# A GUIDE TO FORENSIC ACCOUNTING INVESTIGATION

SECOND EDITION

Steven L. Skalak
Thomas Golden
Mona Clayton
Jessica Pill

# A Guide to Forensic Accounting Investigation

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# Preface

The catastrophic business failures of this decade have been revealing on many levels. From my professional perspective as a forensic accounting investigator, I couldn't help but notice the need across much of the business community for a better grasp of the scope and skills of the forensic accounting investigator. Most people seemed to be struggling. How could these massive frauds have occurred? How can such events be deterred—if not wholly prevented—in the future? Who is responsible for deterrence, detection, and investigation? Is it a matter of systems, of attitudes, of aggressive internal policing, of more stringent regulatory oversight, of "all of the above," and more still? What methods are effective? What should an auditor, a corporate director, an executive look for? There were far more questions than answers, and all the questions were difficult. Forensic accounting investigation had become important to the larger business community and the public. They were relying on it to solve problems, deter new problems, and contribute to new, tougher standards of corporate behavior and reported information. But all concerned, from CEOs to financial statement auditors, still have much to learn about the relatively new discipline of forensic accounting investigation.

The keynotes of the past ten years are tough new legislation and regulation to strengthen corporate governance and new oversight of the financial community, corporations, and auditors. Also, the accounting profession continues to review the need for new and different approaches to fraud. All of these initiatives are intended to increase investor confidence in corporate information and financial markets.

Pushing these trends relentlessly forward is the conviction of the concerned public that corporate fraud is unacceptable. It may well occur—this is an imperfect world—but everything must be done to deter, detect, investigate, and penalize it. Investors look to corporate directors and executives, internal and external auditors, and regulators to keep companies honest. They want to be able to trust securities analysts to report and recommend without concealed self-interest. And they expect lenders, business partners, and others who deal with a corporation to exercise and require sound business ethics.

Where fraud is concerned, there is no silver bullet. Clearly, a book would help to address the needs of three broad constituencies: management, corporate directors, and auditors (internal and external). Just as clearly, it shouldn't be a book that focused only on concepts and facts. It would need to look at practice. It would have to convey effective working attitudes and realistic perspectives on many issues, from the varied skills required of forensic accounting investigators to working with attorneys and reporting findings. It would have to offer case studies that reveal the thinking of both experienced investigators and the fraudsters they pursue. In short, it would have to bring its readers into the complex and evolving culture of forensic accounting investigation while serving as a comprehensive, reliable, easily used reference source.

This is a book that some readers will explore page by page; others will use it as a reference. However it is approached, it will reveal the complexity of fraud deterrence, detection, and investigation and offer a step-by-step method to understanding that complexity. Some readers will seek in this book a broad appreciation for investigative techniques so that they can more effectively manage the process when and if needed. Others will want to commit the details to memory. For both types of reader, it is all here: common fraudulent schemes, the psychology of the fraudster, the need for professional skepticism, responding to whistle-blowers, working with lawyers and prosecutors, new technologies that facilitate detection, and much more.

In practical reality, no one can guarantee that all frauds will be either prevented or detected in a timely manner. Yet the toolbox of those who safeguard the integrity of corporate information and investigate possible wrongdoing is well filled. This book will make that clear. It puts before the reader what is, to my mind, an extraordinary array of best practices, tools, and techniques for the deterrence, detection, and investigation of corporate fraud. The skills and knowledge of the forensic accounting investigator are evident on every page.

This is by no means a casual book, tossed off to meet an ephemeral need. We hope that the effort that has gone into it will make it substantively useful over the long term. With proper knowledge and diligence among all those who are responsible for providing financial information for the capital markets, financial fraud can be significantly deterred. As the suspicion and reality of fraud diminish across the corporate world, investors will regain confidence in the integrity of corporate information. The ultimate purpose of this book reaches past the audit profession—and the directors and managers who hire and work with auditors—to address the needs of the capital markets worldwide.

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We owe particular gratitude to our Chicago- and New York–based practice teams. The directors, managers, staff, and assistants with whom we work closely, as well as many other colleagues, performed research, checked exhibits, read chapters, chased facts, and provided insights. Their tireless effort and enthusiasm energized us each day in the conviction that this book will be useful to many people in these challenging times.

Our greatest thanks go to our fellow authors—practitioners in the United States and around the world, and a number of attorneys with other firms or government, who drew on their time, experience, and wisdom to write many of the chapters. At the head of each chapter, readers will find these individuals clearly and gratefully identified. This is their book as much as it is ours.

The following roster names, with gratitude, the authors who created the original drafts of all chapters and approved their final form. All are partners or employees of PricewaterhouseCoopers apart from clearly identified exceptions.

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The authors offer this book with the hope that it answers a very real need and will provide its readers with a new and compelling vision of the role of forensic accountants in the deterrence, detection, and investigation of corporate fraud. The views expressed in this book are those of the individual authors and are not necessarily the views of PricewaterhouseCoopers or any other PricewaterhouseCoopers partner or employee. Unless otherwise indicated, the authors are not attorneys and their comments are based on their personal experiences and do not represent legal advice.

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CHAPTER 1

# Fraud: An Introduction

**Steven L. Skalak, Manny A. Alas, and Gus Sellitto**

Fraud evokes a visceral reaction in us. It is an abuse of our expectation of fair treatment by fellow human beings. Beyond that, it is a blow to our self-image as savvy managers capable of deterring or detecting a fraudulent scheme. Whether we react because of our values or our vanity, nobody likes to be duped. Many elements of modern society are focused on maintaining an environment of fair dealing. Laws are passed; agencies are established to enforce them; police are hired; ethics and morals are taught in schools and learned in businesses; and criminals are punished by the forfeiture of their ill-gotten gains and personal liberty—all with a view to deterring, detecting, and punishing fraud. The profession of accounting and auditing grew out of society's need to ensure fair and correct dealings in commerce and government.

One of the central outcomes of fraud is financial loss. Therefore, in the minds of the investing public, the accounting and auditing profession is inextricably linked with fraud deterrence, fraud detection, and fraud investigation. This is true to such an extent that there are those whose perception of what can be realistically accomplished in an audit frequently exceeds the services that any accountant or auditor can deliver and, in terms of cost, exceeds what any business might be willing to pay (see Chapter 3). In the past decade, public anger over occurrences of massive fraud in public corporations and the conduct of financial institutions has spawned substantial government spending, regulatory reform, global convergence of accounting standards, new auditing standards, new oversight of the accounting profession, and greater penalties for those who conspire to commit or conceal financial fraud or act corruptly.

This book addresses the distinct roles of corporate directors, management, external auditors, internal auditors, and forensic accounting investigators with respect to fraud deterrence, fraud detection, and fraud investigation.[1] As will quickly become

[1] *Forensic accountants* are members of a broad group of professionals that includes but is not limited to those who perform financial investigations. The public often uses the term *forensic accountants* to refer to financial investigators, although many forensic accountants do not perform financial investigations. In Chapter 29, we discuss the many other services encompassed under the broader term *forensic accounting*. A forensic accounting investigator is trained and experienced in investigating and resolving suspicions or allegations of fraud through document analysis to include both financial and nonfinancial information, interviewing, and third-party

apparent later in this introductory chapter, these professionals are by no means the only ones concerned with combating fraud. However, each has a significant role in the larger effort to minimize fraud.

## FRAUD: WHAT IS IT?

Generally, all acts of fraud can be distilled into four basic elements:

1. A false representation of a material nature[2]
2. Scienter—knowledge that the representation is false, or reckless disregard for the truth
3. Reliance—the person receiving the representation reasonably and justifiably relied on it
4. Damages—financial damages resulting from all of the foregoing

By way of illustration, consider the classic example of the purchase of a used car. The salesperson is likely to make representations about the quality of the car, its past history, and the quality of parts subject to wear and tear, ranging from the transmission to the paint job. The elements of fraud may or may not arise out of such statements. First, there is a distinction between hype and falsehood. The salesperson hypes when he claims that the 1977 Chevy Vega "runs like new." However, were he to turn back the odometer, he would be making a false representation. Second, the false statement must be material. If the odometer reading is accurate, the salesperson's representation that the car runs like new or was only driven infrequently, is, strictly speaking, mere hype: The purchaser need only look at the odometer to form a prudent view of the extent of use and the car's likely roadworthiness. Third, the fraudster must make the material false misrepresentation with *scienter,* that is, with actual knowledge that the statement is false or with a reckless disregard for the truth. For example, the car may or may not have new tires. But if the salesperson, after making reasonable inquiries, truly believes that the Vega has new tires, there is no knowing misrepresentation. There may be negligence, but there is no fraud. Fourth, the potential victim must justifiably rely on the false representation. A buyer who wants a blue car may actually believe the salesperson's representation that "it's really blue but looks red in this light." Reliance in that case is, at best, naive and certainly not justified. Finally, there must be some form of damage. The car must in fact prove to be a lemon when the purchaser drives off in it and realizes that he has been misled. Regardless of context, from Enron, Siemens, or Countrywide to

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inquiries, including commercial databases. See the Auditing and Investigation section at the end of this chapter. *Auditors* is used throughout this text to represent both internal and external auditors unless otherwise specified as pertaining to one group or the other.

[2] The term *material* as used in this context is a legal standard whose definition varies from jurisdiction to jurisdiction. It should not be confused with the concept of materiality as used in auditing, in which one considers the effect of fraud and errors related to financial statement reporting.

Honest Abe's Used Car Lot, fraud is fraud, and it displays the four simple elements noted earlier.

## FRAUD: PREVALENCE, IMPACT, AND FORM

Fraud is a feature of every organized culture in the world. It affects many organizations, regardless of size, location, or industry. According to the Association of Certified Fraud Examiners' survey, approximately $994 billion was lost by U.S. companies in 2008 due to occupational fraud and abuse, and over one in four cases cost the organization in excess of $1 million.[3] Twenty-nine percent of all fraud is committed by accounting department employees, and 18 percent of frauds were committed by members of upper management.[4] According to PwC's 2009 Securities Litigation Study, senior officers of companies continue to be named in the majority of filings during 2009. The percentage of U.S. federal securities class action lawsuits naming the CEO, CFO, chairman, and president were 81 percent, 62 percent, 47 percent, and 62 percent, respectively.[5]

If one were to look at the FBI's statistics for white-collar crime, however, one would not reach this conclusion because those statistics are based upon prosecutions and, as discussed in Chapter 19, "Supporting a Criminal Prosecution," the overwhelming majority of frauds are not prosecuted. Based upon our own experience as well as on surveys conducted by PricewaterhouseCooper (hereafter referred to throughout as PwC) (PwC Economic Crime Survey) and the Association of Certified Fraud Examiners (ACFE), we believe that fraud is pervasive.

According to the 2009 PwC Global Economic Crime Survey statistics, 30 percent of organizations fell victim to fraud over the previous 12 months. This is compared to 43 percent in 2007 and 45 percent in 2005, which both look back two years.[6] Respondents from Eastern and Western Europe were among the companies reporting the highest incidents of fraud; for example, 71 percent of organizations in Russia and 43 percent in the United Kingdom reported having experienced fraud in their organization.[7] Across all companies surveyed, 27 percent said that the direct financial impact of fraud exposure was more than $500,000, and 25 percent of those reporting

[3] U.S. organizations lose an estimated 7 percent of their annual revenues to fraud, according to a survey of Certified Fraud Examiners who investigated cases between January 2006 and February 2008. When applied to the projected 2008 U.S. Gross National Product, the 7 percent figure translates to approximately $994 billion in fraud losses. The full study can be found at: www.acfe.com/RTTN/2008-rttn.asp. Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud and Abuse* (Austin, TX: Association of Certified Fraud Examiners, 2004), ii.

[4] Id.

[5] PricewaterhouseCoopers *Securities Litigation Study 2009*.

[6] PricewaterhouseCoopers, *Global Economic Crime Survey 2007,* 4, www.pwc.com/en_GX/gx/economic-crime-survey/pdf/pwc_2007gecs.pdf.

[7] PricewaterhouseCoopers, *Global Economic Crime Survey 2009,* 10, www.pwc.com/en_GX/gx/economic-crime-survey/pdf/global-economic-crime-survey-2009.pdf.

accounting fraud believed that it had cost them more than $1 million.[8] Overall, the reality of fraud is greater than the perception. Statistics from our 2007 survey show that 13 percent and 6 percent of respondents thought it was likely that they would experience asset misappropriation and accounting fraud, respectively, over the next two years. Interestingly, those numbers may be low, given that in our 2009 survey, 20 percent of companies reported being victims of asset misappropriation and 11 percent reported having experienced accounting fraud.[9]

## FRAUD IN HISTORICAL PERSPECTIVE

Fraud in one form or another has been a fact of business life for thousands of years. In Hammurabi's Babylonian Code of Laws, dating to approximately 1800 B.C.E., the problem of fraud is squarely faced: "If a herdsman, to whose care cattle or sheep have been entrusted, be guilty of fraud and make false returns of the natural increase, or sell them for money, then shall he be convicted and pay the owner ten times the loss."[10] The earliest lawmakers were also the earliest to recognize and combat fraud.

In the United States, frauds have been committed since the colonies were settled. A particularly well-known fraud of that era was perpetrated in 1616 in Jamestown, Virginia, by Captain Samuel Argall, the deputy governor. Captain Argall allegedly "fleeced investors in the Virginia Co. of every chicken and dry good that wasn't nailed down."[11] According to the book *Stealing from America,* within two years of Argall's assumption of leadership in Jamestown, the "whole estate of the public was gone and consumed. . . ."[12] When he returned to England with a boat stuffed with looted goods, residents and investors were left with only six goats.[13]

Later, during the American Civil War, certain frauds became so common that legislatures recognized the need for new laws. One of the most egregious frauds was to bill the United States government for defective or nonexistent supplies sold to the Union Army. The federal government's response was the False Claims Act, passed in March 1863, which assessed corrupt war profiteers double damages and a $2,000 civil fine for each false claim submitted. Remarkably enough, this law is still in force, though much amended.

Soon after the Civil War, another major fraud gained notoriety: the Crédit Mobilier scheme of 1872. Considered the most serious political scandal of its time, this fraud was perpetrated by executives of the Union Pacific Railroad Company, operating in conjunction with corrupt politicians. Crédit Mobilier of America was set up by railroad management and by Representative Oakes Ames of Massachusetts,

[8] Id., 13.
[9] Id., 18.
[10] *Hammurabi's Code of Laws* (1780 B.C.E.), L. W. King, trans.
[11] Carol Emert, "A Rich History of Corporate Crime; Fraud Dates Back to America's Colonial Days," the *San Francisco Chronicle,* July 14, 2002.
[12] Id.
[13] Id.

ostensibly to oversee construction of the Union Pacific Railroad.[14] Crédit Mobilier charged Union Pacific (which was heavily subsidized by the government) nearly twice the actual cost of completed work and distributed the extra $50 million to company shareholders.[15] Shares in Crédit Mobilier were sold at half price, and at times offered gratis, to congressmen and prominent politicians for the purpose of buying their support. Among the company's famous shareholders were Vice President Schuyler Colfax, Speaker of the House James Gillespie Blaine, future vice presidents Henry Wilson and Levi Parsons Morton, and future president James Garfield.[16]

## TYPES OF FRAUD

There are many different types of fraud, and many ways to characterize and catalog fraud; those of the greatest relevance to accountants and auditors, however, are the following broad categories:

- *Employee Fraud*[17]*/Misappropriation of Assets*. This type of fraud involves the theft of cash or inventory, skimming revenues, payroll fraud, and embezzlement. Asset misappropriation is the most common type of fraud.[18] Primary examples of asset misappropriation are fraudulent disbursements such as billing schemes, payroll schemes, expense reimbursement schemes, check tampering, and cash register disbursement schemes. Sometimes employees collude with others to perpetrate frauds, such as aiding vendors intent on overbilling the company. An interesting distinction: Some employee misdeeds do not meet the definition of fraud because they are not schemes based on communicating a deceit to the employer. For example, theft of inventory is not necessarily a fraud—it may simply be a theft. False expense reporting, on the other hand, is a fraud because it involves a false representation of the expenses incurred. This fraud category also includes employees' aiding and abetting others outside the company to defraud third parties.
- *Financial Statement Fraud*. This type of fraud is characterized by intentional misstatements or omissions of amounts or disclosures in financial reporting to deceive financial statement users. More specifically, financial statement fraud involves manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared. It also refers to the intentional misapplication of accounting principles to manipulate results.

[14] Id.
[15] Peter Carlson, "High and Mighty Crooked: Enron Is Merely the Latest Chapter in the History of American Scams," *The Washington Post*, February 10, 2002.
[16] D. C. Shouter, "The Crédit Mobilier of America: A Scandal that Shook Washington," *Chronicles of American Wealth*, No. 4, November 30, 2001, www.raken.com/american_wealth/other/newsletter/chronicle301101.asp.
[17] *Employee* here refers to all officers and employees who work for the organization.
[18] Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud and Abuse* (Austin, TX: Association of Certified Fraud Examiners, 2008), 11.

> According to a study conducted by the Association of Certified Fraud Examiners, fraudulent financial statements, as compared with the other forms of fraud perpetrated by corporate employees, usually have a higher dollar impact on the victimized entity as well as a more negative impact on shareholders and the investing public.[19]

As a broad classification, corruption straddles both misappropriation of assets and financial statement fraud. Transparency International, a widely respected not-for-profit think tank, defines corruption as "the abuse of entrusted power for private gain."[20] We would expand that definition to include corporate gain as well as private gain. Corruption takes many forms and ranges from executive compensation issues to payments made to domestic or foreign government officials and their family members. Corrupt activities are prohibited in the United States by federal and state laws. Beyond U.S. borders, contributions to foreign officials are prohibited by the Foreign Corrupt Practices Act.

This book is primarily concerned with fraud committed by employees and officers, some of which may lead to the material distortion of financial statement information, and the nature of activities designed to deter and investigate such frauds. Circumstances in which financial information is exchanged (generally in the form of financial statements) as the primary representation of a business transaction are fairly widespread. They include, for example, regular commercial relationships between a business and its customers or vendors, borrowing money from banks or other financial institutions, buying or selling companies or businesses, raising money in the public or private capital markets, and supporting the secondary market for trading in public company debt or equity securities. This book focuses primarily on three types of fraud:

1. Frauds perpetrated by people within the organization that result in harm to the organization itself
2. Frauds committed by those responsible for financial reporting, who use financial information they know to be false so they can perpetrate a fraud on investors or other third parties, whereby the organization benefits
3. Corrupt acts by companies or their executives, whereby the executive personally or the company benefits

## ROOT CAUSES OF FRAUD

As society has evolved from barter-based economies to e-commerce, so has fraud evolved into complex forms—Hammurabi's concern about trustworthy shepherds was just the beginning. In the early 2000s, companies headquartered in the developed world took the view that their business risk was highest in emerging, or Third World

[19] Id.
[20] Transparency International, "TI's Vision, Mission, Values, Approach and Strategy," www.transparency.org.

regions, where foreign business cultures and less-developed regulatory environments were believed to generate greater risk.[21] Gaining market access and operating in emerging or less-developed markets seemed often enough to invite business practices that were wholly unacceptable at home. Sharing this view, the governments of major industrial countries enacted legislation to combat the potential for corruption. The United States enacted the Foreign Corrupt Practices Act (FCPA); countries working together in the Organisation for Economic Co-operation and Development (OECD) enacted the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (known as the *OECD Convention*); the United Nations adopted the United Nations Convention against Corruption (UNCAC); Canada enacted the Corruption of Foreign Public Officials Act; and the United Kingdom passed its Bribery Act in 2010.

This way of thinking about risk and markets and of combating corruption and fraud is no longer adequate, however. The new paradigm for understanding risk postulates that fraud risk factors are borderless and numerous. Fraud is now understood to be driven by concerns over corporate performance, financing pressures including access to financing, the competition to enter and dominate markets, legal requirements and exposure, and personal needs and agendas.[22] The need for this new paradigm has become increasingly clear in the past few years, when the greatest risk to investors has appeared to be participation in the seemingly well-regulated and well-established U.S. and European markets. More recently, events at several major European multinationals have shown that the risk of massive fraud and corruption knows no borders.

The recent spate of Ponzi schemes, corruption, and financial scandals has demonstrated that large-scale corporate improprieties can and do occur in sophisticated markets; they are by no means the exclusive province of foreign or remote markets. Capital market access and the related desire of listed companies to boost revenue growth, and investors' desire to achieve significant and stable returns, through whatever means necessary, are major factors contributing to financial malfeasance worldwide.

## A HISTORICAL ACCOUNT OF THE AUDITOR'S ROLE

We have briefly examined the elements, forms, and evolution of fraud. We can now examine the role of one of the key players in the effort to detect fraud, the auditor.

### Auditing: Ancient History

Historians believe that recordkeeping originated about 4000 B.C.E., when ancient civilizations in the Near East began to establish organized governments and

[21] PricewaterhouseCoopers, "Financial Fraud—Understanding Root Causes," *Investigations and Forensic Services Report* (2002), 1.

[22] PricewaterhouseCoopers, *Global Economic Crime Survey 2007*, www.pwc.com/en_GX/gx/economic-crime-survey/pdf/pwc_2007gecs.pdf.

businesses.[23] Governments were concerned about accounting for receipts and disbursements and collecting taxes. An integral part of this concern was establishing controls, including audits, to reduce error and fraud on the part of incompetent or dishonest officials.[24] There are numerous examples in the ancient world of auditing and control procedures employed in the administration of public finance systems. The Shako dynasty of China (1122–256 B.C.E.), the assembly in classical Athens, and the Senate of the Roman Republic all exemplify early reliance on formal financial controls.[25]

Much later, in the twelfth and thirteenth centuries, records show that auditing work was performed in England, Scotland, Italy, and France. The audits in Great Britain performed before the seventeenth century were directed primarily at ensuring the accountability of funds entrusted to public or private officials.[26] Those audits were not designed to test the quality of the accounts, except insofar as inaccuracies might point to the existence of fraud.

Economic changes between 1600 and 1800, which saw the beginning of widespread commerce, introduced new accounting concerns focused on the ownership of property and the calculation of profit and loss in a business sense. At the end of the seventeenth century, the first law prohibiting certain officials from serving as auditors of a town was enacted in Scotland, thus introducing the modern notion of auditor independence.[27]

### Growth of the Auditing Profession in the Nineteenth Century

It was not until the nineteenth century, with the growth of railroads, insurance companies, banks, and other joint stock companies, that the auditing profession became an important part of the business environment. In Great Britain, the passage of the Joint Stock Companies Act in 1844 and later the Companies Act in 1879 contributed greatly to the auditing field in general and to the development of external auditing in the United States.[28] The Joint Stock Companies Act required companies to make their books available for the critical analysis of shareholders at the annual meeting. The Companies Act in 1879 required all limited liability banks to submit to auditing, a requirement later expanded to include all such companies.[29] Until the beginning of the twentieth century, independent audits in the United States were modeled on British practice and were in fact conducted primarily by auditors from

[23] Robert Hiester Montgomery, *Montgomery's Auditing,* 12th ed. (New York: John Wiley & Sons, 1998), 1–7.
[24] Id.
[25] Id.
[26] Id.
[27] Id.
[28] Id.
[29] Dr. Sheri Markose, "Honest Disclosure, Corporate Fraud, Auditors and Stock Market Valuation," lecture from course EC247: "Financial Instruments and Capital Market Institutions," University of Essex (Essex, U.K., 2003).

Britain, who were dispatched overseas by British investors in U.S. companies. British-style audits, dubbed "bookkeeper audits," consisted of detailed scrutiny of clerical data relating to the balance sheet. These audits were imperfect at best. J. R. Edwards, in *Legal Regulation of British Company Accounts, 1836–1900,* cites the view of Sir George Jessel, a lawyer and judge famous in his day, on the quality of external auditing soon after passage of the Companies Act:

> *The notion that any form of account will prevent fraud is quite delusive. Anybody who has had any experience of these things knows that a rogue will put false figures into an account, or cook as the phrase is, whatever form of account you prescribe. If anybody imagines that will protect the shareholders, it is simply a delusion in my opinion. . . . I have had the auditors examined before me, and I have said, "You audited these accounts?" "Yes." "Did you call for any vouchers?" "No, we did not; we were told it was all right, we supposed it was, and we signed it."*[30]

Yet by the end of the nineteenth century, the most sophisticated minds in the auditing field were certain that auditors could do much better than this. Witness the incisive view of Lawrence R. Dicksee, author of a manual widely studied in its day (and still available today, many editions later):

> *The detection of fraud is the most important portion of the Auditor's duties, and there will be no disputing the contention that the Auditor who is able to detect fraud is—other things being equal—a better man than the auditor who cannot. Auditor[s] should, therefore, assiduously cultivate this branch of their functions. . . .*[31]

In response to the rapidly expanding American business scene, audits in the United States evolved from the more cumbersome British practice into "test audits." According to *Montgomery's Auditing,* the emergence of independent auditing was largely due to the demands of creditors, particularly banks, for reliable financial information on which to base credit decisions.[32] That demand evolved into a series of state and federal securities acts, which significantly increased a company's burden to publicly disclose financial information and, accordingly, catapulted the auditor into a more demanding and visible role.

### Federal and State Securities Regulation before 1934

Before the creation of the Securities and Exchange Commission (SEC) in 1934, financial markets in the United States were severely under-regulated. Before the

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[30] J. R. Edwards, *Legal Regulation of British Company Accounts, 1836–1900* (New York: Garland, 1986), 17.
[31] L. R. Dicksee, *Auditing: A Practical Manual for Auditors* (New York: Arno, 1976), 6. Reprint of the 1892 edition.
[32] Id., 1–9.

stock market crash of 1929, there was very little appetite for federal regulation of the securities market, and proposals that the government require financial disclosure and prevent the fraudulent sale of stock were not seriously pursued.[33] Investors were largely unconcerned about the dangers of investing in an unregulated market. In fact, many were seduced by the notion that they could make huge sums of money on the stock market. In the 1920s, approximately 20 million large and small shareholders took advantage of the postwar boom in the economy and tried to make their fortunes by investing in securities.[34]

Although there was little interest during the first decades of the century in instituting federal oversight of the securities industry, state legislatures had already begun to regulate the securities industry.[35] States in the Midwest and West were most active in pursuing securities regulation in response to citizens' complaints that unscrupulous salesmen and dishonest stock schemes were victimizing them.[36] The first comprehensive securities law of the era was enacted by Kansas in 1911. That law, the first of many known as *blue-sky laws,* required the registration of both securities and those who sold them.[37] The intent was to prevent fraud in the sale of securities and also to prevent the sale of securities of companies whose organization, plan of business, or contracts included provisions that were "unfair, unjust, inequitable, or oppressive" or if the investment did not "promise a fair return." In the two years following the enactment of the securities laws in Kansas in 1911, 23 states passed some form of blue-sky legislation.[38]

It was only after the stock market crash in 1929 and the ensuing Great Depression that interest in enacting federal securities legislation became widespread. Congress passed the Securities Act of 1933, which had the basic objectives of requiring that investors receive financial and other significant information concerning securities offered for public sale, and prohibiting deceit, misrepresentations, and other fraud in the sale of securities. The primary means of accomplishing these goals was the disclosure of important financial information through the registration of securities.[39]

The second fundamental set of laws, the Securities Exchange Act of 1934, created the Securities and Exchange Commission and granted it broad authority over all aspects of the securities industry, including registering, regulating, and overseeing brokerage firms, transfer agents, and clearing agencies. The Act addressed the need for regulation of the securities industry, as well as the need to address the potential

[33] U.S. Securities and Exchange Commission, "Introduction—The SEC: Who We Are, What We Do," www.sec.gov.
[34] Id.
[35] Wisconsin Department of Financial Institutions, "A Brief History of Securities Regulation," www.wdfi.org/fi/securities/regexemp/history.htm.
[36] Id.
[37] Id.
[38] Id.
[39] U.S. Securities and Exchange Commission, "Introduction—The SEC: Who We Are, What We Do."

for fraud inherent within it. Several sections of the Act deal with fraud, including Section 9 (Manipulation of Security Prices), Section 10 (Manipulative and Deceptive Devices), Section 18 (Liability for Misleading Statements), Section 20 (Liability of Controlling Persons and Persons Who Aid and Abet Violations), and Section 20A (Liability to Contemporaneous Traders for Insider Trading).

## Current Environment

The financial scandals in the years 2000 and 2001 at major corporations and conflict of interest issues in the financial services industry caused investor confidence in the stock market to decline dramatically. In response to the wave of corporate malfeasance, the U.S. Congress passed the Sarbanes-Oxley Act of 2002, intended to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[40]

Sarbanes-Oxley prohibits accounting firms from providing many consulting services for the companies they audit, requires audit committees to select and essentially oversee the external auditor, and generally strengthens the requirement that auditors must be independent from their clients. Section 101 of the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public companies that are subject to the securities laws and related matters. The purpose of the PCAOB is to protect the interests of investors and to further the public interest.[41] The PCAOB was authorized to establish auditing and related professional practice standards, and Rule 3100 requires the auditor to comply with these standards.[42] The Sarbanes-Oxley Act began an extensive and still-evolving series of audit rule changes, prompting the issuance of three auditing standards.

In October 2002, the AICPA issued *Statement on Auditing Standards (SAS) No. 99,* "Consideration of Fraud in a Financial Statement Audit." Effective for audits of financial statements for periods beginning on or after December 15, 2002, SAS 99 sought to improve auditing practice, especially as it relates to the auditor's role in detecting fraud, if it exists, in the course of the audit. According to the AICPA president and CEO, the standard was meant to "substantially change auditor performance, thereby improving the likelihood that auditors will detect material misstatements due to fraud" by putting "fraud in the forefront of the auditor's mind."[43] Furthermore, according to the AICPA's own assessment, the standard would be the "cornerstone

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[40] Sarbanes-Oxley Act of 2002, Public Law 107–204, 107th Cong., 2d sess. (January 23, 2002), 1 (from statute's official title: "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes").

[41] Public Company Accounting Oversight Board, Sarbanes-Oxley Act of 2002, www.pcaobus.org/rules/Sarbanes_Oxley_Act_of_2002.pdf.

[42] Public Company Accounting Oversight Board, Rules of the Board, 127, www.pcaobus.org/documents/rules_of_the_board/Standards-AS1.pdf.

[43] American Institute of Certified Public Accountants, "AICPA Issues New Audit Standard for Detecting Fraud, Cornerstone of Institute's New Anti-Fraud Program," October 15, 2002, www.aicpa.org/news/2002/p021015.htm.

of a multifaceted effort by the AICPA to help restore investor confidence in U.S. capital markets . . . to reestablish audited financial statements as a clear picture window into Corporate America."[44] The standard, however, does not increase or alter the auditor's fundamental responsibility, which is to plan and conduct an audit such that if there is a fraud or error causing a material misstatement of a company's financial statements, it may be detected. While this seems an unambiguous mandate, there still remains a difference between the public perception that audits should detect all fraud and the actual standards governing the conduct of audits. There is a significant and legitimate difference between *performing an audit* and *conducting a financial fraud investigation*. That difference is explored throughout this book.

In November 2003, the SEC approved the final versions of corporate governance listing standards proposed by the NYSE and NASDAQ stock markets. Both standards expand upon the Sarbanes-Oxley Act of 2002 and SEC rules to impose significant new requirements on listed companies. These sweeping reforms mandate independence of directors, increased transparency, and new standards for corporate accountability. These and other governance standards emphasize the importance of enhancing governance, ethics, risk, and compliance oversight capabilities.

In 2004, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued its new Enterprise Risk Management framework. The new COSO framework identifies key elements of an effective enterprise risk management approach for achieving financial, operational, compliance, and reporting objectives. The new COSO framework emphasizes the critical role played by governance, ethics, risk, and compliance in enterprise management.

On November 1, 2004, the United States Organizational Sentencing Guidelines (the Guidelines) were amended to provide expanded guidance regarding the criteria for effective compliance programs. The Guidelines emphasize the importance of creating a "culture of compliance" within the organization; establish the governance and oversight responsibilities of the board and senior management; and frame the need for dedicating appropriate resources and authority. The Guidelines also focus on the relationship between governance, ethics, risk management, and compliance.

These efforts, though laudable, have not prevented a further wave of financial market turmoil. The collapse of the credit markets in the United States and Europe was brought on in part by the bursting real estate bubble and the consequent exposure of poor lending practices as financial institutions chased fee income from generating new transactions, instead of traditional sources of profitability based on their interest rate spread between assets and liabilities. At the same time, the rise of unregulated private equity, hedge fund, and other investment partnerships promising returns beyond market expectations in size and stability fueled speculative investing and poor due diligence practices. The failure during this liquidity crisis of massive financial market participants like Countrywide and Merrill Lynch (both absorbed by Bank of America), Bear Stearns being merged with JP Morgan Chase, Lehman Brothers falling into liquidation, and Citigroup and AIG, among others, receiving billions in government support payments (see Exhibit 1.1) has been the consequence of speculation in the markets.

[44] Id.