



Causes, consequences, and deterrence of financial statement fraud

Zabihollah Rezaee*

*Fogelman College of Business and Economics, 300 Fogelman College Admin. Building,
The University of Memphis, Memphis, TN 38152-3120, USA*

Received 15 June 2002; received in revised form 11 November 2002; accepted 15 December 2002

Abstract

Financial statement fraud (FSF) has cost market participants, including investors, creditors, pensioners, and employees, more than \$500 billion during the past several years. Capital market participants expect vigilant and active corporate governance to ensure the integrity, transparency, and quality of financial information. Financial statement fraud is a serious threat to market participants' confidence in published audited financial statements. Financial statement fraud has recently received considerable attention from the business community, accounting profession, academicians, and regulators. This article (1) defines financial statement fraud; (2) presents a profile of financial statement fraud by reviewing a selective sample of alleged financial statement fraud cases; (3) demonstrates that "cooking the books" causes financial statement fraud and results in a crime; and (4) presents fraud prevention and detection strategies in reducing financial statement fraud incidents. Financial statement fraud continues to be a concern in the business community and the accounting profession as indicated by recent Securities and Exchange Commission (SEC) enforcement actions and the Corporate Fraud Task Force report. This paper sheds light on the factors that may increase the likelihood of financial statement fraud. This paper should increase corporate governance participants' (the board of directors, audit committees, top management team, internal auditors, external auditors, and governing bodies) attention toward financial statement fraud and their strategies for its prevention and detection. The Sarbanes-Oxley Act of 2002 was enacted to improve corporate governance, quality of financial reports, and credibility of audit functions. The Act establishes a new regulatory framework for public accountants who audit public companies, creates more accountability for public companies and their executives, and increases criminal penalties for violations of securities and other applicable laws and regulations. Given the difficulties and costs associated with deterring financial statement fraud, understanding the interactive factors described in this article (Cooks, Recipes, Incentives, Monitoring

* Tel.: +1-901-678-4652; fax: +1-901-678-0717.

E-mail address: zrezaee@memphis.edu (Z. Rezaee).

and End-Results (CRIME)) that can influence fraud occurrence, detection and prevention is relevant to accounting and auditing research.

© 2003 Elsevier Ltd. All rights reserved.

Keywords: Financial statement fraud; Corporate governance; Sarbanes-Oxley Act of 2002; Cooking the books; Fraud prevention and detection strategies

1. Introduction

Financial statement fraud (FSF) has received considerable attention from the public, press, investors, the financial community, and regulators because of high profile reported fraud at large companies such as Lucent, Xerox, Rite Aid, Cendant, Sunbeam, Waste Management, Enron Corporation, Global Crossing, WorldCom, Adelphia, and Tyco. The top executives of these and other corporations were accused of cooking the books and, in many cases, were indicted and subsequently convicted. The collapse of Enron has caused about \$70 billion lost in market capitalization which is devastating for significant numbers of investors, employees and pensioners. The WorldCom collapse, caused by alleged financial statement fraud, is the biggest bankruptcy in the United States history. Loss of market capitalization resulting from the reported financial statement fraud committed by Enron, WorldCom, Qwest, Tyco, and Global Crossing is estimated about \$460 billion (Cotton, 2002). These and other corporate scandals have raised three important questions of (1) how severe is corporate misconduct in the United States, (2) can corporate financial statements be trusted, and (3) where were the auditors? It is trusted that the majority of publicly traded companies in the United States have a responsible corporate governance, a reliable financial reporting process, effective audit functions, conduct their business in an ethical and legal manner, and through continuous improvements enhance their earnings quality and quantity. Nevertheless, the pervasiveness of reported financial statement frauds caused by “cooking the books” and related alleged audit failures have eroded the public confidence in corporate America.

The reliability, transparency, and uniformity of the financial reporting process allow investors to make intelligent decisions. Published audited financial statements that reflect a true and honest financial performance instead of a rosy picture and inflated and fraudulent earnings are useful to market participants, including investors and creditors. Enron, WorldCom, and other corporate scandals, earnings restatements, customized and managed pro forma earnings have undermined investors' confidence in the quality and reliability of the financial system. Capital markets participants (e.g. investors, creditors, analysts) make investment decisions based on financial information disseminated to the market by corporations. Thus, the quality, reliability, and transparency of published audited financial statements are essential to the efficient allocation of resources in the economy. Auditors lend creditability to the information disclosed in a firm's financial statements by reducing the risk that the information is materially misstated. The importance of financial information to the efficiency of securities markets is repeatedly noted in speeches given by Securities and Exchange Commission (SEC) commissioners. For example, “Audited financial statements provide the foundation for our securities markets. Audited financial statements allow investors to make decisions on whether to buy, hold, or sell a particular security” (SEC,

2002a). “Accurate information also improves the quality of markets by allowing markets to discover the true price at which specific securities trade” (SEC, 2002b).

Market participants assess lower information risk associated with high-quality financial reports. This lower perceived information risk will make capital markets more efficient, induce lower cost of capital and higher securities prices. Thus, the society, business community, accounting profession, and regulators have a vested interest in the prevention and detection of financial statement fraud because its occurrences undermine the confidence in corporate America. This article (1) defines financial statement fraud; (2) presents a profile of financial statement fraud by reviewing a selective sample of reported financial statement fraud cases; (3) demonstrates that “cooking the books” causes financial statement fraud and results in a crime; and (4) presents fraud prevention and detection strategies in reducing financial statement fraud incidents.

2. Financial statement fraud

Financial statement fraud is a deliberate attempt by corporations to deceive or mislead users of published financial statements, especially investors and creditors, by preparing and disseminating materially misstated financial statements. Financial statement fraud involves intent and deception by a clever team of knowledgeable perpetrators (e.g. top executives, auditors) with a set of well-planned schemes and a considerable gamesmanship. Financial statement fraud may involve the following schemes (1) falsification, alteration, or manipulation of material financial records, supporting documents, or business transactions; (2) material intentional misstatements, omissions, or misrepresentations of events, transactions, accounts or other significant information from which financial statements are prepared; (3) deliberate misapplication, intentional misinterpretation, and wrongful execution of accounting standards, principles, policies and methods used to measure, recognize, and report economic events and business transactions; (4) intentional omissions and disclosures or presentation of inadequate disclosures regarding accounting standards, principles, practices, and related financial information; (5) the use of aggressive accounting techniques through illegitimate earnings management; and (6) manipulation of accounting practices under the existing rules-based accounting standards which have become too detailed and too easy to circumvent and contain loopholes that allow companies to hide the economic substance of their performance.

3. Profile of financial statement fraud

Financial statement fraud has cost investors more than \$500 billion during the past several years (Rezaee, 2002; Cotton, 2002). Financial statement fraud committed by Enron is estimated to cause a loss of about \$70 billion in market capitalization to investors, employees and pensioners who held the company’s stock in their retirement accounts. The US General Accounting Office (GAO) released a report in October 2002, which indicates that the number of restatements due to accounting irregularities has grown significantly during the past several years. The GAO study reports about 10% of all listed companies announced at least

one restatement between January 1997 and 30 June 2002 which represent a 145% growth rate during this time period and is expected to grow to 170% by the end of year 2002 (GAO, 2002). Table 1 summarizes a sample of the most recent high profile alleged financial statement fraud cases, including Enron, WorldCom, and Global Crossing.¹ A thorough review of these cases determines that five interactive factors explain and justify the occurrences of these high profile alleged financial statement frauds. These interactive factors are referred to as cooks, recipes, incentives, monitoring, and end results, with the abbreviation of CRIME (Rezaee, 2002). The right combination of these factors is a prerequisite for the commission of financial statement fraud as discussed in the following pages.

This schema of “five interactive factors” encapsulated in the acronym CRIME provides several contributions. First, it increases the understanding of financial statement fraud by focusing on five interactive factors that explain causes and effects of financial statement fraud. Second, it emphasizes the importance of vigilant and effective corporate governance participants including the board of directors, the audit committee, management, internal auditors, external auditors, and governing bodies (e.g. Securities and Exchange Commission, SEC, American Institute of Certified Public Accountants, AICPA) can play in preventing and detecting financial statement fraud. Finally, it suggests fraud prevention and detection strategies by presenting new initiatives taken by Congress (e.g. Sarbanes-Oxley Act of 2002), regulators (e.g. SEC certification requirements, and accelerated filing deadlines) and the accounting profession (e.g. AICPA’s six leadership roles) in an attempt to improve corporate governance, quality of financial reports, credibility of audits and reduce financial statement fraud incidents.

3.1. *Cooks*

The first letter in the word “CRIME” is “C,” which stands for “COOKS.” The GAO report (2002) indicates that almost 75% of the total 150 accounting-related SEC cases brought from January 2001 to February 2002 were against public companies or their directors, officers, and employees whereas the other 25% involved accounting firms and CPAs. Financial statement fraud cases presented in Table 1 and the results of the 1999 COSO Report (Beasley et al., 1999) reveal that in the majority of these cases (more than 80%), the chief executive officer (CEO) and/or chief financial officers (CFOs) were associated with financial statement fraud. Other individuals typically involved with financial statement fraud are controllers, chief operation officers, board of director members, other senior vice presidents, and both internal and external auditors. A majority of financial statement frauds occur with participation, encouragement, approval, and knowledge of top management teams including CEOs, CFOs, presidents, treasurers, and controllers. A consensus may be emerging that financial statement fraud is more often the result of actions or inactions, deliberate or inadvertent, by the top management team of publicly traded companies. This has been used as a basis and rationale for holding company officials personally responsible for occurrences of financial statement fraud, liable for resulting losses, and subject to fines as well as potential incarceration. There are also numerous instances of fraud at the subsidiary or divisional level that do not

¹ Due to the space constraints, only a limited number of the reported financial statement fraud cases are summarized in Table 1. A more comprehensive list of these and other cases is available upon request from the author.

Table 1
Sample of financial statement fraud cases

Company	Cooks	Recipes	Incentives	Monitoring	End results (consequences)
Aurora Foods, Inc.	CFO, CEO, senior financial analysts, manager of customer financial services	Overstating reported earnings, understating trade marketing expenses	Meet analysts' forecasts by inflating the company's financial results to raise funds in an IPO	Lack of vigilant board of directors and audit committee; lack of diligent management	Repayment of bonuses of the executives, barring the executives from serving as officers or directors of a public company, and substantial reduction in price of stock
Cendant Corporation	Three former top executives	Earnings management by overstating revenue by \$500 million between 1995 and 1997	Sell CUC and Cendant stock at inflated prices	Lack of responsible corporate governance and ineffective audit functions	Cost more than \$15 billion in market capitalization and lawsuits against the accounting firm
Enron Corporation	Chairman, CEO, CFO	Established Special Purpose Entities (partnerships) to (1) hide debt; (2) create common equity; and (3) overstate earnings	Mislead investors about company's profitability and debt	Lack of responsible corporate governance. Ineffective audit functions	Filed for Chapter 11 bankruptcy protection, lost more than \$60 billion in market capitalization, and more than 20 class action lawsuits were filed
Global Crossing	Top executives, principal officers	Disclosing false and misleading financial statements, insider trading to inflate its market value	Overstating revenues to meet the company's performance goals	Lack of diligent management and ineffective audit functions	Filed for Chapter 11 bankruptcy protection. Loss of over \$40 billion of market capitalization
HBO & Company	Four top executives, Co-President	Earnings management from 1997 through March 1999	Exceed analysts' quarterly earnings expectations	Lack of vigilant board of directors and audit committee; lack of diligent management	Share prices fell almost 50% in one day and class action lawsuits against the company
KnowledgeWare	Top management team	Inflating the reported earnings by engaging in a phony software sale	Meet analysts' earnings expectations	Lack of diligent management; irresponsible corporate governance	The company was acquired at about one half of its previously agreed share price
MicroStrategy, Inc.	Three top executives	Overstatement of revenues	Inflate stock prices to increase demand for issuing new shares	Lack of diligent management; lack of vigilant board of directors and audit committee	Restatement of past financial results causing a 92.4% reduction in stock value
Sunbeam Corporation	Chief executive officer and four other former executives	Earnings management by creating recorded revenue on contingent sales and using improper bill-and-hold transactions	Improve company's performance and restructuring strategies to meet analysts' expectations	Irresponsible corporate governance; ineffective audit functions	Civil penalties and permanent bar of accused executives to become officers or directors of any public company
WorldCom	Chief financial officer, controller, and other executives	Unlawfully and willfully falsified financial records by overstating earnings by more than \$7 billion	Inflate stock prices, cover up financial difficulties	Greedy and arrogant executives, irresponsible corporate governance, ineffective audits	Filed for Chapter 11 bankruptcy protection and indictment of top executives with criminal fraud

typically involve senior corporate officers. Thus, in many of these instances the SEC does not bring an enforcement action and they are not usually publicized.

The Sarbanes-Oxley Act of 2002 contains several provisions designed to make top executives of public companies more accountable regarding the quality, integrity, and reliability of financial reports. These provisions require that (1) CEOs and CFOs certify the accuracy and completeness of financial reports; (2) management be responsible for establishing and maintaining adequate and effective internal controls; (3) management does not take any actions to fraudulently influence, coerce, manipulate, or mislead auditors in the performance of their audits of financial statements; (4) management should reconcile pro forma statements with financial statements; (5) management's Discussion and Analysis (MD&A) sections should discuss and fully disclose critical accounting estimates and accounting policies; (6) top executives return any benefits they have received if it is proven that they misstated their company's financial reports filed with the SEC; (7) companies prompt disclosure of insider stock trades; and (8) companies ban loans to their executives and directors. The proper implementation of these provisions of the Act is expected to influence the behavior of top executives of public companies and encourage them to be more conscientious regarding reporting their company's financial performance and conditions.

3.2. Recipes

The second letter in the word "*CRIME*" is "*R*," which stands for "*RECIPES*." Financial statement fraud can be committed in a variety of ways, ranging from most frequently occurring such as revenue frauds to least commonly occurring such as accounts payable frauds. Recipes of financial statement fraud can range from overstating revenues and assets to understating liabilities and expenses, which typically began with misstatement of interim financial statements and continue into annual financial statements. Earnings management is the most common method of engaging in financial statement fraud (i.e. distorting earnings to achieve earnings targets, analyst forecasts, and/or an earnings trend). Financial statement fraud can also vary in terms of direct falsification of transactions and events or intentional delay (early) recognition of transactions or events that eventually occur. An example of the former is intentional overstatement of sales by creating fictitious invoices whereas the latter would be involved in intentionally overstating sales using otherwise legitimate shipments after the end of the reporting period. Fictitious transaction frauds are often considered more aggressive methods of fraud schemes and occur more frequently and draw more attention from auditors and regulators than the intentional early (delayed) recognition of transactions.

Fraud cases presented in Table 1 and the findings of the 1999 COSO Report (Beasley et al., 1999) indicate that the majority of the financial statement fraud (about 90%) involved the manipulation, alteration, and falsification of reported financial information with a small percentage (almost 10%) involving misappropriation of assets. Fraud schemes are many and often involve more than one technique to misstate financial statements. The majority of misstatements or financial statement frauds are caused by overstating of revenues and assets while about 20% involved understatements of liabilities and expenses. The GAO report (2002) reveals that about 38% of the 919 investigated restatements (due to accounting irregularities) involved revenue recognition. Fraudulent revenue schemes often used by companies are (1) bill and hold sales transactions; (2) side agreements; (3) conditional

sales; (4) improper recognition of consignment sales as completed sales; (6) unauthorized shipments; and (7) illegitimate cutoff of sales transactions at the end of the reporting period. Enron Corporation disclosed that it had overstated earnings by more than half a billion dollars and established private partnerships that kept billions of dollars of debt off its books. Enron used sophisticated financing vehicles known as Special Purpose Entities (SPEs) and other derivative instruments to increase leverage without having to report debt on the balance sheet. WorldCom improperly reported about \$7 billion of expenses as capital expenditures during 2000–2002.

3.3. *Incentives*

The third letter in the word “*CRIME*” is “*I*,” which stands for “*INCENTIVES*,” and explains the most common motivations for companies and their cooks to perpetrate financial statement fraud. Economic incentives are common in financial statement fraud cases, even though other types of motives such as psychotic, egocentric, or ideological motives can play a role in financial statement fraud. Economic pressure and incentives to meet Wall Street forecasts are the fundamental motives for publicly traded companies to engage in financial statement fraud. A psychotic motivation is associated with a “habitual criminal” and is not common to financial statement fraud. Those in corporate governance positions are routinely scrutinized for their behaviors (e.g. management, top executives, auditors). Egocentric motivations are any pressures to fraudulently enhance personal prestige. This type of motive can be seen in those people with very aggressive behavior and desire to achieve higher functional authority in the corporation. Ideological motivations encourage individuals to think their behavior or cause is morally superior and can be seen in aggressive top executives who attempt to be market leaders or improve their market position in the industry. The economic motive of meeting analysts’ forecasts and making Wall Street happy coupled with egocentric and ideological motives are the primary causes of financial statement fraud. Financial statement fraud is more likely to occur when a company has a strong motive and economic reason to report more favorable financial performance than otherwise would be reported by complying with generally accepted accounting principles (GAAP) requirements.

Empirical studies (e.g. Carter and Stover, 1991; Latham and Jacobs, 2000a, 2000b) identify two fundamental variables, management stock ownership and proximity to debt covenant limits, that affect management’s propensity to engage in financial statement fraud. These studies suggest goal congruence between management and shareholders in the 0–5% and in the above 25% ranges of management stock ownership. However, in the range of 5–25%, opportunistic behavior by management is anticipated, and thus the probability of engagement in financial statement fraud increases. Prior studies (Carcello and Palmrose, 1994; Dechow et al., 1996; Lys and Watts, 1994) have also examined financial distress measured in terms of weak financial condition and poor financial performance as an incentive mechanism. These studies conclude that incentives to engage in financial statement fraud by providing misleading financial information increases when the firm is in financial distress. Thus, as the company’s financial condition and performance deteriorate, the probability of occurrence of financial statement fraud increases.

Most recent financial statement fraud cases summarized in Table 1 and results of the 1999 COSO Report (Beasley et al., 1999) show the following reasons for companies and

their cooks (fraudsters) to engage in financial statement fraud: (1) avoid reporting a pretax loss and to exaggerate financial performance; (2) meet or exceed security analysts' expectations of earnings' growth; (3) increase the stock price and create demand for issuing new shares; (4) obtain national stock exchange listing status or meet minimum exchange listing requirements to prevent being delisted; (5) cover up assets misappropriated for personal use; and (6) conceal deficiencies in performance. Recent corporate scandals reveal that many corporations have provided their top executives with incentives to inflate earnings in an attempt to improve their own compensation packages (e.g. stock options, bonuses). These incentives should be eliminated by giving proper authority to shareholders to approve executive compensation packages.

3.4. *Monitoring*

The fourth letter in the word "*CRIME*" is "*M*," which stands for "*MONITORING*." The financial reporting process of publicly traded companies includes a monitoring mechanism. The monitoring mechanism consists of (1) a direct oversight function of the board of directors, the audit committee, external auditors, and regulatory agencies and (2) an indirect overseeing function by those who follow the company in the role of owner/investor as an intermediary such as analysts, institutional investors, and investment bankers. Responsible corporate governance, consisting of a vigilant board of directors and audit committee, entails setting a proper "tone at the top" by creating an environment that demands high-quality financial reporting and no tolerance for misstated financial statements. This culture is the most important proactive monitoring mechanism of preventing and detecting financial statement fraud. The [Sarbanes-Oxley Act of 2002](#) addresses these monitoring mechanisms including improving corporate governance and enhancing accountability and transparency of financial reports.

As part of the monitoring mechanism, the audit committee can play the important role of overseeing the integrity and quality of the financial reporting process and the effectiveness of both internal and external audit functions. Companies should view the audit committee as a value-added oversight function rather than merely a window dressing position to satisfy the new requirements of the SEC. Companies that engage in financial statement fraud can neutralize the effectiveness of their corporate governance by (1) having unitary leadership for their board of directors when the CEO also serves as chair of the board; (2) establishing ineffective audit committees consisting of inside and gray directors who do not meet frequently; and (3) having ineffective audit functions. Implementation of provisions of the [Sarbanes-Oxley Act of 2002](#) is expected to improve independence, objectivity, and effectiveness of the audit committee by requiring the audit committee be composed of independent members of the board of directors with sufficient financial expertise.

The second most important proactive monitoring mechanism is the presence of an adequate and effective internal control structure and effective audit functions. While management is primarily responsible for designing and maintaining adequate and effective internal controls, internal and external auditors should ensure that internal controls are adequate and effective in preventing, detecting, and correcting financial statement fraud and leave no room for management to override control activities ([NCFRR, 1987](#)). The SEC issued new implementation rules pertaining to certification requirements of the [Sarbanes-Oxley Act of 2002](#). These rules require CEOs and CFOs to establish and maintain their company's

system of “disclosure controls and procedures” and periodically evaluate the adequacy and effectiveness of such a system. Internal auditors are in a good position to assist management to establish, maintain, and monitor this new system of disclosure controls and procedures required under the Act and SEC rules.

External auditors have traditionally been considered responsible for discovering material misstatements in the financial statements caused by errors and fraud. The financial audit can be viewed as a value-added function by financial statement users when external auditors detect material misstatements caused by errors and fraud and withstand pressures from their clients to selectively report them. McEnroe and Martens (2001, p. 356) find that “The investing public agrees with the US Supreme Court’s view of the independent audit as a ‘public watchdog’ function.” The Sarbanes-Oxley Act of 2002 is expected to improve objectivity and effectiveness of audit functions by (1) creating an independent Public Company Accounting Oversight Board (PCAOB) consisting of a majority of non-practicing accountants to establish auditing, quality control, ethics, independence and other standards pertaining to the preparation of audit reports as well as monitoring and disciplining auditors; (2) prohibiting the registered accounting firms from providing several non-audit services (e.g. bookkeeping, financial information system design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing services); (3) the registered public accounting firms will have to rotate their lead auditor or coordinating partner and the reviewing partner off of the audit every 5 years; (4) the registered public accounting firms must report to the audit committee all critical accounting policies and practices used by the client; (5) the auditors attest to and report on the assessment made by management of the effectiveness of internal controls as part of the audit of financial statements; and (6) the auditors are to retain work papers and audit evidence for at least 5 years subsequent to the audit of financial statements.

The extent and quality of monitoring by the board of directors, audit committees, auditors, institutional investors, and financial analysts can have a significant impact on the probability of prevention and detection of financial statement fraud. O’Brien and Bhushan (1990) find a significant positive relationship between company size, analyst following, and institutional ownership. The extent of monitoring, either direct (corporate governance and accountability) or indirect (analysts), creates an environment that reduces the likelihood of errors and fraud (Latham and Jacobs, 2000a, 2000b). Greater institutional and analyst following could also be viewed as increasing the likelihood of detection of financial statement fraud. Prior research (e.g. Deis and Giroux, 1992; Latham et al., 1998; Palmrose, 1987) finds a positive association between auditor brand name (Big Five versus non-Big Five) and the perception of audit quality and the probability of detecting financial statement fraud. The perception is that Big Five (now Big Four) public accounting firms are more likely to detect financial statement fraud than non-Big Five because they have (1) greater ability to withstand client pressure; (2) greater concern for their reputation; (3) greater resources, in terms of both competent personnel and advanced technology; and (4) a more developed audit strategy and process.

3.5. *End results*

The last letter in the word “*CRIME*” is “*E*,” which stands for “*END RESULTS*.” The summary of financial statement fraud cases presented in Table 1 and the findings of the

1999 COSO Report (Beasley et al., 1999) indicate that the consequences associated with financial statement fraud can be very severe. Adverse consequences range from filing for Chapter 11 bankruptcy to changing owners, delisting by the national stock exchange to substantial decline in stock value. Top executives involved in “cooking the books” often suffer personal consequences of (1) losing the value of their stock-based compensation; (2) being forced to resign or being fired; (3) being barred by the SEC from serving as officers or directors of another publicly traded company; and (4) being sanctioned with fines or jail terms. Independent auditors involved in financial statement fraud often suffer personal and professional consequences. Andersen, one of the Big Five accounting firms that audited financial statements of Enron and WorldCom, has been indicted for its audit failures and destroying audit evidence. The jury’s guilty verdict of obstruction of justice effectively ended Andersen’s audit practice and caused Andersen to surrender its state licenses. A federal judge eventually sentenced Andersen to 5 years probation and a \$500,000 fine.

There must be a strong motivation for corporations to engage in financial statement fraud because the costs of corporate offenses can be very significant. Davidson et al. (1994) find that the capital markets did not view all corporate offenses as equally severe and thus, the market reacted differently to the seriousness of violations by corporations. Davidson et al. (1994) detect no evidence of a stock market effect for firms indicted for tax evasion, theft of trade secrets, kickbacks, and overcharging customers while they detected significant negative stock market effects for firms indicted on charges of bribery, price-fixing, or fraudulent financial reporting. Dechow et al. (1996) find that the cost of capital for firms convicted of financial statement fraud significantly increased. Feroz et al. (1991) studied 188 firms that were sanctioned by the SEC and find that penalties for even unsuccessful financial statement fraud are significant. Given the high cost associated with financial statement fraud and even unsuccessful fraudulent financial reporting activities, the decision by corporations to engage in such activities must be justified by strong motives that compel firms to behave illegally.

4. Financial statement fraud case analysis

In this section, a reported financial statement fraud case is analyzed in light of the five interactive fraud factors: Cooks, Recipes, Incentives, Monitoring and End-Results (CRIME). In June 2001, Andersen agreed to pay a \$7 million fine to settle allegations that it helped to overstate a client’s profit by nearly \$1.4 billion (SEC, 2001). In this lawsuit, the SEC claimed that Andersen “knowingly and recklessly” issued false and misleading audit reports for Waste Management, Inc. between 1992 and 1996. While under the settlement Andersen neither admitted nor denied wrongdoing, but it agreed to the first antifraud injunction in more than 20 years. This landmark fraud case is (1) the largest ever civil penalty in a SEC enforcement action against a Big Five professional services firm; (2) the first antifraud injunctions in more than 20 years; and (3) the largest restatement of fraudulent earnings reported by a company in United States history. Waste Management was formed in 1998, when Waste Services of Houston acquired Waste Management of Illinois. This case originally drew the attention of analysts in 1997 when the company’s new chief executive officer quit after 3 months. Analysts presumably concluded that the departed CEO might have discovered accounting problems. The SEC began examining Waste Management’s books in

November 1997 when the company announced that a change in accounting methods would result in a \$1.2 billion loss and reduce reported retained earnings over the previous 5 years by \$1 billion.

Auditors at Andersen, in 1992, found that their client misstated taxes, insurance, and deferred costs by \$93.5 million but the client refused to restate financial statements to correct the mistake. In the subsequent year, the auditors documented another \$128 million misstatement that would have reduced income from continuing operations by 12%. Nevertheless, the auditors determined that the misstatement was not material enough to require disclosure. In 1995, another \$160 million misstatement was considered by auditors to be immaterial and thus, not warranting disclosure on the financial statements. During the period between 1992 and 1996, Waste Management continued to engage in \$1.4 billion in financial statement fraud, and the auditors did not stand up to management to disclose detected material misstatements.

The important lesson to be learned from this landmark case is financial statement fraud equals CRIME. First, the financial statement fraud was committed by Waste Management through overstatement of financial position. Second, cooks were the top management team, including the chief financial officer and chief accounting officer, at Waste Management. Third, the recipe was overstated earnings and hidden expenses for 5 years. Fourth, there were several incentives for the client and auditors to engage in financial statement fraud. There were tremendous pressures on management to meet earnings' expectations and make Wall Street happy. Today, the pressures on management to beat analysts' forecasts are greater than ever in a capital market where information and stock prices move instantaneously and in an efficient manner. Auditors were also under pressure to retain their clients at the expense of compromising their ethical conduct and professional responsibilities. Andersen considered Waste Management as a "crown jewel" client and failed to stand up to management pressure to disclose discovered misstatements in the financial statements for several years. In addition, there were apparent conflicts of interest between the top management team of Waste Management and auditors of Andersen in the sense that (1) every chief financial officer and chief accounting officer in Waste Management's history had previously worked as an auditor at Andersen; (2) over several years, Andersen billed Waste Management more fees for management advisory services than auditing services (\$11.8 million for other services comparing to \$7.5 million for auditing); (3) an Andersen affiliate billed Waste Management an additional \$6 million for consulting services; and (4) the compensation of Andersen's lead partner on the Waste Management audits was based in part on the amount of money Andersen billed Waste Management for non-audit services.

Monitoring in this fraud scheme formula refers to the lack of existence of responsible corporate governance in monitoring management functions for fair presentation of financial statements in conformity with GAAP. An absence of oversight by the audit committee, coupled with ineffective monitoring of the top management team by the board of directors as well as inadequacy and ineffectiveness of the internal control structure in preventing, detecting, and correcting financial statement fraud, might have been a significant contributing factor to the occurrence of misstatements and audit improprieties. During the 1995 financial statement audit, the assigned auditors informed a managing partner at Andersen about \$67 million of misstatements and Waste Management's fraudulent accounting practice of using one-time gains to mask other misstatements. However, the managing partner at

Andersen considered the misstatements not to be material and not sufficient enough to warrant disclosure or a modified audit report (e.g. qualified, adverse).

The financial statement fraud committed by Waste Management resulted in (1) the settlement of a shareholder class action in Chicago which cost the company and its auditor a combined total of \$220 million, where Andersen paid \$75 million; (2) the recognition of \$3.54 billion in charges and write-downs in 1997 when the fraudulent accounting practices were initially uncovered; (3) stock prices falling substantially upon discovery and announcement of financial statement fraud; (4) the top management team at Waste Management, including the chief financial officer and the chief accounting officer, were forced to resign; (5) the auditors at Andersen charged as “knowingly and recklessly” issuing false and misleading audit reports for several years; (6) the auditors consenting to an injunction of fraud that is the first antifraud injunction in more than 20 years against a Big Five accounting firm; (7) one former and three current partners of Andersen barred for several years from auditing a US publicly traded company; (8) Andersen paying a record \$7 million fine which is the largest ever civil penalty against a Big Five accounting firm; and (9) three of Chicago-based Andersen’s current and former partners fined a total of \$120, 000 in a civil lawsuit.

5. Fraud prevention and detection strategies

The recent reported financial statement fraud and resulting decline in the stock market show the importance of the quality of financial reports and audit functions as well as the understanding of what may have caused the occurrence of accounting scandals. Collapses of high profile companies (e.g. Enron, WorldCom, Global Crossing) have left a dirty smear on the effectiveness of corporate governance, quality of financial reports, and credibility of audit functions. These alleged financial statement frauds have raised serious concerns about (1) the effectiveness corporate governance; (2) integrity and ethical conducts of top executives particularly when CEOs and CFOs are being indicted of cooking the books; (3) adequacy and effectiveness of internal controls; (4) reliability of financial reports; (5) quality of audits; and (6) veracity of stock markets.

Many factors contributed to recent Enron, WorldCom, and Global Crossing debacles. These factors are (1) lack of vigilant oversight functions (e.g. the board of directors, the audit committee); (2) arrogant and greedy management; (3) improper business conducts by top executives; (4) ineffective audit functions; (5) lax regulations; (6) inadequate and less transparent financial disclosures; and (7) inattentive shareholders. The commission of financial statement fraud by high profile corporations encourages publicly traded companies to take proactive roles by establishing fraud prevention and detection strategies to prevent and detect financial statement fraud. These strategies should be developed to foster the quality, integrity, and reliability of the financial reporting process as well as the effectiveness of audit functions and should include:

5.1. Fraud vulnerability review

Fraud vulnerability reviews should be performed both periodically and on an ongoing basis. Corporations should consider and implement fraud vulnerability reviews and fraud

hotlines that can be used by insiders (e.g. employees, internal auditors) and outsiders (e.g. customers, suppliers) to report fraudulent activities. Furthermore, corporations should establish an appropriate whistle-blowing policy. In the wake of Enron, WorldCom, and Global Crossing debacles, many publicly traded companies (e.g. Coca-Cola, United Technologies, Eastman Kodak) have created a confidential reporting office and/or an ombudsman on staff to hear out whistle-blowing gripes from employees regarding company affairs including the allegations of fraud (Burke, 2002). Furthermore, Section 301 of the *Sarbanes-Oxley Act of 2002* requires audit committees to establish procedures for receiving and treating complaints regarding accounting and auditing matters, including complaints from those who desire to remain anonymous. The Act also provides whistle-blower protection to employees of public companies when they disclose information or assist in prevention and detection of fraud.

5.2. *Gamesmanship review*

In achieving the goal of creating shareholder value, top corporate executives may try every trick in the book to manage earnings, meet analysts' earnings expectations, and prevent stock prices from falling. A gamesmanship review is a comprehensive assessment of a top management team's philosophies, attitudes, operating styles, decisions, actions, beliefs, and ethical values pertaining to the financial reporting process and continuous review of management's financial reporting relationships with security analysts, internal auditors, external auditors, the board of directors, and the audit committee. A periodic gamesmanship review by the board of directors and its representative audit committee can improve the quality, transparency, and reliability of financial reporting by preventing and reducing the possibility of collusion between financial statement fraud perpetrators. Management should ensure that the individuals hired are ethical, honest, competent, and stay ethical. This is not an easy task because temptation can override good intentions encouraging fraudulent behaviors based on greed and opportunity. Establishing an ethical work environment by promoting an ethical tone at the top and demonstrating zero tolerance for unethical and fraudulent behavior can reduce incidence of fraud.

5.3. *Vigilant and effective corporate governance*

Corporate governance determines the way a corporation is governed through proper accountability for managerial and financial performance. Corporate governance participants are the board of directors, audit committee, top management team, internal auditors, external auditors, and governing bodies. Traditionally, the focus has been placed on the role of external auditors in deterring financial statement fraud. In recent years, however, the attentions are placed on the entire corporate governance responsibility to ensure the quality, integrity, transparency, and reliability of financial reports. Corporate governance protects investors' interests, ensures the integrity, quality, transparency, and reliability of financial reports, monitors the adequacy and effectiveness of internal control structure, and ensures the quality of audit functions as depicted in Fig. 1.

Corporate governance specifies the division of rights and responsibilities of different participants in the organization. Corporate governance has traditionally focused on the

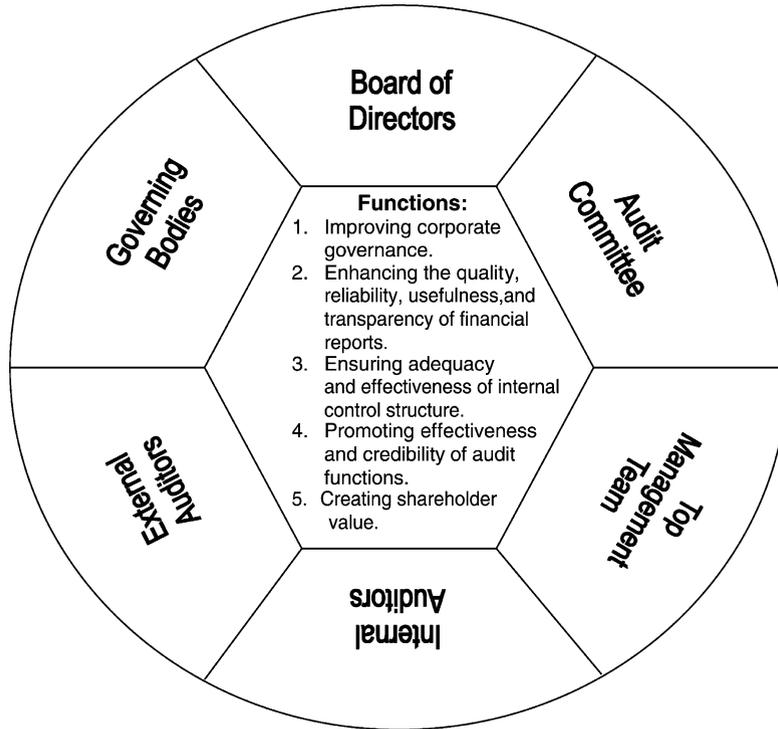


Fig. 1. Corporate governance and its functions.

fiduciary aspect of governance in ensuring that the organization's assets are safeguarded. The corporate governance structure has been centered on the establishment and maintenance of adequate and effective internal control systems to protect assets from loss and theft and ensure reliability of financial reports. Boards of directors are primarily responsible for the governance of their corporation. Enron, WorldCom, and Global Crossing debacles suggest that boards of directors have failed to fulfill their responsibilities as good caretakers. Boards are elected to act as shareholders' eyes and ears to ensure creation of shareholder value.

Recent high profile corporate misdeeds have galvanized more interest in and discussion of corporate governance. Thus, organized stock exchanges have established guiding Principles Of Corporate Governance in an attempt to improve corporate governance, quality of financial reports, and effectiveness of internal controls, and credibility of audit functions. The Business Roundtable (BRT), the association of CEOs of about 150 of the largest corporations in America, issued its 2002 Principles of Corporate Governance. The BRT's Principles of Corporate Governance recommended that (1) a substantial majority of the board of directors comprises independent directors in fact and appearance; (2) only independent directors sit on the audit committee; (3) the audit committee recommends the selection and tenure of the outside auditor; (4) the management compensation structure links the interests of management to the long-term interests of the shareholders; and (5) shareholders approve stock options (BRT, 2002).

5.4. *Vigilant audit committees*

The audit committee's role has evolved over the years and now with the recommendations of the Blue Ribbon Committee (BRC, 1999), the new rules of the SEC and requirements of the Sarbanes-Oxley Act of 2002, it can be best described as an oversight responsibility in the areas of corporate governance, financial reporting, internal control structure, and audit functions. Future audit committees are ultimately expected to be guardians of investors' interests and accountability. Recent developments in audit committee structure, composition, and qualifications will challenge publicly traded companies to improve the oversight functions and practices of their audit committees. This challenge will provide opportunity to improve corporate governance and the quality of financial reporting which is in the best interests of investors and the financial community. Audit committee members should be financially literate enough to ask tough questions and effectively oversee the organization's internal controls, financial reporting process, and audit functions.

The Sarbanes-Oxley Act of 2002 requires the audit committees to (1) be directly responsible for the appointment, compensation, and oversight of the work of the external auditors; (2) be composed of independent members of the board of directors; (3) have authority to engage advisors; (4) pre-approve any permissible non-audit services provided by the external auditors; (5) establish procedures for employee whistle-blowers to submit their concerns regarding accounting and auditing issues; (6) disclose that at least one member of its audit committee is a financial expert; (7) receive regular reports from the independent auditors on accounting treatments; and (8) receive corporate attorneys' reports of evidence of a material violation of securities laws or breaches of fiduciary duty.

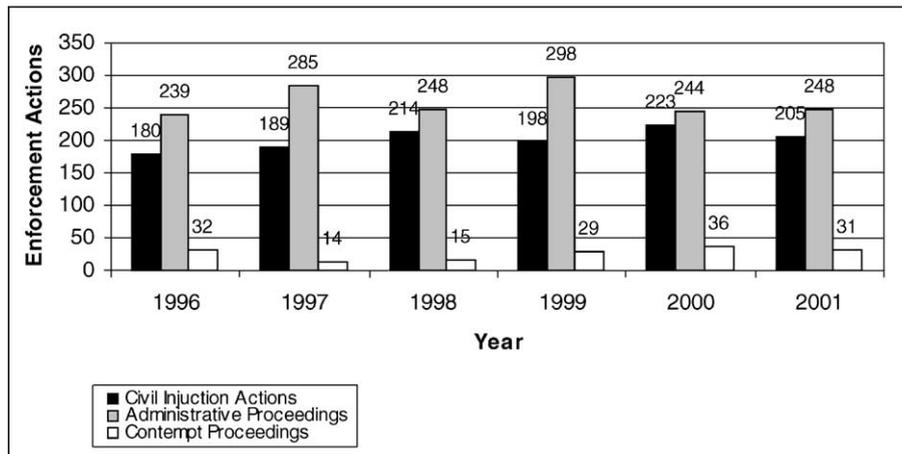
5.5. *Fraud prevention programs*

Corporations should develop fraud prevention programs, establish appropriate policies and procedures, communicate fraud policies and procedures to everyone within the corporation, enforce compliance with them and periodically monitor their effectiveness in preventing and detecting financial statement fraud. Fraud prevention programs should be implemented and enforced by a group consisting of forensic accountants, internal auditors, investigators, attorneys, and human resource personnel, and clearly specify that fraud prevention policies and procedures apply to all employees, including management. This group should periodically report to the board of directors and its representative audit committee regarding the efficiency and effectiveness of the program.

5.6. *Enforcement procedures*

Several enforcement procedures are recently being initiated to combat fraud. First, the SEC has recently considered combating financial statement fraud by publicly traded companies as its first priority as it is evidenced by a number of fraud allegations recently brought against corporations, their executives, and auditors. The SEC's Enforcement Division Director Richard H. Walker, in the 1999 AICPA National Conference on SEC Developments, warned combating fraud remains a No.1 priority (Walker, 1999). There are indicators that financial statement fraud is still all too common . . . the Division is "moving towards turning

Table 2
SEC's enforcement actions



Source: The author's presentation based on data provided in Securities and Exchange Commission's 2000 Annual Report, available at <http://www.sec.gov/pdf/annrep00/ar00full.pdf>, and 2001 Annual Report, available at <http://www.sec.gov/pdf/annrep01/ar01enforce.pdf>.

the 'Numbers Game' into a game of Monopoly—that is, cook the books, and you will go directly to jail without passing go" (Walker, 1999). Table 2 shows a number of enforcement actions brought by the SEC against publicly traded companies from 1996 to 2001. Second, several sections of the *Sarbanes-Oxley Act of 2002* are intended to deter corporate wrongdoings and occurrences of financial statement fraud. The Act (1) creates new criminal penalties for obstruction of justice by destruction of documents by providing for up to 20 years in jail for knowingly destroying or creating evidence with intent to obstruct a federal investigation or matter in bankruptcy; (2) establishes long statutes of limitations for securities fraud cases up to 5 years after the fraud; and (3) creates new criminal penalties for defrauding shareholders of public companies—in some cases up to 25 years. Finally, a multi-agency Corporate Fraud Task Force was formed with members from the SEC and the Department of Justice in July 2002, to combat financial statement fraud and accounting scandals in an attempt to restore confidence in the capital markets and the economy.

The Corporate Fraud Task Force (1) has opened more than 100 investigations into suspected corporate fraud; (2) has charged more than 150 defendants with civil and/or criminal wrongdoings; and (3) has obtained convictions for about 50 cases (Bush, 2002). In following the SEC's enforcement procedures, corporations should develop their internal fraud enforcement procedures and create severe penalties for "cooking the books." Perpetrators of financial statement fraud, from top executives to employees, should understand that "cooking the books" is a crime that will be prosecuted. Companies should adopt no tolerance policies for financial statement fraud. Thus, any top executives or employees who engage in financial statement fraud should be dismissed or, alternatively, their stock options or bonuses should be adjusted or canceled if the company has to restate its financial statements resulting from fraudulent financial activities.

5.7. *Forensic fieldwork audit*

The O'Malley Panel on Audit Effectiveness (POB, 2000) recommends external auditors to use forensic-type fieldwork audit procedures by using a high level of professional skepticism throughout the audit process and paying special attention to fraud symptoms and red flags that may signal the occurrence of financial statement fraud. A professional skepticism is an attitude that entails a questioning mind and a critical assessment of audit evidence. Auditors should use forensic fieldwork audit procedures and continuous transaction testing in areas particularly susceptible to fraud. To restore the public confidence in financial reports, the auditing standards board (ASB) of the AICPA has issued an exposure draft (ED) and subsequently a new standard, Statement on Auditing Standards (SAS) No. 99 entitled "Consideration of Fraud in a Financial Statement Audit" (AICPA, 2002), which would supersede SAS No. 82. SAS No. 99 introduces new guidelines and requirements to assist auditors to more effectively detect material financial statement fraud. SAS No. 99 requires auditors to plan and perform every audit with a questioning mind, recognizing that financial statement fraud could occur. Although SAS No. 99 is not suggesting any changes to the auditor's current responsibility for detecting financial statement fraud, it requires auditors to query management on its views of the likelihood and risks of fraud in the entity and management's programs and controls to address such risks.

Implementation of the provisions of SAS No. 99 is expected to improve auditors performance in detecting financial statement fraud by requiring auditors to (1) brainstorm how frauds could occur, use these discussions to identify fraud risks and design audit tests responsible to the risks of fraud while maintaining professional skepticism; (2) inquire of management and others in the client organization (e.g. audit committee, internal auditors, key personnel) as to the risk of fraud and whether they are aware of any frauds; (3) test areas, locations, and accounts that otherwise might not be tested or anticipated by management; and (4) perform certain audit procedures to test for management override of controls. A recent survey conducted by Jakubowski et al. (2002) reports that almost all the respondents (99%) thought that SAS No. 82 has not led to an increase in the discovery of financial statement fraud. This suggests that SAS No. 82 neither increases the auditor's assumed responsibility for detecting financial statement fraud nor improves audit effectiveness in discovering fraud.

The AICPA has recently taken several initiatives to improve investor antifraud education and ways investors can help protect themselves against financial statement fraud. The AICPA is planning to (1) design antifraud criteria and controls intended for public companies; (2) ask organized stock exchanges to mandate effective antifraud training for management, boards of directors, and audit committees; (3) conduct antifraud education training for directors and other corporate officials; and (4) improve existing attestation standards for auditors to examine and report on their client antifraud controls and criteria and communicate the result to the public (Melancon, 2002).

5.8. *Auditors' independence*

The performance of substantial attestation and assurance services other than financial audit (e.g. non-audit services) may create conflicts of interest, and users may question the

independence of auditors particularly when the fees for such services significantly exceed the client's audit fees. External auditors must ensure that the availability and performance of non-audit services does not impair their independence and objectivity for financial statement audits of publicly traded companies. The audit fees paid by companies to their independent auditors count only for about one-fourth of total fees charged by auditors to their clients. US News and World Report (23 July 2001) states that "only 27 cents of every dollar companies paid their independent auditors last year had to do with the all-important sign off on corporate financial statements" (Lavelle, 2001, p. 40). To preserve auditors' independence, the [Sarbanes-Oxley Act of 2002](#) requires the registered accounting firms to (1) be subject to oversight by a Public Company Oversight Board (PCAOB); (2) comply with auditing and other professional standards; (3) retain audit work papers for at least 7 years; (4) submit audits to second partner reviews; (5) rotate audit partners assigned to an audit engagement every 5 years; (6) be responsible to the audit committee and regularly report to the audit committee on accounting treatments; and (7) cease offering certain non-audit services such as bookkeeping, system design, and internal audit outsourcing to public audit clients.

5.9. Communication with the board of directors and the audit committee

Open and candid communication between external auditors and the board of directors and its representative audit committee can improve the quality of financial reports by focusing on the areas that may indicate the existence of potential fraudulent financial activities. The audit committee involvement with the audit process by overseeing the audit strategy can promote the effectiveness of audits. The audit committee should oversee and review the audit plan and scope of audit functions to ensure that the external auditor is independent, competent, and knowledgeable about the client business and industry. However, the extent of the working relationship between the external auditors and the board of directors and the audit committee should not adversely affect the auditor's objectivity and independence. The [Sarbanes-Oxley Act of 2002](#) requires that auditors report to and be overseen by the audit committee of their client and management. Auditors must also report to the audit committee on the critical accounting policies and practices used by management in measuring, recognizing, and reporting financial transactions.

5.10. Internal audit efficacy

Internal auditors are viewed as a first-line defense against fraud because of their knowledge and understanding of the business environment and the internal control structure. Internal auditors' responsibilities for detecting, investigating, and reporting financial statement fraud, according to their standards are to (1) identify symptoms and red flags that indicate that financial statement fraud may have been perpetrated; (2) identify opportunities (e.g. ineffective internal control, lack of vigilant audit committee) that may allow financial statement fraud to occur; (3) assess the identified symptoms and opportunities, investigate the possibility of their occurrences, and determine actions necessary to reduce or minimize their likelihood of occurrences; and (4) notify the appropriate individuals within the company, top executives if they are not involved in fraud or, otherwise, the board of directors and its representative audit committee for further investigation of the possibility of financial

statement fraud (IIA, 2002). As front-line combatants against financial statement fraud, internal auditors are expected to assist their organization to improve the quality and integrity of financial reports.

6. Summary and conclusion

Financial statement fraud is (1) a serious threat to market participants' confidence in financial information; (2) estimated to cost corporations substantial money; and (3) viewed as unacceptable, illegitimate, and illegal corporate conduct. The opportunity to engage in financial statement fraud increases as the firm's control structure weakens, its corporate governance becomes less effective, and the quality of its audit functions deteriorates. Companies take the risk of having to suffer the adverse consequences of engaging in financial statement fraud as long as there is some uncertainty that their deceptive actions may not be detected. Given this uncertainty, companies may engage in a financial statement fraud if they are (1) predisposed toward violating GAAP requirements by issuing fraudulent financial statements as acceptable accounting practices; (2) motivated to engage in fraudulent financial activities in response to internal and external economic and ownership pressures; and (3) provided with the opportunity to perpetuate financial statement fraud because of irresponsible and ineffective monitoring by corporate governance.

This article demonstrates that financial statement fraud can be equated to the term CRIME when "C" stands for Cooks, "R" for Recipes, "I" for Incentives, "M" for Monitoring or lack of it, and "E" for End Results. The FSF = CRIME fraud scheme fits many of enforcement actions brought against publicly traded companies and their auditors by the SEC for alleged financial statement fraud (e.g. Enron, Global Crossing, WorldCom, Tyco). One message from this article is that financial statement fraud is a serious threat to investors' confidence in financial information. Financial statement fraud adversely affects the integrity, quality, and reliability of published audited financial statements. Perpetrators of financial statement fraud, from top executives to employees, should understand that "cooking the books" is a crime that will be prosecuted. The second message is that quality financial reports, including reliable financial statements free of material misstatements can be achieved when there is a well balanced functioning system of corporate governance as depicted in Fig. 1. Although the responsibility of corporate governance participants (the board of directors, the audit committee, the top management team, internal auditors, external auditors, governing bodies) varies regarding the preparation and dissemination of financial statements, a well defined cooperative working relationship among these participants should reduce the probability of financial statement fraud.

This paper sheds light on the factors that may increase the likelihood of financial statement fraud and how corporate governance participants should fulfill their responsibilities for preventing and detecting financial statement fraud. This paper should increase corporate governance participants' attention toward financial statement fraud and their strategies for its prevention and detection. Given the difficulties and costs associated with deterring financial statement fraud, understanding the interactive factors described in this article (CRIME) that can influence fraud occurrence, detection, and prevention is relevant to accounting and auditing research.

Financial statement fraud continues to be a concern in the business community and the accounting profession. This study identifies five interactive financial statement fraud factors by analyzing a selected sample of alleged financial statement fraud cases presented in Table 1. Future research should employ a large sample of the SEC's alleged financial statement fraud cases across different industries to examine the nature of the relationship among these identified interactive financial statement fraud factors (CRIME). Future researchers are encouraged to establish more comprehensive financial statement fraud prevention and detection strategies by focusing on the role and responsibility of corporate governance participants explored in this study. Finally, this paper, by demonstrating that financial statement fraud can be equated to the term CRIME, contributes to the prior research (e.g. Wright and Wright, 1997) on "the book-or-waive" decisions by auditors regarding the disposition of detected misstatements in financial statements. Future research in this area should incorporate these five interactive factors in auditors' decision process or model when they are assessing whether to book or waive discovered misstatements.

In the wake of recent corporate and accounting scandals, lawmakers (e.g. Congress), regulators (e.g. the SEC) and the accounting profession (e.g. AICPA) have considered new rules, regulations, and standards to (1) improve corporate governance; (2) enhance the quality of corporate financial reporting and disclosures in providing reliable and relevant information regarding companies' conditions and results; (3) ensure a more effective oversight of public accounting firms in enhancing auditors' objectivity, independence, and quality of their audits; (4) refrain auditors to engage in activities that may create potential conflicts of interest (e.g. internal audit outsourcing, information technology); and (5) create a new accounting regulatory system. This study underscores the importance and relevance of these initiatives in continuous improvement of the corporate governance structure, quality of the financial reporting process, and the effectiveness of audit functions. It also suggests that the accounting profession take further measures to improve efficacy of audits.

The Sarbanes-Oxley Act of 2002 was enacted in response to a series of high profile financial reporting scandals involving prominent companies, considerable audit failures, and resulting erosion in market confidence. Many provisions of the Act require the SEC and other regulators to adopt additional regulations aimed at (1) creating a new regulatory framework for accountants; (2) establishing higher standards for corporate governance; (3) improving quality and transparency of financial reports; (4) enhancing effectiveness of audit functions; (5) imposing far-reaching requirements on public companies and their executives; and (6) increasing criminal penalties for violations of securities and related laws and regulations. However, many rules pertaining to the implementation of provisions of the Act are yet to be finalized which meanwhile causes considerable uncertainty regarding its eventual impact (e.g. the extent to which the new oversight board will issue audit standards). Critics of the Act (e.g. Cotton, 2002) state that it does not address the core problem of auditors' conflicts of interest and has narrow implications because it applies to only publicly traded companies and their associates (e.g. auditors, attorneys, analysts). Nevertheless, these emerging rules and regulations should not substitute for needed reforms by the accounting profession to restore public confidence in accounting and auditing disciplines. The accounting profession is provided a rare opportunity for significant and lasting reforms. The future will tell how effectively the accounting profession addresses these challenges.

References

- American Institute of Certified Public Accountants (AICPA). Statement on auditing standards (SAS) no. 82. Consideration of fraud in a financial statement audit. New York, NY: AICPA; 1997.
- American Institute of Certified Public Accountants (AICPA). Statement on auditing standards (SAS) no. 99. Consideration of fraud in a financial statement audit. New York, NY: AICPA; 2002.
- Beasley MS, Carcello JV, Hermanson DR. Fraudulent financial reporting: 1987–1997. An analysis of public companies. New York, NY: COSO; 1999.
- Blue Ribbon Committee (BRC). Report and recommendations of the blue ribbon committee on improving the effectiveness of corporate audit committee. New York, NY: NYSE and NASD; 1999.
- Business Roundtable (BRT). Principles of corporate governance; 2002 May. Available at <http://www.brt.org>.
- Burke M. Corporate confidential: ombudsman. *Forbes* 2002:48.
- Bush GW. President continues fight against corporate fraud and abuse; 2002. Available at <http://www.whitehouse.gov/news/releases/2002/09/print/20020926-10.html>.
- Carcello JV, Palmrose ZV. Auditor litigation and modified reporting on bankrupt clients. *J Accountancy Res* 1994;32(Suppl):1–30.
- Carter R, Stover R. Management ownership and firm value compensation policy: evidence from converting savings and loan associations. *Finan Manage (Winder)* 1991;80–90.
- Cotton DL. Fixing CPA ethics can be an inside job; 2002. Available at <http://www.washingtonpost.com/ac2/wp-dyn/A50649-2002Oct19?Language=printer>
- Davidson W, Worrell D, Lee C. Stock market reactions to announced corporate illegalities. *J Bus Ethics* 1994;(13):583–613.
- Dechow PM, Sloan RG, Sweeney AP. Causes and consequences of earnings manipulation: an analysis of firms subject to enforcement actions by the SEC. *Contemporary Acc Res* 1996;13(Spring):1–36.
- Deis D, Giroux G. Determinants of audit quality in the public sector. *Acc Rev* 1992;67(Oct):462–79.
- Feroz E, Park K, Pastena V. The financial and market effect of the SEC's accounting and auditing enforcement releases. *J Acc Res* 1991;29(Suppl):107–42.
- Institute of Internal Auditors (IIA). Practice Advisory 1210. A2-1, A2-2: identification of fraud, responsibility for fraud detection. Altamonte Springs, FL: IIA; 2002 (January 5).
- Jakubowski ST, Broce P, Stone J, Conner C. SAS 82's effects on fraud discovery. *The CPA J* 2002;(Feb):43–6.
- Latham C, Jacobs F. Monitoring and incentives factors influencing misleading disclosures. *J Managerial Issues* 2000a;(Summer):169–87.
- Latham C, Jacobs F. Monitoring and incentive factors influencing misleading disclosures. *J Managerial Issues* 2000b;XII(2):169–87.
- Latham C, Jacobs F, Roush, P. Does auditor tenure matter? *Res Acc Regul* 1998;(Fall):165–78.
- Lavelle M. Auditor exposed. Cozy deals alleged. *U.S. News and World Report* July 23 2001;40.
- Lys T, Watts R. Lawsuits against auditors. *J Accountancy Res* 1994;32(Suppl):65–93.
- McEnroe JE, Martens SC. Auditors' and investors' perceptions of the "expectation gap." *Acc Horizons* 2001;15(4):345–58.
- Melancon BC. A new accounting culture: a speech made by president and CEO of the American Institute of CPAs to the Yale Club in New York 2002 Sept 4. Available at <http://www.aicpa.org/news/2002/p020904a.htm>.
- National Commission on Fraudulent Financial Reporting (NCFRR). Report of the National Commission on Fraudulent Financial Reporting (Treadway Report). Washington, DC: U.S. Government Printing Office; 1987.
- O'Brien PC, Bhushan R. Analyst following and institutional ownership. *J Acc Res* 1990;(Suppl):55–73.
- Palmrose Z. Litigation and independent auditors: the role of business failures and management fraud. *Aud: J Practice Theory* 1987;6(2):90–103.
- Public Oversight Board (POB). The panel on audit effectiveness report and recommendations (Aug). Stamford, CT: POB; 2000.
- Rezaee Z. Financial statement fraud: prevention and detection. New York, NY: Wiley; 2002.
- Sarbanes-Oxley Act of 2002. Public company accounting reform and investor protection act of 2002. Available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf.

- Securities and Exchange Commission (SEC). Arthur Andersen LLP agrees to settlement resulting in first antifraud injunction in more than 20 years and largest-ever civil penalty; 2001. Available at <http://www.sec.gov/news/press/2001-62.txt>.
- Securities and Exchange Commission (SEC). Speech by SEC Commissioner Hunt Jr Isaac C Remarks before the ABA Committee on Federal Regulation of Securities; 2002a April 6. Available at <http://www.sec.gov/new/speech/spch550.htm>.
- Securities and Exchange Commission (SEC). Speech SEC Chairman Harvey L. Pitt. Remarks before the annual meeting of the Bond Market Association; 2002b April 25. Available at <http://www.sec.gov/new/speech/spch553.htm>
- United States General Accounting Office (GAO). Financial restatements, trends, market impacts, regulatory responses, and remaining challenges; 2002.
- Walker RH. Speech by the SEC's Enforcement Division Director in 1999. AICPA national conference on SEC developments; 1999. Available at <http://www.sec.gov/news/speech/speecharchive/1999/spch334.htm>
- Wright A, Wright S. An examination of factors affecting the decision to waive audit adjustments. *J Acc Aud Finance* 1997;12(Winter):15–36.