostensibly innocent people within the accounting department know that they've been asked to make entries without understanding why. They know they've watched numbers on their computer screens change for reasons they don't completely understand. They know they've been asked to second-guess reserves without understanding the underlying reason. They don't know that they are now assisting in the perpetuation of a fraud. But they suspect it, and it begins to eat at them. It eats at their conscience, and they worry.

And at some point, they see that they are up to their eyeballs in a massive financial fraud. The problem is that, by the time that light bulb has gone on, it is too late. They are participants.

ISOLATING THE ELEMENTS

Even though the example is hypothetical, those knowledgeable of fraudulent financial reporting will recognize the pattern. Let's break out the key elements and focus on each one.

1. *It doesn't start with dishonesty.* Fraudulent financial reporting does not start with dishonesty. Quite the contrary; well-meaning executives will often intellectually bend over backward to rationalize that what they're doing is allowed.
2. *It starts with pressure.* Rather than starting with dishonesty, fraudulent financial reporting starts with a certain kind of environment, one characterized by almost unendurable pressure for overly aggressive financial performance.

The example described earlier assumes—as is very much the case in today's financial reporting environment—pressure created by the market expectations of Wall Street analysts. But the pressure can come from almost anywhere. It may come from a hard-driving CEO who wants to make a name for himself by attaining a certain return on equity. It may come from the need to satisfy the performance demands of one or more large shareholders. For a bank, the pressure may come from an unwillingness to report increased loan loss reserves to the FDIC. For some, the

pressure may come from a senior executive who simply is not a very good manager.

Whatever the source, deliberate financial misreporting starts with pressure. It starts with pressure to attain an aggressive performance target and with a vivid realization that a failure to attain that target will be viewed as unforgivable.

3. *It starts out small.* Massive financial fraud rarely starts out massive. Its origin typically is precisely the opposite. It starts out very small—so small that the one or two participants don't even appreciate that they are stepping over the line. Then, as the need to disguise past performance inadequacies is compounded by the need to make up for new ones, the problem starts to grow.
4. *It starts with hazy areas of financial reporting.* Rarely does even a lone participant in a large-scale financial fraud start with a deliberate decision to do something dishonest. It is true, of course, that some people are dishonest and that they make deliberate decisions to lie, cheat, and steal. But rarely do those kinds of individuals survive long in a company, and they almost never make their way up to senior levels.

When we're talking about massive financial fraud, we're talking about a fraud perpetrated by people who are not by nature or training the type to step over the line. What do they do? They exploit what they perceive to be ambiguities in the rules. They exploit ambiguities with regard to revenue recognition. They exploit the need to exercise judgment in the establishment and adjustment of reserves. They exploit areas where the conventions of GAAP do not necessarily point to a particular number. Then, as the fraud grows deeper, they end up taking positions that should have been objectively viewed as indefensible.

5. *The fraud grows over time.* If the financial misreporting came and went away in a single quarter, that would be the end of it, and no one would be the wiser. That wouldn't make it right, but it wouldn't make it a massive financial fraud.

The problem is that the nature of financial misreporting requires borrowing from future quarters. Whether it be through changes in revenue recognition practices, the adjustment of reserves, the delay of expenses, or whatever, the nature of the fraud at its origin is such that the participants are almost always borrowing from Peter to pay Paul.

As the quarters progress, therefore, the problem is mathematically incapable of staying the same. Insofar as the perpetrator is always borrowing from future quarters to meet the present one, the fraud mathematically

has got to get worse—in the absence of a dramatic business upturn. The fraud grows, moreover, not only in terms of its numerical significance, but also in terms of the number of people needed to perpetrate it. As the fraud numerically grows larger, the efforts of increasing numbers of individuals are needed simply to keep up with its implementation.

6. *There's no way out.* In a sense, getting caught up in financial fraud is a one-way street. It's easy to start down the road. It can be almost impossible to turn back.

That's not to say that the participants will not be looking for a way out. As fear turns to desperation, those involved may dream of some kind of extraordinary event—a massive restructuring, a corporate acquisition, a divestiture—that will create enough smoke around the company's accounting that the improper entries may be removed from the books.

Indeed, it may be that the dream of such an extraordinary event—combined with the lack of any other alternative—is what keeps the fraud going. All the while, though, it keeps getting larger and larger, and the hoped-for event remains a mirage on the horizon.

THE DANGER OF “MANAGED EARNINGS”

Such an understanding of the origin and growth of fraudulent financial reporting points to the underlying weakness in the argument of those who would seek to defend the practice of what has become known as “managed earnings.” Now, in talking about managed earnings one has got to be careful. There are two types of managed earnings. One type is simply conducting business in order to attain controlled, disciplined growth. The other involves deliberate manipulation of the accounting in order to create the appearance of a certain level of performance, often to create the *illusion* of controlled, disciplined growth—when in fact all that is happening is that accounting entries are being manipulated.

The topic at hand, of course, is the latter—the manipulation of accounting entries. Still, the practice of even this kind of managed earnings has had its defenders. The argument goes like this. In a volatile stock market, precise reporting of the sharp edges of business upticks and downturns can turn a stock price into a roller coaster. That kind of volatility serves no one. It is far better, therefore, for management to use its judgment in the application of GAAP to take a longer term view and smooth out earnings as they are reported. Such smoothing can be attained, for example, by putting away extra reserves (i.e., overestimating expenses and establishing concurrent liabilities) when times

are good and tapping into them during temporary business downturns by acknowledging previous periods' expense overstatements and reversing them in the current period. According to one publication, some financial officers of public companies “see it as their duty to take the rough edges off operating results.” *BusinessWeek* has reported “a tolerance bordering on a thirst for earnings management.” The *Wall Street Journal*, in a much-discussed editorial, came close to accepting just this kind of approach.

Certainly some can argue that aspects of the objectives of this kind of managed earnings are to an extent laudable. A long-term approach is obviously better than an approach that is limited only to the present quarter. And the volatility in many companies' stock prices has genuinely reached the point where it can seem almost unbearable.

A major fallacy in the argument for managed earnings, however, lies in its implicit premise that the practice can be neatly packaged and controlled. The problem is that it cannot be. True, establishing cookie-jar reserves in good times is easy enough and, in a different era, might have even been defended as good, conservative financial reporting. However, when downturns arrive, it can be more difficult for management to make the decision that investors should be permitted to see the truth. Nor can a normal manager be expected to forecast accurately which downturns are only the result of the normal ebb and flow of the business, and therefore theoretically appropriate for use of the cookie-jar reserves, and which signify a more serious reversal in the company's prospects. More than that, once any cookie-jar reserves are exhausted, the temptation to exploit other reserves—ones that had been appropriately estimated—are almost irresistible. It is easy to see how even such well-meaning management would find itself on a treadmill.

That is not to ignore other problems with the defense of accounting adjustments to smooth out earnings. Probably a more obvious one is its advocacy of distortion of a company's true operations in order to accommodate the investment expectations of financial analysts and the public. The fulfillment of expectations can be rewarding, but when it is achieved through distortion, it rarely works out in the long run.

Still another problem with a managed-earnings approach to financial reporting is the effect it can have on a company's financial reporting culture. Managerial acceptance of managed earnings, and in particular the use of cookie-jar reserves, can send an extraordinarily dangerous message to the troops: “Where it is for the good of the company, it is all right to camouflage the truth.” Once that genie is out of the bottle, it will never go back. Managers at all levels will perceive themselves as having license, if not encouragement, to do

what they have internally tried to resist all along—camouflage their own dismal inadequacies by subtle rearrangement of the numbers. Where that should happen, investors, creditors, and suppliers will never be able to trust the numbers again. Not even management itself will be certain it is getting the truth. Under such a circumstance, lack of rigor in financial reporting can be expected to infect every fiber of the enterprise and become part of the corporate culture. If a company should get to that point, probably the best move is to sell the stock short. It is only a matter of time.

Any public company, of course, is supposed to have in place systems of corporate governance and internal control that keep any of this from happening. In particular, modern scholars of corporate governance would point to a triumvirate of internal control elements whose principal objectives would include the prevention of financial fraud: the audit committee, the internal audit department, and the outside auditor. To understand the origin of financial fraud, therefore, we have to consider how accounting irregularities are able to get by each of them.

THE AUDIT COMMITTEE

Let's start with the audit committee. Under modern systems of internal control and corporate governance, it is the audit committee that is to be at the vanguard in the prevention and detection of financial fraud. What kinds of failures do we typically see at the audit committee level when financial fraud is given an opportunity to develop and grow undetected?

There is no single answer, but several audit committee inadequacies are candidates. One inadequacy potentially stems from the fact that the members of the audit committee are not always genuinely independent. Sure, they're required by the rules to attain some level of technical independence, but the subtleties of human interaction cannot always be effectively governed by rules. Even where technical independence exists, therefore, it may be that one or more members in substance, if not in form, have ties to the CEO or others that make any meaningful degree of independence awkward if not impossible.

Another inadequacy is that audit committee members are not always terribly sophisticated—particularly in the ways that financial reporting systems can be corrupted. Sometimes, companies that are most susceptible to the demands of analyst earnings expectations are new, entrepreneurial companies that have recently gone public and that have engaged in a heroic struggle to get outside analysts to notice them in the first place. Such a newly hatched

public company may not have exceedingly sophisticated or experienced financial management, let alone the luxury of sophisticated and mature outside directors on its audit committee. Rather, the audit committee members may have been added to the board in the first place because of industry expertise, because they were friends or even relatives of management, or simply because they were available.

A third inadequacy is that audit committee members are not always clear on exactly what they're supposed to do. Although modern audit committees seem to have a general understanding that their main focus should be oversight of the financial reporting system, for many committee members that "oversight" can translate into listening to the outside auditor several times a year. A complicating problem is a trend in corporate governance involving the placement of additional responsibilities (enterprise risk management is a timely example) upon the shoulders of the audit committee even though those responsibilities may be only tangentially related, or not at all related, to the process of financial reporting.

Some or all of the previously mentioned audit committee inadequacies may be found in companies that have experienced financial fraud. Almost always there will be an additional one. That is that the audit committee—no matter how independent, sophisticated, or active—will have functioned largely in ignorance. It will not have had a clue as to what was happening within the organization. The reason is that a typical audit committee (and the problem here is much broader than newly public startups) will get most of its information from management and from the outside auditor. Rarely is management going to reveal financial manipulations. And, for reasons explained later, relying primarily on the outside auditor for the discovery of fraud is chancy at best. Even the most sophisticated and attentive of audit committee members have had the misfortune of accounting irregularities that have unexpectedly surfaced on their watch.

The unfortunate lack of access to candid information on the part of the audit committee directs attention to the second in the triumvirate of fraud preventers: the internal audit department.

INTERNAL AUDIT

It may be that the internal audit department has historically been one of the least understood, and most ineffectively used, of all vehicles to combat financial fraud. Theoretically, internal audit is perfectly positioned to nip in the bud an accounting

irregularity problem. The internal auditors are theoretically trained in financial reporting and accounting. The internal auditors should have a vivid understanding as to how financial fraud begins and grows. Unlike the outside auditor, internal auditors work at the company full time. And, theoretically, the internal auditors should be able to plug themselves into the financial reporting environment and report directly to the audit committee the problems they have seen and heard.

The reason all of these theoretical vehicles for the detection and prevention of financial fraud have not been effective is that, where massive fraud has surfaced, the internal audit department has often been somewhere between nonfunctional and nonexistent. In part, this may be the result of an unfortunate cultural tradition in which, as one business leader has put it, internal auditors are viewed as the “Rodney Dangerfields of corporate governance”—they get no respect. Whatever the explanation, where massive financial fraud has surfaced, a viable internal audit function is often nowhere to be found.

THE OUTSIDE AUDITOR

That, of course, leaves the outside auditor, which, for most public companies, means some of the largest accounting firms in the world. Indeed, it is frequently the inclination of those learning of an accounting irregularity problem to point to a failure by the outside auditor as the principal explanation. Criticisms made against the accounting profession have included compromised independence, a transformation in the audit function away from data assurance, the use of immature and inexperienced audit staff for important audit functions, and the perceived use by the large accounting firms of audit as a loss leader rather than a viable professional engagement in its own right.

Each of these is certainly worthy of consideration and inquiry, but the fundamental explanation for the failure of the outside auditor to detect financial fraud lies in the way that fraudulent financial reporting typically begins and grows. Most important is the fact that, as discussed earlier, the fraud almost inevitably starts out very small—well beneath the radar screen of the materiality thresholds of a normal audit—and almost inevitably begins with issues of quarterly timing. Quarterly timing has historically been a subject of less intense audit scrutiny, for the auditor has been mainly concerned with financial performance for the entire year. The combined effect of the small size of an accounting irregularity at its origin and the fact that it begins with an allocation of financial results over quarters almost guarantees that, at least at the outset, the fraud will have a good chance of escaping outside auditor detection.

These two attributes of financial fraud at the outset are compounded by another problem that enables it to escape auditor detection. That problem is that, at root, massive financial fraud stems from a certain type of corporate environment. Thus, detection poses a particular challenge to the auditor. The typical audit may involve fieldwork at the company once a year. That once-a-year period may last for only a month or two. During the fieldwork, the individual accountants are typically sequestered in a conference room. In dealing with these accountants, moreover, employees are frequently on their guard. There exists, accordingly, limited opportunity for the outside auditor to get plugged into the all-important corporate environment and culture, which is where financial fraud has its origins.

As the fraud inevitably grows, of course, its materiality increases as does the number of individuals involved. Correspondingly, also increasing is the susceptibility of the fraud to outside auditor detection. However, at the point where the fraud approaches the thresholds at which outside auditor detection becomes a realistic possibility, deception of the auditor becomes one of the preoccupations of the perpetrators. False schedules, forged documents, manipulated accounting entries, fabrications and lies at all levels—each of these becomes a vehicle for perpetrating the fraud during the annual interlude of audit testing. Ultimately, the fraud almost inevitably becomes too large to continue to escape discovery, and auditor detection at some point is by no means unusual. The problem is that, by the time the fraud is sufficiently large, it has probably gone on for years.

That is not to exonerate the audit profession, and commendable reforms are being put in place. These include greater involvement of the outside auditor in quarterly data, the reduction of materiality thresholds, and a greater effort on the part of the profession to assess the corporate culture and environment. Nonetheless, compared to, say, the potential for early fraud detection possessed by the internal audit department, the outside auditor is at a noticeable disadvantage.

THE FRAUD SURFACES

Having been missed for so long by so many, how does the fraud typically surface? There are several ways. Sometimes there is a change in personnel, from either a corporate acquisition or a change in management, and the new hires stumble onto the problem. Sometimes the fraud—which quarter to quarter is mathematically incapable of staying the same—grows to the point where

it can no longer be hidden from the outside auditor. Sometimes detection results when the conscience of one of the accounting department people gets the better of him. All along he wanted to tell somebody, and it gets to the point where he can't stand it anymore and he does. Then you have a whistleblower.

There are exceptions to all of this. But in almost any large financial fraud, one will see some or all of these elements. We need only change the names of the companies and the industry.

<http://www.pbookshop.com>