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**ARE PUBLIC COMPANY AUDITORS COMPLICIT IN FINANCIAL  
STATEMENT FRAUDS?**

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## **ABSTRACT**

The rising tide of corporate scandals and audit failures has shocked the public, and the integrity of auditors is being increasingly questioned. The object of this research is to find out whether or not public company Auditors are complicit in Financial Statement frauds. Substantial empirical evidence, and criminal filings and lawsuits against COO, CFO, CPA, CEO etc points to the fact that most auditors, especially public company auditors have been truly complicit in financial statements frauds.

This study analyzes Accounting and Auditing Enforcement Releases (AAERs) issued by the U.S Securities Exchange Commission against auditors in respect of financial statement frauds.

The Study revealed that of the over 2,190 cases brought before the commission, over 80% are fraudulent Accounting related cases. In sum, our results suggest that regulators believe auditors have been complicit in many of the cases have been charged accordingly.

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## Introduction

An independent audit has historically been viewed as necessary and essential for the effective functioning of capital markets by providing reasonable assurance on the integrity of the financial statements and related disclosures. Due to the presence of information asymmetries between inside managers and outside owners and creditors of enterprises, auditors play an important role in alleviating agency problems and in adding credibility to financial statements. Auditors are expected to exercise due care which includes professional skepticism and judgment in adhering to professional standards in their audit engagements. However, the rising tide of fraudulent financial reporting in major corporations has shocked the public and tarnished the reputation of the auditing profession (Firth, Mo, & Wong, 2005; Francis, 2004).

Audit failures are serious problems that investors cannot tolerate (Stabus, 2005). Andersen's failure on the Enron audits led to a big increase in concern about auditor integrity and independence in the eyes of regulatory authorities as well as in the eyes of investors and the public. Although many Accounting professionals insisted that finding fraud is not part of their job, Brewster (2003, p. 295) stated that '... the truth is that fraud detection (by auditors) is exactly what most members of U.S. Congress, the Securities and Exchange Commission (SEC), and the public believe it should be about'. This implies that the regulators and financial statement users expect auditors to detect and report frauds. Historically, it was assumed that auditors' traditional audit planning and clients' internal control procedures would be sufficient to assess the fraud risks in clients' financial statements. After the promulgation of the new Statement on Auditing Standards (SAS) No. 99 (AICPA, 2005), which supersedes the old SAS No. 82 in December 2002, auditors are responsible for gathering and analyzing much more information with which to assess fraud risks than they have in the past. Specifically, auditors are required to discuss among the audit team members

the potential for material misstatement due to fraud, to make expanded inquiries of management and others within the entity regarding their knowledge of actual or alleged fraud at the entity, and to expand their use of analytical procedures to identify risks of the material misstatement. These changes in the auditing standards imply that the regulators and policy makers are expecting auditors to perform more work in their audit procedures with the aim of increasing the detection of fraud (AICPA, 2005; Young, 2002).

While much of the focus in the accounting literature has been on frauds found in the U.S., corporate scandals and audit failures are not the sole preserve of the U.S. Given the rapid globalization of business and investment, audit failures have occurred and continue to happen in many other countries across the globe. This study examines whether public company auditors have been complicit in financial statement frauds or not. The study is based on empirical evidence of financial reporting fraud as disclosed in the Accounting and Auditing Enforcement Releases (AAERs) of the Securities Exchange Commission (SEC) of the United State of America.

#### Evolution of Under-Auditing

American Accountants held relatively low social status during the early and middle 19th century, but the confluence of a number of events elevated the profession into the elite category in the late 19th and early 20th centuries. Many things contributed to the rise of the accounting profession, including the growth of railroads and their regulation by the Interstate Commerce Commission; enactment of laws, especially a constitutional amendment allowing taxation on personal and corporate income; regulation by the New York Stock Exchange that required audited financial statements by listed companies; and the federal government's need for financial expertise during World War 1. The biggest boost, however, came during the early 1930s, when Congress passed the Securities Act of 1933 and the Securities Exchange

Act of 1934. Collectively, these statutes required business enterprises that wanted to issue securities to the public to publish audited financial reports in certain SEC filings. Such documents, of course, call for independent external auditors (Ketz, 2002).

From the beginning, the U.S Congress expected the Public Accounting Profession to watch over management and attempt to prevent corporate executives including auditors from engaging in the accounting abuses of the 1920s unearthed in congressional hearings, or from engaging in any new fraudulent schemes. Further, Congress expected that when the independent external auditor could not forestall managerial manipulations, it would at least blow the whistle on those managers who wilfully issued inaccurate financial statements. With this and other institutional arrangements, Congress hoped to curb managers' temptations to distort accounting truth (Ketz, 2002).

#### Financial Statement Frauds

Association of Certified Fraud Examiners (ACFE) (2008) posit that financial statement fraud involves the intentional misstatement or omission of material information from the organization's financial reports; these are the cases of "cooking the books" that often make front page headlines. Financial statement fraud cases often involve the reporting of fictitious revenues or the concealment of expenses or liabilities in order to make an organization appear more profitable than it really is. Financial misstatements are the most costly form of occupational fraud, with median losses of \$2 million per scheme (ACFE 2008).

Klimaitienė, & Grundienė, (2010) speculate that corporate executives usually attempt to use constructed accounting techniques to make the company look good financially by engaging in financial statement fraud. Accountants are reported to have played key role in most financial statements frauds. Taxonomies of financial statement fraud are also developed

to identify common fraud schemes (Rezaee, 2009). Table 1 provides various authors that distinguished these common financial frauds by schemes:

Table 1: Financial frauds common schemes

	Rezaee (2009)	Albrecht, W. Steve et al. (2009)	Golden et al. (2009)	Wells (2008)	Singleton (2006)
1	Improper revenue recognition	Revenue related fraud	Timing	Asset/Revenue overstatements and understatements	Timing differences
2	Overstatement of assets other than accounts receivable	Inventory and cost of goods sold frauds	Improper accounting for construction contracts	Timing differences	Fictitious revenues
3	Understatement of expenses/liabilities	Understating liabilities	Related-party transactions	Fictitious revenues	Concealed liabilities
4	Misappropriation of assets	Overstatement of asset fraud	Revenue and receivable misappropriation	Concealed Liabilities & Expenses	Inadequate disclosures
5	Inappropriate disclosure	Inadequate disclosure fraud	Inflating the value of receivables	Improper disclosures	Improper asset valuation
6	Other miscellaneous techniques	Other type of financial statement fraud	Improperly holding open the books	Improper assets valuations	
7			Other schemes and misappropriations		

**Source:** Klimaitienė, & Grundienė (2010)

Improper revenue-recognition is the availability of acceptable alternatives for recognizing revenue and is the ease of manipulating net income using revenue and receivable (Albrecht, W. Steve et al., 2009). Most improper asset valuations involve the fraudulent overstatement of inventory or receivables. Other improper asset valuation include manipulation of the allocation of the purchase price of an acquired business in order to inflate future earnings,

misclassification of fixed and other assets, or improper capitalization of inventory or start-up costs (Wells, 2008). The auditor may also consider timing, particularly as it relates to the company's quarterly and year-end periods. In which periods were the sales agreements obtained? When was the product or equipment delivered? When did the buyer become obligated to pay? What additional services were required of the seller? As these questions suggest, the timing of transaction can be manipulated to accelerate revenue recognition (Singleton, 2006). Often associated with deliberate actions by management not to disclose material financial information either within the body of the financial statements, in the related footnotes, or in its management's discussion and analysis (MD&A) (Rezaee, 2009). The easiest way to identify understatement of liability fraud exposures is to identify the various transactions that involve liabilities and can be understand. In the identifying these transactions, need accurately specify the type of organization, which are dealing with, because different kinds of companies have different types of liabilities and liability-fraud exposures (Albrecht, W. Steve et al., 2009). Transaction between related parties are often difficult to audit because they are not always accounted for in manner of collusion always exists, given that the parties are, by definition, related. Internal controls, moreover, might not identify the transactions as involving related parties. While related-party transaction may involve improper revenue recognition, they may also involve other parts of the balance sheet or income statement. Inflating the value of legitimate receivables has the same impact as creating fictitious ones. Generally Accepted Accounting Principles (GAAP) requires accounts receivable to be reported at net realizable value, that is, the gross value less an estimated allowance for uncollectible accounts. A related scheme involves not writing off or the delaying of the write-off of receivable that have, in fact, become uncollectible (Bayley, L., and S. Taylor. 2007; Beasley, M. 1996; Beneish,1997; Golden et al., 2009; Klimaitienė, & Grundienė, 2010).



Among the kinds of financial fraud, tax fraud is one of the most common, resulting in billions of dollars lost every year. According to the IRS website, there were between 2,000-3,000 tax fraud investigations initiated each year from 2007 to 2010 (IRS, 2011).

The above analysis clearly showed that overstatement of assets and revenues; false, inadequate, or omitted disclosures; understatements of liabilities and expenses are the three most commonly used in financial fraud schemes.

### What Is the Auditor's Role in Finding Fraud?

In the standard audit reports that accompany corporate financial statements, the auditor's responsibility for detecting fraud is not discussed. Indeed, the word fraud isn't mentioned at all. Yet whenever an accounting deception is uncovered, one of the first questions investors ask is, "Where were the auditors?" The auditing profession calls the discrepancy between what investors expect and what auditors do an "expectations gap." In recent years, audit firms have attempted to close the gap by educating the public on their role. Last May, for instance, the Center for Audit Quality, the trade group for audit firms, issued a brochure on public-company accounting that said auditors consider potential areas of misconduct for a particular company when deciding what areas of a business to review. However, the CAQ cautioned, "because auditors do not examine every transaction and event, there is no guarantee that all material misstatements, whether caused by error or fraud, will be detected."

Now, the Public Company Accounting Oversight Board (PCAOB) is also trying to close the expectations gap, based on a recommendation made more than a year ago by a Treasury Department–appointed advisory group that studied the auditing industry. The advisory group suggested that the audit report — which is the sole communication between auditors and investors on a particular company — explain the auditors' role and their limitations in finding fraud. Such a clarification had been demanded by observers of the

advisory group. "If the discovery of material errors and fraud is not a major part of what the audit is about, it is not clear what value-added service the auditor offers the investor and capital markets," wrote Andrew Bailey, University of Illinois accountancy professor emeritus. Officially, the PCAOB's rules require auditors to provide "reasonable assurance" that the financial statements they've reviewed "are free of material misstatement whether caused by error or fraud." However, the language auditors use in their reports doesn't match the text of the rules. In a meeting last week, the PCAOB's own advisory group suggested that auditor reports be revised to add the phrase "whether caused by error or fraud" to indicate that auditors do have some responsibility for noticing fraud. On their own, audit reports don't tell investors how auditors reached their conclusions beyond stating the general scope they worked under and that they followed generally accepted auditing standards. Written in boilerplate language, the reports are instead short summaries expressing that the financial statements under review fairly present the company's operations and cash flows.

Many years ago, auditor reports included the term *certify* as if to guarantee the reviewed financial statements with an external stamp of approval. But that wording stopped being used in the 1930s, according to the PCAOB. Since then, the reports have been considered to be opinions. However, the reports do "not adequately reflect the amount of audit work and judgment" that go into drawing those opinions, the Treasury advisory group concluded. Some investors, such as those who responded to a 2008 CFA Institute survey, would like auditors to identify their clients' key risks as well as highlight areas that could possibly have questionable estimates made by management. "Investors want to know where the high risks are," said Mary Hartman Morris, a California Public Employees' Retirement System investment officer, at the PCAOB meeting. However, except for its investor members, the PCAOB's advisory group — which also includes finance executives, accounting-firm representatives, and accounting professors — generally refrained from

recommending that audit reports move in a more detailed direction. The group cited the complexity of amending existing auditing standards, the possibility of increased liability, and the uncertainty over whether doing so would provide true value to investors. The group also largely passed over the idea of going beyond the current "pass/fail" model for the audit report, such as by instituting a grading system. For the most part, the advisory group discouraged the regulator from changing auditors' responsibilities or adding new procedures to their workloads. However, they seemed to agree that the public needs a more realistic view of an auditor's job. For example, "some people seem to confuse falsified documents, which the auditor can't authenticate, and falsified accounting records, which auditors should authenticate," said Douglas Carmichael, an accountancy professor at Ziklin School of Business at Baruch College. As the PCAOB contemplates a solution, the board may need to think more about investors' wants rather than their expectations, suggested PCAOB board member Charles Niemeier. "Investors are not satisfied with the status quo," he said, "and I think that is justified, considering the disclosure of financial problems tends to come after the fact." In the meantime, the PCAOB is working on establishing a financial-reporting fraud center for collecting information on preventing and detecting fraud. (Bayley, L., and S. Taylor. 2007; Beasley, M. 1996; Beneish, 1997; Barton, & Simko, 2002).

More recently, the role of auditors in detecting fraud as well as errors has received greater emphasis. In Australia additional requirements were imposed on external auditors to consider the possibility of fraud when conducting an audit under AUS 210 (Australian Accounting Research Foundation [AARF] 2004) and more recently ASA 240 (AUASB 2006). It is reasonable to expect that this increased emphasis on fraud awareness and detection affected the internal auditors' duties as well. Even back in the late 1990s, there is evidence that this was occurring in Australia as a survey found that fraud detection was being included in internal audit work (Birkett et al. 1999). Some studies have evaluated the ability

of internal auditors to perform fraud-related work. External and internal auditors achieved a high level of consensus in their financial statement fraud risk ratings suggesting that internal auditors are as aware as external auditors of where fraud is likely to be detected (Apostolou et al. 2001).

### **Empirical Studies on Financial Statement Fraud**

About 100 of the SEC's enforcement cases brought in 2010 fiscal year involved accounting fraud. Charges were filed against 29 public companies, 19 CEOs, 19 CFOs, 16 Inside Directors and 1 Outside Director. SEC's civil fraud charges can result in fines against companies and individuals and prohibitions against officials working again for public companies. Additionally, the Commission is making more criminal referrals, many of which have led to convictions and jail time.

Over half the cases brought by the Commission involved improper income recognition, including conditional and other non-GAAP sales; outright fictitious sales; improper "bill and hold" sales; failure to record expenses; and improper adjustments to revenue. Revenue timing was also a significant problem; indeed in one case (Sirena Apparel out of LA) senior managers reset a computer clock in order to hold a quarter open to meet a target. Employees of that company even placed bets with each other over how many additional days it would take to make the numbers!

On the balance sheet side, about a quarter of the Commission's cases involved overvaluation of assets. Misuse of reserves, failure to record liabilities, and improper capitalization of expenses were also significant problems.

Release No. 66269 of SEC (2012), proceedings arise out of the Respondents' improper professional conduct during audits of the 2004, 2005 and 2006 financial statements of Symmetry Medical Sheffield LTD, f/k/a Thornton Precision Components, Limited

("TPC"). TPC has, since 2003, been a wholly owned U.K. subsidiary of Symmetry Medical, Inc. ("Symmetry"). Since December 2004, Symmetry has been an NYSE listed company. TPC's financial data has at all relevant times been included in Symmetry's consolidated financial statements filed with the Commission as part of Symmetry's quarterly 10-Q and annual 10-K filings. From 1999 through late September 2007, TPC's management was engaged in a scheme to improperly boost TPC's revenues, net income and other performance indicators by fraudulently manipulating TPC's financial accounts. TPC booked fictitious sales revenues, understated costs of goods sold, created fictitious inventories, improperly capitalized certain tool and die to reduce expenses, and engaged in other accounting manipulations, resulting in material overstatements of net income and material misstatements of other financial line items in Symmetry's financial statements.

In another case, JBI, Inc. ("JBI"), John W. Bordynuik ("Bordynuik") and Ronald Baldwin ("Baldwin") collectively engaged in a scheme to commit securities and accounting fraud by stating materially false and inaccurate financial information on the financial statements of JBI, Inc. for two reporting periods during 2009. Specifically, the Defendants misrepresented and overstated the actual value of JBI's assets and, hence, of the company itself by almost 1,000%. The Defendants then used the overvalued financial statements in two private capital raising efforts (Private Investment in Public Equity or PIPES) that raised more than \$8.4 million from unwitting investors.

Also, From 2003 through 2007, Todd Farha, former chief executive officer of Well Care Health Plans, Inc., Paul Behrens, Well Care's former chief financial officer, and Thaddeus Bereday, Well Care's former general counsel, (collectively, the "Defendants"), devised and carried out a fraudulent scheme that deceived the Florida Agency for Health Care Administration (AHCA), Florida Healthy Kids Corporation (Healthy Kids), and Well Care investors by improperly retaining over \$40 million in health care premiums the Company was

statutorily and contractually obligated to reimburse to the state agencies, and recording this amount as revenue, which materially inflated the Company's net income and diluted earnings per share ("EPS") in the Company's public financial statements.

This case arises from a scheme to artificially inflate the financial results of InPhonic, Inc. ("InPhonic"), a publicly-owned retailer of wireless telephones. From late 2005 through early 2007, Len A. Familant, an InPhonic senior vice president, and Paul V. Greene, president of telephone supplier America's Premier Corporation ("APC"), engaged in a series of fraudulent "round-trip transactions" that resulted in misstatement of InPhonic's reported financial results for the third quarter of 2005 and each quarter of 2006.

On November 16, 2011, SEC issued an order instituting proceedings (OIP) against Paul Free, a certified public accountant and former Controller and Chief Accounting Officer of Delphi Corporation from 1998 through 2002, pursuant to Commission Rule of Practice 102(e)(3)(i),<sup>1</sup> that temporarily suspended him from appearing or practicing before the Commission as an accountant. The OIP finds that Free was enjoined on October 31, 2011 by the United States District Court for the Eastern District of Michigan from violating and/or aiding and abetting violations of Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Securities Exchange Act of 1934 and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, and 13b2-2 thereunder. The underlying complaint alleged that Free, while Delphi's Controller and Chief Accounting Officer, engaged in conduct that resulted in the Company materially misstating its financial condition and operating results in filings with the Commission, in offering documents, and in other statements to investors. The complaint alleged, for example, that Free, among others, was responsible for Delphi having improperly accounted for and disclosed a payment that it made to its former parent company, pursuant to a settlement agreement (SEC, 2012).

The Commission is increasing its sanctions against individuals who commit fraud on behalf of corporations. In 2011, 78 individuals were charged with committing fraud, and 12 more were charged with aiding and abetting fraud. Additionally, many financial fraud cases

are being brought more swiftly and efficiently than ever before. For example, the Commission's case against MicroStrategy, involving premature recognition of revenue leading to incorrect financial statements, was brought in a matter of months. That investigation led to settled fraud charges against the company's CEO, COO, and CFO, and a record disgorgement by those individuals of \$10 million (SEC, 2012).

A study of Ernst & Young as cited by Bostan, & Grosu, (2010) shows a preoccupying growth in accounting fraud tendency despite the predictions and adequate normative in the matter, the predictive regulations, and the fact that most of the companies are endowed nowadays with specific behaviour codes that have provoked the recent financial scandals. The factors that stand at the base of the company accounting fraud risks were so classified as follows:

1. the growth of the organizations' complexity;
2. reduced diffusing of the internal audit functions;
3. the acceptance of the companies of a certain risk level as a typical business item;
4. the presence of a intern control system that does not fully correspond the companies' economical exigencies; and
5. more and more aggressive company policies.

In every financial fraud or reporting failure, the Commission always asks the question, "Where were the accountants?" All too often we find accountants and even outside auditors who, at best, closed their eyes to the problem, and in some cases were even complicit. Under Rule 102(e), we barred 26 corporate CPAs, holding positions from Accounting Officer up to CFO and CEO. We also barred 11 outside audit professionals.

## Conclusion

Since 1982, the SEC has issued Accounting and Auditing Enforcement Releases (AAERs) during or at the conclusion of an investigation against a company, an auditor, or an officer for alleged accounting and auditing misconduct. These releases provide varying degrees of detail on the nature of the misconduct, the individuals and entities involved, and the effect on the financial statements. Over 2,190 AAERs released between 1982 and 2005 identifies 676 unique firms that have misstated at least one of their quarterly or annual financial statements.

The discussion and the presentation above focused on financial statement frauds perpetuated by corporate executives with the aid of internal and external auditors. Empirical evidence (cases) were collected from the Accounting and Auditing Enforcement Releases (AAERs) issued by the Securities and Exchange Commission (SEC) for accounting frauds committed by companies between 1982 to 2012, which provides a strong basis of allegations and facts of accounting fraud in most U.S companies.



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