

Control Overrides in Financial Statement Fraud

A Report to the
Institute for Fraud Prevention



by

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I. Introduction

In a speech given in 1998, Arthur Levitt, then Chairman of the Securities and Exchange Commission, warned that a “numbers game” was being played in the business world.

Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representationManaging may be giving way to manipulation; Integrity may be losing out to illusion. (Levitt 1998)

Levitt’s warning came amidst accounting scandals at several large corporations, including Cendant, where disclosures about financial misreporting caused the firm’s stock to lose half of its value in a single day and caused holders of its shares to lose \$14 billion (Morgenson 2004). But the worst was yet to come. Beginning in the fall of 2001 with Enron’s collapse and continuing through the following year, Americans were exposed to a stream of revelations about financial frauds at some of the country’s largest and seemingly most successful firms. High-flying New Economy firms like Enron, WorldCom, and Global Crossing became engulfed in scandal.

The scope of the phenomenon was reflected in two statistical indicators: financial restatements and class action securities fraud suits, both of which rose significantly in the latter part of the 1990s. Between 1997 and 2002, nearly 10% of the firms listed on the three major stock exchanges announced plans to file restatements (General Accounting Office 2002a). Over the next three years, the rate of restatement announcements increased so that in the period 2002 – 2005 nearly 16% of all companies listed on the three exchanges announced restatements

(General Accountability Office 2006).¹ In roughly the same time period (1997- 2005), over 2,200 class action law suits alleging securities fraud were filed in federal courts (Securities Class Action Clearing House 2007). The publicity surrounding corporate scandals also had the effect of significantly reducing investor confidence. Polls found that by July 2002, 40% of those individuals interviewed said they were less likely to invest in stocks because of accounting frauds (General Accounting Office 2002a: 34).

Past accounting scandals seemed to be restricted to “fly-by-night” companies, but recent events showed that corporate corruption had spread to highly-trusted and familiar organizations like Fannie Mae, the government-sponsored public corporation, whose reputation was tainted in 2004 by allegations of long-term manipulation of financial results that ultimately required the entity to restate its earnings by \$6.3 billion. The scandal at Fannie Mae that took place over a number of years was notable, not simply because it reportedly involved senior executives who were motivated by substantial bonuses and other forms of compensation, but also because it involved members of the board of directors and internal and external auditors in a wide-ranging scheme to deceive investors (Office of Federal Housing Enterprise Oversight 2006).

These events raise larger questions of *why* this seeming epidemic of accounting frauds occurred when and where it did; questions that have been addressed by a number of people. This report, however, focuses on a much narrower set of questions concerning primarily *how* these events occurred. The primary question we address is this: How were senior executives at so many firms able to engage in financial statement fraud despite the presence of numerous control agents--boards of directors, internal and external auditors--whose function is to prevent those very abuses? In other words, how were they able to override these controls? One way of getting at this question is to ask *who* was involved in these frauds. At one extreme, one finds

organizations like Enron and Fannie Mae, where corruption was widespread and where directors, internal auditors, and external auditors all knowingly facilitated the accounting deceptions. At the other extreme, one finds companies where corruption was limited to a small number of senior executives--often a CEO and CFO--who were able to deceive control agents, withholding information, or providing them with false information, until the damage was done. In-between, one finds cases involving shifting combinations of corporate insiders and outsiders collaborating in, or acquiescing to, schemes to mislead shareholders and regulators.

To answer these questions our research strategy proceeds in two stages. First we create a statistical portrait of the phenomenon of financial statement fraud with data gleaned primarily from several key sources: a sample of firms compiled by the General Accounting Office that filed financial restatements in the period 1997 to 2002; class action securities fraud filed against those firms in relation to those restatements; and documents related to actions taken against those firms by the Securities and Exchange Commission. This sample we refer to as the Large-N Sample. With the data in the Large-N Sample we hope to answer a number of questions about the scope and dimensions of financial statement fraud, including:

- How many companies have been involved in this form of securities fraud?
- In which industries is financial statement fraud the most prevalent?
- Which specific corporate actors, e.g., CEOs, CFOs and board members, are most commonly involved in financial statement fraud?
- Which entities and individuals outside the restating firm most frequently aid and abet the fraud?
- What consequences did these schemes have for shareholders? One significant consequence is the decline in the market value of the companies in which they invested.

The second stage of the research design involves generating a subsample of firms from the Large-N Sample and analyzing each as case studies. This Small-N Sample allows us to take a more nuanced view of the often complex processes behind instances of financial statement fraud. In this analysis we focus on the roles played by boards of directors, senior management, middle management, and outside auditors in resisting or colluding in fraudulent schemes. To more systematically assess these factors we develop and apply a taxonomy of responses to efforts to commit financial statement fraud.

While our research efforts focus on specific empirical questions, our findings have implications for larger issues. At a policy level, the results of our analysis are relevant to policy debates on the level of restrictions and regulations that should be placed on publicly-held corporations and their auditors. Of more academic interest are the questions that our findings raise for our understandings of the way that equity markets operate; specifically, “efficient market” theories that postulate that stock prices accurately reflect firms’ true value because the information available to investors is accurate. We address both of these issues more fully in the Conclusions section of this report.

II. Review of the Literature

The intentional manipulation of financial results is a topic of long-standing interest in accounting and finance literature where the phenomenon is most often referred to as “earnings management.” In these discussions, “earnings management” is not seen as synonymous with financial fraud. Rather, financial statement fraud is seen as an “extreme form of earnings management.” Dechow and Skinner distinguish forms of earnings management that fall within Generally Accepted Accounting Principles (GAAP), including what they term “aggressive accounting,” from “fraudulent accounting”--practices that violate GAAP standards (Dechow and Skinner 2000: 239). In this view, earnings management is not an all together negative phenomenon as it often represents a form of “flexible accounting” (Dechow and Skinner 2000: 247 -248).

Empirical studies in this area are generally methodologically sophisticated and provide a high level of precision in their analyses and conclusions. Taken as a whole, research in this area has provided valuable insights into the causes, consequences, and dimensions of the phenomenon.

Causes

A number of studies have combined data on financial restatements, SEC actions, and law suits with characteristics of firms, to develop models that predict false financial statements. These analyses have identified the causal factors behind attempts to manipulate earnings as: (1) capital markets pressure; (2) composition of boards of directors; (3) forms of executive compensation; and (4) insider trading.

Capital Market Pressures

Several studies have investigated how efforts by senior managers to raise capital at low costs have resulted in pressure to engage in earnings manipulation (Dechow, Sloan, and Sweeney, 1996; Richardson, Tuna, and Wu, 2002). In these cases, managers want to maintain an illusion of high performance by their companies in order to raise capital for their firms.

Board Composition

A number of studies have tested the theory that the composition of corporate boards influence the likelihood that the firm will engage in earnings manipulation. Research by Beasley (1996) and Klein (2002) demonstrates that the more “independent” boards are, as measured by their proportion of outside directors, the less likely they are to manipulate earnings. A study by Dechow, Sloan, and Sweeney (1996) examined AAERs filed against 92 firms in the period April 1982 to December 1992. The characteristics of these firms were compared to those of a matched-sample of firms that were not accused of earnings manipulation during the same period. They found that firms accused of manipulating earnings were: (1) “more likely to have boards of directors dominated by management” and (2) “more likely to have a Chief Executive Officer who simultaneously serves as Chairman of the Board...” (Dechow, Sloan, and Sweeney 1996: 5).

Forms of Executive Compensation

One of the clear themes that emerged out of recent accounting scandals has been the way that executive compensation that is tied to a firm’s performance can provide incentives for financial statement fraud. This proposition has been tested in a number of studies, which have generally found support for the notion that firms whose executives are given performance-based compensation, in the form of stock options or bonuses, are much more likely to file restatements

(Kedia 2003), be subject to actions by the SEC (Erickson, Hanlon, and Maydew 2006), or to be the subject of class action law suits (Peng and Roel, 2004).

Insider Trading

A related issue has to do with insider trading by senior executives. In a number of recent, highly-publicized cases of accounting fraud, there was evidence that executives sold their stock in their firms ahead of the public release of negative information about the firm's performance. Summers and Sweeney (1998) examined a sample of 51 companies that had been identified as being involved in financial statement fraud between 1980 and 1987. These firms were compared to a control sample of non-fraudulent companies. Their analysis provides evidence that "insiders in companies with fraudulent financial statements reduce their net position in the entity's stock through a high level of stock sales activity" (Summers and Sweeney 1998: 132). In a similar study, Beneish (1999) focused on the extent to which senior managers at firms accused of earnings management sell their stock in the firm during the period in which earnings are manipulated. Based on an analysis of 64 firms that were either accused by the SEC or identified by the media as engaging in earnings manipulation in the period 1987 – 1993, Beneish found that compared with a control group of firms not accused of earnings manipulation, managers in the companies in his sample were much more likely to have sold their stock at inflated prices and exercised options.

Consequences

Research in this area has focused on the impact that evidence of financial misstatements has had on firms, their executives and their board members. Most of the research on the impact on firms has focused on changes in their market capitalization following revelations of financial

misstatements. To summarize this extensive literature, a number of studies have documented and precisely estimated the serious negative impact that these disclosures have on firm value. Several studies have estimated the impact of restatement announcements on market capitalization estimating average negative declines of: 4.2% (Agrawal and Chada, 2005) and 9% (Palmrose, Richardson, and Scholz, 2001) using a two-day window surrounding the restatement announcement; 9.5% (General Accounting Office 2002) and 11% (Wu 2002) using a three-day window; and 13.38% using a 7-day window (Anderson and Yohn 2002). Other studies have demonstrated the significant negative impact of class action securities fraud law suits on market capitalization (Gande and Lewis, 2005; Fich and Shivdasani, 2005; Karpoff, Lee, and Martin, 2004; Hedge, Malone, and Finnerty, 2003).

While revelations of deceptive financial reporting have been shown to have a very significant impact on shareholders, empirical studies tend to find that those disclosures have little impact on board members (Srinivasan 2006) or senior managers (Agrawal, Jaffee, and Karpoff, 1999; Beneish, 1999). Relatively few lose their positions or are subject to meaningful disciplinary actions following “bad news” about the integrity of their financial reporting.

Dimensions

Other studies have generally focused on the broader questions of the prevalence of earnings management/financial statement fraud and the forms it takes. In 1987, the Treadway Commission (National Commission on Fraudulent Financial Reporting, 1987) released the first systematic study of financial statement fraud. The study was groundbreaking in that it drew attention to a serious problem. The research presented in the report, however, did not focus on

the incidence and correlations of financial statement fraud, but instead surveyed practitioners for their views on the severity of the problem.

Many of these empirical details were described in a seminal study commissioned by the Committee of Sponsoring Organizations that was published in 1999. In that study, Beasley et al. examined SEC Audit and Accounting Enforcement Releases (AAERs) during the period 1987 – 1997. Among their key findings were: (1) the median dollar amount associated with the financial statement frauds was \$4.1 million; (2) top senior executives were frequently involved (72% of the cases); (3) boards of directors were most often insiders; (4) frauds typically involved overstatement of assets and revenues; (5) the majority (56%) were audited by big six/eight accounting firms; (6) external auditors were named in 29% of the AAERs; (7) over half of the firms suffered severe consequences--bankruptcy/delisting (Beasley, Carcello, and Hermanson 1998).

The Beasley et al. study was released two years before the Enron implosion and the cascade of accounting scandals that followed. Congress responded to these scandals by asking the General Accounting Office (GAO) to conduct a study of financial restatements. The GAO's report, (General Accounting Office 2002a) released in October 2002, produced some startling results. The GAO found that in the period from January 1, 1997 to June 30, 2002 some 845 companies filed one or more restatements; these firms comprised nearly 10% of all companies listed on the three major stock exchanges. Immediate investor losses (using a three-day window), as measured by changes in market capitalization in the short term, totaled \$100 billion, and longer-term losses totaled nearly \$240 billion. The GAO also found that accounting scandals had significant negative impacts on investor confidence.

A Criminological Perspective

While these studies have provided valuable insights into the dynamics of financial statement fraud, their focus on technical accounting issues, and their heavily quantitative approach, often fails to capture the scope and enormity of the scandals that engulfed companies like Enron, WorldCom, and Global Crossing. Reading these articles written by academic accountants and finance economists, a criminologist is struck by the way that the deviant and criminal aspects of the phenomenon seem to be downplayed, despite the fact that the behavior that triggers the events under study--restatements, SEC lawsuits, class action lawsuits--most often involve some form of deception and in the majority of cases, ill-gotten gains. Thus, from a criminological perspective, a number of things seem to be missing in this work.

At the outset, one can note that the term “white-collar crime” is almost never used in these articles, though many of the individuals involved were eventually convicted of crimes and would certainly fit the definition of white-collar criminals. There is also little discussion about how specific individuals benefited from these acts of deception and by how much; though personal gain is suggested in the analysis of stock options and insider trading, the exact amount of illicit profit is rarely calculated. (This omission becomes apparent when one reads the complaints in class action securities fraud law suits where the dollar amount of illicit gains by senior executives is often clearly specified). Similarly, there is almost no discussion of the victims of these acts of deception other than some analyses of changes in “shareholder wealth” following revelations of dishonest accounting practices.²

In addition, empirical studies of “earnings management” tend to present senior managers as agents who rationally react to the environments in which they find themselves, rather than proactively working to create those environments. Moreover, the larger regulatory environment

is rarely investigated nor are the political processes that lie behind the creation of those environments examined--the analyses simply start with the assumption that these environments are given. In other words, the analyses never question how and by whom the rules of the “game” are created and who benefits from them.³

There is an emerging criminological perspective that seeks to fill in some of these gaps in the accounting/finance literature. Financial statement fraud can be seen as a form of what Black calls “control frauds”--“situations in which those who control firms or nations use the entity as a means to defraud customers, creditors, shareholders, donors, or the general public” (2005a: 734). According to Black, accounting fraud is an “optimal strategy” for many white-collar crimes because:

it simultaneously produces record (albeit fictional) profits and prevents the recognition of real losses. This combination reduces the risk of detection and successful prosecution because the CEO can use normal corporate mechanisms (e.g., raises, bonuses, stock options, dividends and appreciation in the value of the firm’s stock) to convert the creditor’s funds to his personal use. The blessing by the top tier audit firm of the fictional profits provides “cover” to the CEO against fraud prosecutions that would never exist were he simply to embezzle funds. The false profits also aid the CEO’s ability to enlist political aid and provide immense psychic value. (2005a: 736)

From this perspective, control agents--auditors, boards of directors, law firms, and regulators--are often allies of corporations who utilize them to “mimic a robustly healthy, legitimate firm.” Accordingly, researchers should endeavor to understand “how such frauds use the protective coloration of legitimate firms, and win the blessing of regulators, accountants, and other legitimating professionals...” (Black 2005a: 737).

Black's theoretical statement is consistent with and supports the recent work of Tillman and Indergaard (2005; 2007) on the corporate scandals of the late 1990s. Focusing on the New Economy industries of energy trading, telecommunications, and internet-related firms (dot-coms), they locate the origins of these scandals at the nexus of larger changes that were taking place in economic institutions, business organizations, and corporate culture. At the level of institutions, they argue that the 1990s saw successful efforts to deregulate these industries; policy changes that were influenced by the argument that New Economy industries operated under a different set of economic rules than Old Economy industries and were largely self-regulating. Concurrent with these changes was a broader trend (particularly among New Economy industries) towards financialization--"a pattern of accumulation in which profits accrue primarily through financial channels rather than through trade and commodity production" (Krippner, 2005: 174).

These trends led to changes in the way businesses were organized, with many (again, particularly in New Economy industries) moving away from self-contained, hierarchical structures to network structures in which firms develop ongoing and flexible relationships with other firms, and in which business is increasingly organized around "deals" and the "deal flows." Another aspect of these new arrangements was that groups that once acted as control agents who enforced formal rules of accountability on firms were now part of an array of "reputational intermediaries"--that included accounting firms, law firms, banks, and stock analysts--who gave legitimacy to the firms' transactions and "helped managers pump the stock values of firms or assisted in financial engineering that indirectly had the same effect" (Tillman and Indergaard 2005: 27).

As these changes altered the environment in which firms operated, new organizational cultures were emerging within many companies in which corruption was “normalized,” i.e., became a routine and taken-for-granted part of everyday life in the organization. This was particularly evident in the routinization of corrupt accounting practices.

Fraudulent activities were organized in such a way as to focus people on the task at hand while blocking off questions of whether what was being done was appropriate. A central activity in accounting frauds--the quarterly effort to manipulate the financial results--was encoded in a way that encouraged one to treat it as a regular task that did not need to be thought out. (Tillman and Indergaard 2005: 224-225)

As a result of these changes in institutions, organizations, and cultures, the 1990s saw the emergence of what Tillman and Indergaard (2007) refer to as “criminogenic institutional frameworks” in which firms and their agents were encouraged to engage in corrupt and sometimes criminal activities, including, prominently, accounting fraud.

Thus, one of the main differences in the accounts of corrupt corporate practices by accountants and finance economists and those offered by proponents of the criminological perspective, is the prominent role that institutional change takes in the latter version, whereas in the former the context of events is typically static. This focus on institutional change is also found in the explanations of the accounting scandals of the late 1990s offered by people like securities law expert John Coffee (2005; 2004) and well-known economist and policymaker Joseph Stiglitz (2003).

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In this study we have tried to combine the methodological tools developed by academic accountants and finance economists with the conceptual insights found in the criminological perspective. Empirically, we cover much the same ground as earlier studies in the accounting/economics literature, although the way we frame some of the issues draws on the criminological perspective.

III. Data and Methods

Data sources

A major obstacle in studies of white-collar and corporate crime is the paucity of systematic data that can be relied upon to define populations and samples. In this study we were very fortunate to have at our disposal a sample of restatements that were announced between January 1, 1997 and June 30, 2002. The data were collected as part of an analysis conducted by the GAO and made available to the public. The sample consisted of 919 restatements announced by 845 companies. Not all restatements indicate fraud or misconduct. The GAO study “focused on financial restatements resulting from accounting irregularities, including so-called aggressive accounting practices, intentional and unintentional misuse of facts applied to financial statements, oversight or misinterpretation of accounting rules, and fraud.” In doing so, the GAO researchers “excluded restatements resulting from mergers and acquisitions, discontinued operations, stock splits, issuance of stock dividends, currency-related issues, ...changes in business segment definitions, changes due to transfers of management, changes made for presentation purposes, general accounting changes under generally accepted accounting principles (GAAP), litigation settlements, and arithmetic and general bookkeeping errors” (General Accounting Office 2003: 5).

In finance and accounting literature, restatements are often interpreted as indicating “a serious breach of a firm’s internal control system (or an attempt by management to mislead readers of the statement)...” (Kinney and McDaniel 1989: 71). The view that restatements are evidence of intentional efforts to mislead investors is supported by Richardson, et al., who asserts that firms that file earnings restatements “can be characterized as firms that knowingly and intentionally engaged in earnings manipulation” (Richardson, Tuna, and Wu, 2002: 1).

Thus, while restatements are not necessarily evidence of fraud, they point to the possibility of fraudulent actions.

Starting with the GAO data set, we were able to further narrow our focus to companies that were engaged (or, were alleged to be engaged) in fraudulent conduct by determining which of these firms had been the subject of either class action securities fraud lawsuits or actions by the Securities and Exchange Commission alleging fraudulent behavior on the part of corporate insiders and their allies.

Data on class action lawsuits were obtained from the Securities Class Action ClearingHouse based at Stanford University and available online (<http://securities.stanford.edu>). Documents related to actions taken by the Securities and Exchange Commission were also available online at www.sec.gov.

Information on the positions of individuals named as defendants in class action suits was obtained largely from the complaints in those suits. Where complaints were not available, that information was located in a variety of sources including searches of Lexis-Nexis.

Share price information, used to calculate investor losses, was taken from a variety of sources, including on-line data bases, e.g., Mergent Online, MarketWatch (www.marketwatch.com) and the OTC Bulletin Board (www.otcbb.com). Where share price information could not be obtained from those sources we went to the *Daily Stock Price Record*, a hard copy listing of historical stock prices. Needed information on outstanding shares was also obtained from the *Daily Stock Price Record*. Industry codes (North American Industry Codes) for individual companies were obtained from Mergent Online.

Methodological Issues

Before we turn to a description of the sample, a discussion of two fundamental methodological issues is warranted.

Using Class Action Suits and Regulatory Actions as Data Sources on Individuals' Involvement in Fraud

Most previous studies of financial statement fraud, or “earnings manipulation,” have analyzed actions taken by the SEC as reported in their Audit and Accounting Enforcement Reports (AAERs). Yet, many observers have noted that the SEC’s enforcement actions are limited by a number of factors, primarily the limited resources available to the agency, which means that it is practically impossible for the agency to take actions against every reported case of financial statement fraud. As a result, the SEC must prioritize cases in deciding which to pursue. According to a GAO report, “[the] SEC generally prioritizes the cases in terms of: (1) the message delivered to the industry and public about the reach of SEC’s enforcement efforts; (2) the amount of investor harm done; (3) the deterrent value of the action; and (4) SEC’s visibility in certain areas such as insider trading and financial fraud” (General Accounting Office 2002b: 6). An analysis of the types of cases that the SEC decides to pursue discovered that the agency tended to focus on smaller firms and those in financial distress, leading the researchers to conclude that the “SEC...preferred weaker opponents” (Cox and Thomas 2003: 778).

The limitations this creates for researchers was recognized by Beasley, et al., (1999) whose study of financial statement fraud in the period 1987 – 1997 focused empirically on AAERs issued by the SEC in that period.

Because the identification of fraud cases is based on review of AAERs, the findings are potentially biased by the enforcement strategies employed by the staff of the SEC. Because

the SEC is faced with constrained resources, there is the possibility that not all cases of identified fraud occurring in the U.S. are addressed in the AAERs. There may be a heavier concentration of companies contained in the AAERs where the SEC assesses the probability of successful finding of financial statement fraud as high. In addition, the cases contained in the AAERs represent instances where the SEC alleged the presence of financial statement fraud. In most instances, the company and/or individuals involved admitted no guilt. (1999: 11)

Our solution to this problem is to expand our empirical focus to include class action securities fraud lawsuits. From one point of view, these privately-initiated actions expose cases of corporate malfeasance not covered by the SEC; class action attorneys, in this view, represent “private attorneys general” (Coffee 1986: 669). As the Supreme Court noted in a 1964 ruling, “private enforcement ... provides a necessary supplement to Commission [SEC] action” (*J.I. Case v. Borak* 1964). Thus, class action securities fraud cases along with SEC actions capture a much larger proportion of all cases of financial statement fraud.

A second issue confronts our use of class action suits and SEC actions as sources of data on financial statement fraud. In our study we treat the fact that individuals and organizations named as defendants and respondents were named in these allegations of misconduct as indicators of their actual participation in fraudulent activities, even though we recognize that these indicators are imperfect. Simply alleging that someone was involved in securities fraud is a long way from proving it. It could be argued that only a conviction in a criminal court would provide sufficient evidence of intentional involvement in fraudulent actions. Yet, we feel that for several reasons these allegations of misconduct provide indicators that are sufficient for our purposes.

First, a similar issue confronts criminologists who use data on arrests as proxy measures of individual involvement in crime. The facts that many arrests do not result in conviction and many crimes never result in arrest are obvious limitations to this interpretation of arrests. Nonetheless, criminologists frequently rely on arrest data as indicators of individual involvement in crime (Blumstein and Cohen 1979: 565).

Second, the use of administrative and civil actions by agencies like the SEC as measures of white-collar crime also has a lengthy tradition in criminological research that began with the pioneering work of Edwin Sutherland, who in the 1940s reviewed actions taken by federal agencies against corporations to develop statistical information on the extent of white-collar crime (Sutherland, 1983 [1950]). A similar methodology was used by Clinard and Yeager (1980) in their study of corporate crime in the 1970s. In the 1990s Calavita, et al. (1997) analyzed criminal referrals made by federal regulators to estimate the prevalence of fraud in the savings and loan industry.

Finally, it could be argued that while allegations made by the SEC might provide reasonable proxy measures for participation in fraud, similar allegations found in class action suits do not. It has been argued that many class action securities fraud cases represent nothing more than “strike suits” filed by opportunistic attorneys whose allegations are often “meritless.”⁴ Yet, there is reason to believe that for our sample in particular, this criticism is not valid or is at least not as valid as it once was. All of the class action suits for the firms in the sample were filed after the passage of the Private Securities Litigation Reform Act (PSLRA) in 1995, which, in an effort to curb “frivolous” suits, made it much more difficult to file class action securities fraud suits. Specifically, the PSLRA raised the pleading standards for securities fraud suits requiring, among other things, that where a complaint alleged misstatements, “the complaint

shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading...” Second, the new law required that the complaint demonstrate a “strong inference” that defendants acted “with the required state of mind,” i.e., that the defendant intentionally engaged in an effort to deceive (Public Securities Litigation Reform Act 1995). Together, these standards made it much more difficult for plaintiffs to file cases against firms suspected of engaging in financial statement fraud without specific evidence that defendants deliberately attempted to mislead investors. In a study of post-PSLRA dismissals, Pritchard and Sale hypothesized that complaints that alleged that a “firm and its managers ignored generally accepted accounting principles (GAAP) provided numbers not supported by those principles and thereby intentionally misled the investing public” (Pritchard and Sale 2005: 134-135) particularly when coupled with evidence of a restatement are most likely to meet the new pleading standards; their empirical results confirmed this hypothesis. These are exactly the types of complaints found in the cases in our sample where class action suits were filed.

Of course, frivolous and meritless suits are still filed and those cases are often eventually dismissed, but we feel confident for the reasons discussed above that our use of data sources is appropriate and yields valid data on who is involved in cases of financial statement fraud.

Cases versus Events

In the process of coding the data, a number of practical questions arose which pointed to larger conceptual issues regarding the relationship between restatements, class action suits, and actions taken by the SEC. Put in more general methodological terms, they pointed to the need to more specifically define the relationship between “cases” and “events” in our study.

For this study the basic unit of analysis--the case--consists of companies. For each of those companies, we are attempting to record and link several events that are fixed in time: a

restatement announcement; a class action lawsuit; an action(s) taken by the Securities and Exchange Commission. In general, we have attempted to ensure that these events are related-- that they generally refer to the same sets of behavior, i.e., the filing of false financial statements. However, we have to recognize that there may not be an exact correspondence between these events. The restatement may be the result of a series of fraudulent actions; some or all of those events may form the basis for a class action lawsuit; and the SEC may take action against the firm, its members, and others for violations that stem from these actions, but may include other actions. So, while there is a great deal of overlap among the various actions that comprise these events, there is also diversity.

We have attempted to insure this overlap by scrutinizing the various documents so as not to include legal actions that refer to events unrelated to the restatement. So, for example, one might find a restatement that results in a class action suit. But, the only SEC action that exists refers to an insider trading case involving securities brokers. That event does not directly relate to the financial statement fraud and therefore the SEC documents would not be coded. If, on the other hand, the insider trading case involved company insiders and was directly related to the financial statement fraud, then the SEC actions would be coded.

In some ways, this methodological problem is more acute in studies of white-collar crime, where one often finds many individuals and organizations involved in a complicated mix of criminal and regulatory violations that may take place over an extended period of time. In more typical street crimes, there is commonly one offender, who commits one crime that begins and ends within a relatively short period of time, which leads to a single arrest, which leads to prosecution on charges related to that crime. So, the correspondence of these events seems much closer. However, even in street crime cases things are often more complicated than that. There

may be more than one defendant in a single “case,” there may have been more than one crime committed as part of that case, leading to multiple counts in an indictment; and the defendant may be involved in other “cases” at the same time he/she is being prosecuted for the first crime.

The Small-N Sample

While Large-N Samples are good for “identifying general patterns and relationships, testing theories, and making predictions,” (Ragin, 1994: 132-133) they may miss the subtleties, nuances, and processes that lie behind these patterns and relationships. For this type of in-depth information, researchers often turn to case studies. The advantage of case studies is that they allow the researcher to see events more holistically, to relate different aspects of a phenomenon to one another chronologically, and to understand subtle variations over time and across cases. For this report we created what we term a Small-N Sample consisting of 17 companies that were generated at random by SPSS from the Large-N Sample. The criterion for selecting these firms was that all had to have had actions taken by the SEC against the firm. We did this because SEC actions often contain more detailed information about the role of internal and external auditors than are found in class action suits and often provide a chronology of events that led to financial statement fraud. The Small-N Sample represents approximately 10% of the cases in the Large-N Sample that met this criterion.

IV. Findings from the Large-N Sample

We start our analysis with a description of the Large-N Sample that comprises the bulk of our analysis. As described above, the sample was based on the restatements data base created by the GAO, which we modified and to which we added more information.

Table 1. Sample Description

| | Number | Percent |
|--|--------|---------|
| Restatements | 919 | |
| Companies | 834 | 100.00 |
| Companies with class action suits | 348 | 41.73 |
| Companies with SEC actions | 166 | 19.9 |
| Companies with class action suits or SEC actions | 374 | 44.8 |
| Number of defendants in class action suits | 2,281 | 100.00 |
| Number of defendants/ respondents in SEC actions | 865 | 100.00 |
| Number of defendants/ respondents in class action suits or SEC actions | 2,766 | 100.00 |

Table 1 describes the basic dimensions of the Large-N Sample. We began with the 919 restatements found in the GAO data base. The GAO reported that the file contained 845 companies. However, upon closer examination, we determined that 11 of those companies were actually duplicates, reducing the number of firms in the sample to 834. Of those 834 companies, we were able to locate 348, or about 42%, in the class action data base, with relevant suits. This proportion of restating companies that were subject to securities fraud lawsuits is similar to the findings of other researchers. The SEC took actions against 166 of the companies for misconduct related to the restatements. A count of firms that were subject to either class action lawsuits or SEC actions (or both), produced a total of 374 firms (44.8%). We will refer to this group of companies as the “Fraud Sample” and the remaining 460 firms that were the subject of neither a class action suit or an SEC action as the “Non-Fraud Sample”.

For each of the 348 firms that we located in the Class Action data base, we coded the title of the defendants named in a single class action suit.⁵ The result was a total of 2,281 defendants named in the 348 suits. The SEC documents named a total of 865 individuals and organizations as either defendants or respondents. Because we were interested in knowing more about the individuals and organizations allegedly involved in the underlying actions on which the lawsuits and SEC actions were based, we wanted to avoid double-counting individuals and organizations that were named in both of these sets of documents. For this reason entities named in both sources were counted only once. This produced a total of 2,766 individuals and organizations in our final data base.

Industry Concentrations: Financial Statement Fraud in the New Economy

In its study, the GAO had little to say about the industries from which the companies in its sample were drawn. In our earlier work, (Tillman and Indergaard 2005) we argued that in the late 1990s, corporate corruption was concentrated in the energy trading, dot-com, and telecommunications industries. During this period, these three industries were part of what was called the New Economy. Exemplified by the companies that emerged out of Silicon Valley, “New Economy” was a term that was used to describe industries that were largely based on technological innovations like the Internet. More significantly, “New Economy” came to represent firms that adopted different organizational forms and engaged in different types of financial transactions than did traditional businesses. Part of this new way of doing business was the idea that New Economy firms could only function with less regulation than traditional companies. A combination of factors--loosened regulatory standards, new forms of organization and ways of doing business, and the involvement of “reputational intermediaries” such as investment bankers eager to profit from extremely rapid growth in these industries--made New Economy firms particularly vulnerable to fraud and corruption. Therefore, in this study we hypothesized that New Economy firms would be disproportionately represented among those accused of fraud.

To classify the firms in our sample by industry we relied upon the North American Industry Codes (NAICS). Implemented in 1997 by the U.S. Census Bureau and other federal agencies, the NAICS codes were designed to replace the older Standard Industrial Classification (SIC) system. While the SIC codes were oriented towards the older, manufacturing economy, the NAICS codes were designed to take into account recent shifts in the economy. As the Dept. of Labor points out, in NAICS “a new Information sector combines communications, publishing,

motion picture and sound recording, and online services, recognizing our information-based economy. Manufacturing is restructured to recognize new high-tech industries. A new sub-sector is devoted to computers and electronics, including reproduction of software” (U.S. Department of Labor).

To test our hypothesis about the disproportionate representation of New Economy firms among those accused of securities fraud we used the NAICS codes to classify companies as operating in either New Economy industries or Non-New Economy industries.⁶

Table 2. Percentage of Firms in New Economy and Non-New Economy Industries, by Sample (Ns in parentheses)

| Industry | Fraud Sample | Non-Fraud Sample |
|--|--------------|------------------|
| <u>New Economy</u> | 38.8 (143) | 27.2 (120) |
| Energy Production and Distribution | 2.4 (9) | 1.1 (5) |
| Computer/Information/Internet Industries | 34.1 (126) | 24.0 (106) |
| Telecommunications | 2.2 (8) | 2.0 (9) |
| <u>Non-New Economy</u> | 61.4 (226) | 72.8 (321) |
| Subtotal | 100.0 (369) | 100.0 (441) |
| Unknown | (5) | (19) |
| Total | (374) | (460) |

Table 2 describes the distribution of New Economy firms and Non-New Economy firms in both the Fraud Sample (the 374 firms accused of securities fraud) and the Non-Fraud Sample (the 460 firms not named in either class action law suits or actions by the SEC). Here we find general support for our hypothesis. New Economy firms comprised 38% of all the firms in the

Fraud Sample and only 27% of the firms in the Non-Fraud Sample. Broken down by specific industry, the biggest differences were in the “Computer/Information/Internet industries” category, with 34% of the Fraud Sample firms falling into this category, compared with 24% of the Non-Fraud Sample. By comparison, the Beasley, et al. study of fraudulent financial reporting in the period 1987 – 1997, found that 12% of the companies in their sample operated in the “computer hardware/software industry.” (Beasley, et al., 1999: 17-18).

It is important to keep in mind that this comparison is limited to firms that had filed restatements. A better sense of the disproportionate presence of New Economy firms in the Fraud Sample could be gained by a comparison to the proportion of New Economy firms in the larger population of all public companies. That comparison, however, would take us beyond the limits of our data.

Table 3. Non-New Economy Firms, by Industry, by Sample (Ns in parentheses)

| Industry | Fraud Sample | | Non-Fraud Sample | |
|-----------------------|--------------|-------|------------------|-------|
| Manufacturing | 34.96 | (79) | 31.46 | (101) |
| Finance and Insurance | 10.62 | (24) | 19.63 | (63) |
| Retail Trade | 4.42 | (10) | 7.17 | (23) |
| Wholesale Trade | 8.41 | (19) | 5.92 | (19) |
| Information | 6.19 | (14) | 5.92 | (19) |
| All others | 35.40 | (80) | 29.90 | (96) |
| Total | 100.00 | (226) | 100 | (321) |

For Non-New Economy firms, the largest industry category--for both the Fraud Sample and the Non-Fraud Sample--was manufacturing, comprising nearly 35% and just over 31% of the

two samples respectively (Table 3). Companies in the Finance and Insurance industries were a distant second for both samples.

Our finding of the disproportionate representation of New Economy firms among those accused of securities fraud is consistent with recent research on another form of corporate corruption: backdated stock options. An analysis by Herron and Lie (2006) of companies that granted stock options to executives between 1996 and 2005, found evidence that 29% of those companies manipulated stock option grants one or more times. When they broke their sample down into what they defined as “high-tech firms” and “low-tech firms” they found evidence of backdating at 32% of the high-tech firms and 20% of the low-tech firms.⁷ We take this as further evidence of our broader argument that corruption was endemic to the New Economy.

Investor Losses

In studies of white-collar crime, it is often difficult to quantify the harms inflicted on victims. The reasons for this difficulty are several: the crimes are often diffused over large numbers of victims; the boundaries of criminal and non-criminal events are often difficult to demarcate; and it is often difficult to measure the scope of the crimes. In analyses of financial statement fraud where the focus is on restatements, a commonly used measure is the change in a firm’s market capitalization following a restatement.⁸ That is, the difference between market capitalization at a fixed point in time before the restatement, and at a later point after the restatement, is interpreted as a measure of the dollar amount of losses experienced by investors who held shares in the firm. A common strategy is to measure the difference in a three-day window surrounding the restatement based on the share price the day before and the day after the restatement announcement.

This measure is not without limitations. One of the problems is that the fraudulent behaviors that lie behind the restatement may have been known or suspected before the restatement announcement and therefore significant reductions in market value may have preceded that date. This was the case with Enron. The day after Enron announced its restatement on November 8, 2001, the firm's share price dropped by \$.42 from the day before the restatement--reducing its market capitalization to about \$6.5 billion. But, this was a relatively insignificant change compared to the change since 2000 when the firm's market capitalization was approximately \$70 billion. On the other hand, if one extends the window around the restatement to longer periods of time, one risks introducing "noise" into the measure, i.e., other factors may have influenced the share price.⁹

Despite these limitations, a number of researchers have calculated investor losses using a three-day window (Richardson, Tuna, and Wu, 2002; Wu, 2002; GAO, 2002a) or a two-day window (Palmrose, Richardson, and Scholz, 2001; Srinivason, 2005) surrounding the restatement date. In this study we use a three-day window. Following the GAO, we calculate change in market capitalization based on the closing share price on the day before the restatement announcement and the closing share price on the day after the restatement.¹⁰ In about 5% of the cases, the restatement date was the last day the share was traded, so we calculated market capitalization based on the share price at the close of that day.

The 374 firms in the sample made a total of 436 restatement announcements over the period 1997 – 2002. We were able to obtain complete information on outstanding shares and share price values for 400 of the 436 restatements, creating a subsample of 348 firms. Most of the stocks for which share price information was unavailable were traded on the OTC Bulletin Board and many were penny stocks, i.e., trading for under a dollar, and most had relatively small

outstanding shares. As a result the market cap for these companies was relatively low. Thus, we did not think that their exclusion significantly affected our estimates.¹¹

A number of researchers adjust the cumulative changes in market capitalization to take into account overall shifts in the market. However, in its analysis the GAO reported only a 5% difference in the unadjusted and the adjusted values. Therefore, here we present unadjusted estimates.

Table 4. Change In Market Capitalization (3-day Window)

| | |
|---|-----------|
| Number of firms | 374 |
| Number of restatements | 436 |
| Restatements with share price information | 400 |
| Mean % change in market cap | -13.14 |
| Mean change per restatement* | - 210.45 |
| Median change per restatement* | -12.49 |
| Total change* | -84,182.5 |

*In millions of dollars.

The data in Table 4 show that shareholders in the 348 firms in our subsample lost a total of \$84.2 billion. On average these firms lost 13% of their market capitalization following a restatement. This amounts to an average (mean) of \$210 million per restatement. These results are similar to those produced by the GAO, which estimated the mean percentage change in market capitalization at 10% for an average of \$148 million per restatement. The GAO

estimates were for 689 of the 845 in the entire sample and includes firms that were not accused of fraud along with those that were. By contrast, our sample includes only those firms that were accused of fraud. Thus, it appears that investor losses are significantly higher at firms where suspected fraud occurs than in firms where there was no fraud alleged.

These losses are only for the three-day period surrounding the restatement announcement date. As mentioned above, had these periods been extended to encompass longer periods of time, these figures would have likely risen significantly. For example, Richardson, et al., estimated average losses for their sample of restatements at 11% of market capitalization in a three-day window. When they lengthened that window to 120 days before and 120 days after the restatement announcement, losses increased to 25% of market value (Richardson, et al., 2002). Commenting on this finding, securities law expert John Coffee noted: “Twenty-five percent of market value represents an extraordinary market penalty. It shows the market not simply to have been surprised, but to have taken the restatement as a signal of fraud.”(2004: 201)

We should note here that while the total change in market capitalization was negative, many of the firms experienced no change or a positive change in share price following a restatement announcement. Of the 400 restatements, 94 had positive changes in their market capitalization and 17 showed no change. There are a variety of reasons why share values might increase after a restatement announcement. For one, these announcements often specify the impact of the restatement on earnings and other measures. For firms operating under a cloud of suspicion, the announcement may remove uncertainty and reassure investors that problems are being overcome (Wu 2002: 16). Second, restatement announcements may be accompanied by other more positive information about the firm’s future. The firm, for example, with the largest gain in market capitalization in the sample was America Online, which on the same day in

August, 1997 that it announced its plans to restate its third quarter (1997) results, it also announced that its membership had increased by 600,000. This news was generally seen as positive by analysts, (Chandrasekaran 1997) despite the fact that earlier that year, AOL insiders had been accused in a class action lawsuit of “churning” those subscribers, i.e., counting as subscribers people who had signed on for a free trial but never became paid subscribers.

Table 5. Investor Losses at Firms with Largest Losses and Percent of All Losses/Gains

| Firm | Loss* | Percent of Losses/Gains |
|---------------------------|-----------|-------------------------|
| Cendant Corp. | 15,822.06 | 18.79 |
| MicroStrategy Inc. | 12,189.13 | 14.48 |
| Lucent Technologies, Inc. | 12,067.45 | 14.33 |
| McKesson HBOC, Inc. | 9,431.50 | 11.20 |
| JDS Uniphase Corp. | 5,145.30 | 6.11 |
| Total | 54,655.44 | 64.91 |

*In millions of dollars

The fact that overall losses were very large despite the fact that over 25% of the restatements resulted in no losses, suggests that the distribution of investor losses among the firms was uneven. When the restatements were rank-ordered by loss, this fact becomes very

apparent. As shown in Table 5, the five restatements that resulted in the largest negative change in market capitalization accounted for a remarkable 65% of total losses.

The most costly restatement was announced by Cendant, a conglomerate that was formed in late 1997 when CUC International, a catalogue buying-club, merged with HFS, an owner of hotel chains and real estate brokerage firms. On April 15, 1998, Cendant's executives, hinting that fraud on the part of high-ranking insiders was involved, revealed that they had uncovered evidence of accounting irregularities that reduced 1997 profits by \$115 million (Morrow 1998; Morgensen 2004). Cendant's share price plunged from \$36.625 per share to \$19 per share the day after the announcement, resulting in what class action attorneys would later refer to as the "largest loss in market capitalization in history" (*In Re: Cendant Corporation Litigation* 1998: 48).

The second most costly restatement was announced by MicroStrategy Inc. on March 20, 2000. MicroStrategy is a software firm whose products are sold mainly to businesses. MicroStrategy was one of the high-flyers in the dot-com bubble. From early November 1999 to March 6, 2000, just two weeks before the company announced its restatement, MicroStrategy's stock price increased over 400%. On March 20, after a *Forbes* magazine article questioned the firm's accounting practices, executives at the firm announced that the company would be refileing its financial statements for 1997, 1998, and 1999. The next day a class action suit was filed against the firm and its officers alleging that the officers had issued "false and misleading statements on its financial statements." The day before the announcement the firm's stock closed at \$226.75. The day after, it was selling for \$71.31 at the close. One of the biggest losers was MicroStrategy's CEO whose net worth dropped \$6 billion because of the decline in the value of the shares he held in the company (Tolme 2000).

Lucent Technologies accounted for 13% of the aggregate change in market capitalization in the sample. Spun off from AT&T in 1996, Lucent was a major player in the rapidly growing telecommunications industry of the 1990s. By late 2000, technical problems with some of its products had already caused its share price to decline significantly, when on November 21, the company announced that it was modifying already filed statements for the fourth quarter, reducing revenue by \$125 million. The market's reaction was immediate. The firm's share price dropped by \$3.25 to \$17.69 the day after the announcement, as analysts commented publicly that the announcement raised concerns about the firm's credibility.

McKesson HBOC was a software firm that was created in January, 1999 when HBOC, a software developer that specialized in products for the healthcare industry, merged with McKesson, the largest health care supply management company in the country. On April 28, 1999, the company's executives announced that they were investigating accounting irregularities and that the firm would be restating its financial results. The company was immediately hit with class action suits that alleged that fraudulent actions intended to deceive investors were behind the restated revenues. The market's reaction was also immediate and severe; the company's share price dropped by half. The next year, the firm's chairman, a vice-president, and general counsel were indicted on charges that they schemed to artificially inflate the firm's stock price.

In the late 1990s, JDS Uniphase was another major player in the telecommunications industry, specializing in fiber optic components. On April 24, 2001 it announced that it was restating its financial results for the quarter that ended on March 31, 2001. As a result of that restatement, losses in the quarter would skyrocket from \$1.3 billion, as originally stated, to \$41.9 billion. The company's stock price had already declined significantly over the previous year to

\$24.18 per share the day before the announcement. The day after the announcement the stock ended up trading at \$20.29.

The fact that four out of the five firms with the largest losses were New Economy companies (2 software and 2 telecommunications firms), suggests the possibility that on average, losses were larger at New Economy firms than at other firms. This would be consistent with the fact that during the 1990s many New Economy firms grew very rapidly with their market capitalization increasing exponentially in very short periods of time and then crashed very suddenly. We can compare losses at New Economy and Non-New Economy firms in the sample, using the categories relied upon earlier. However, one of the problems with that comparison is that the results would be heavily influenced by extreme values at both ends of the spectrum--those firms with very large losses and those with very large gains. To eliminate the influence of those outliers, we removed the five firms with the largest losses and the five firms with the largest gains from the comparison. The results are presented in Table 6.

Table 6. Market Capitalization Losses/Gains by Industry, Five Firms with Largest Losses and Five Firms with Largest Gains Excluded

| Industry | N | Loss/Gain* | Loss/Gain* |
|--|--------|------------|------------|
| New Economy Firms | 127 | -197.96 | -14.89 |
| Energy Production and Distribution | 9 | -389.38 | -41.31 |
| Computer/Information/Internet Industries | 112 | -193.72 | -14.89 |
| Telecommunications 6 | +10.15 | +23.34 | |
| Non-New Economy Firms | 207 | -131.27 | -14.78 |
| Industry Unknown | 4 | -23.66 | -9.14 |
| All firms | 338 | -155.06 | -14.89 |

*In millions of dollars

There we see investor losses at New Economy firms averaged (mean) just under \$198 million, while at Non-New Economy firms, the average was a little more than \$131 million. Here the losses and gains for all restatements for a firm are summed. However, the medians for the two categories were much closer (-14.89 million vs. -14.78 million dollars) indicating the presence of extreme values among the New Economy firms, despite the removal of the top five losses and the top five gains.

The largest losses were at the nine energy companies in the sample, where average losses were over \$389 million. These nine firms included some of the fastest-growing energy firms of the nineties like Reliant Energy (which lost over \$2 billion in market capitalization in the 3-day window surrounding its restatement) and CMS Energy (which lost \$237 million). Both companies were forced to restate revenues after it was revealed that they had engaged in “round-trip” energy trades with each other that involved bogus transactions in which no energy actually changed hands and whose sole purpose was to boost reported revenues.¹² In CMS’s case, these bogus trades accounted for \$4.4 billion in revenue (Bodipo-Memba 2002).

Throughout the preceding discussion we have referred to changes in market capitalization surrounding restatement announcements as “investor losses” (even though many of the cases involved positive changes). However, we recognize that this interpretation is not straightforward. As Alex Berenson points out in *The Number*, these are paper losses and do not necessarily represent actual out-of-pocket losses to shareholders.¹³ The label that one places on these figures often depends on one’s profession. Economists tend to use neutral terms like “shareholder wealth effects” or “changes in firm value” when describing changes in market capitalization in this context. By contrast, class action attorneys almost always refer to negative changes in market capitalization in terms that relate to impacts on investors, e.g., “losses” or

“damages.”¹⁴ Given our interest in the fraudulent aspects of this phenomenon, which includes its impact on victims/investors, we will continue to use the term “investor losses.” This interpretation is supported by the fact that the revised version of the U.S. Sentencing Guidelines allows federal judges, for the purposes of sentencing, to estimate losses from economic crimes on the basis of “the reduction that resulted from the offense in the value of equity securities or other corporate assets” (18 USCS Appx § 2B1.1, 3 (iv)).

Networks of Fraud

Research by criminologists and sociologists has demonstrated the importance of understanding the role of networks of individuals and organizations in white-collar criminal schemes. This point was underscored in a study of fraud in the savings and loan industry during the 1980s in which the authors examined data on criminal referrals filed by regulators at 455 failed thrifts. The referrals named an average of 10 individuals per institution. Significantly, the referrals included individuals both within and outside the institution. The outsiders included lawyers, accountants, and appraisers who played central roles in orchestrating the frauds that led to the collapse of these institutions (Calavita, Pontell, and Tillman 1997: 62-78). Similarly, a study of the three price-fixing conspiracies by Baker and Faulkner (1993) found extensive ties among their participants and concluded that networking was particularly important in illegal schemes because of the significant role that secrecy played in those activities. Pursuing the same logic, in their study of fraud among New Economy firms in the late 1990s, Tillman and Indergaard argued that “New Economy scandals frequently involved a complex web of financial arrangements among multiple parties” that included bankers, lawyers, accountants, stock analysts, and high-level insiders at numerous related firms (Tillman and Indergaard 2007; Tillman and Indergaard 2005).

The idea that corporate crimes often require extensive and coordinated networks of actors is also implicit in Black's (2005a) discussion of "control fraud". As discussed earlier, the financial statement frauds examined here would seem to be exemplars of "control fraud," in which accounting fraud represents the "optimal strategy because it simultaneously produces record (albeit fictional) profits and prevents the recognition of real losses" (Black 2005a: 736). Black argues that CEOs, in particular, are in a unique position to shape the firm's internal and external controls to assist the fraud. In effect, they are able to control the controllers--internal auditors, external auditors, boards of directors--and create an illusion, to "mimic a robustly healthy, legitimate firm" (2005a: 737).

In the present study we are specifically concerned with understanding how senior executives were able to commit financial statement fraud despite the presence of numerous control agents who, in theory, should have been able to detect and prevent those fraudulent activities. One possibility is that, as Black suggests, those agents colluded with the executives (or were co-opted), assisting them in orchestrating and concealing their misrepresentations. In the more detailed analysis of the case studies in our Small-N Sample we will describe the complexities, nuances and shifting alliances that characterize the relationship between corporate insiders, and their control agents. But here we want to paint with a broad brush, producing a statistical picture that describes the various actors (both individuals and organizations) that have been named as accomplices in cases of financial statement fraud. We do this fully recognizing that an accusation of involvement in fraud is not the same as proof that an individual was in fact a willing participant in that scheme. Nonetheless, as discussed earlier, we will treat these accusations as strong indicators of possible participation in financial statement frauds.

We coded the positions held by all individuals named in either a class action law suit or in an SEC action as well as the type of firm for all organizations named. In order to avoid double-counts we coded each individual or organization only once for each company in the sample (though the same organization or individual could have been coded multiple times for different companies). We coded only individuals and entities that were specifically named as either defendants or respondents. This meant, for example, that persons or organizations named in SEC actions as “related entities” were not coded.

Table 7. Defendants and Respondents Named in Class Action Suits and in SEC Actions

| | |
|------------------------|---------|
| Companies | 374 |
| Defendants/Respondents | 2,766 |
| Mean | 7.2 |
| Median | 5.0 |
| Range | 1 – 101 |

We begin our analysis in Table 7 which shows that a total of 2,766 individuals and organizations were named as defendants or respondents in class action law suits or SEC actions against our sample of 374 companies. The number of defendants/respondents per company varied from 1 to 101 (at Enron), with a mean of 7.2. At the outset, then, our data suggest that large numbers of people were involved in these alleged frauds. Relatively few involved a single individual, e.g., a “rogue CEO,” acting alone. Rather, as we shall see in more detail below,

these were complex schemes that often involved numerous individuals both within and outside the company.

Among the relatively few previous studies of restatements that have examined the positions of individuals alleged to have been involved in financial statement fraud, most have focused on senior executives or board members within the restating company (Beneish 1999; Beasley 1996; Srinivasan 2005). Two exceptions are Beasley, et al.'s (1999) report to the Treadway Commission and the SEC's (2003) analysis of enforcement actions for financial disclosure and reporting violations. Yet, both analyses focused on individuals within the company and outside auditors. Our discussion above suggests the need to also consider firms, (and their employees) other than the principal company and auditing firms, that may have collaborated in the accounting frauds.

Organizational Defendants/Respondents

In this study we distinguished between different types of firms that were named as defendants: (1) the restating company; (2) firms that were not formally related to the restating company but were tied to it by transactions; (3) firms that were formally related to the issuing company including parent companies, holding companies, subsidiaries; (4) accounting firms that performed audits for the issuing company; (5) law firms; (6) banks; (7) other organizations.

We begin with a count that distinguishes between the restating company and other types of organizational defendants/respondents (Table 8).

Table 8. Organizational Defendants/Respondents Named in Class Action Suits or SEC Actions, and Percent of Firms with One or More Named, by Organization Type.

| Type | Number | Percent of Organizational Defendants | Percent of Firms 1+ Named |
|------------------------------|--------|--------------------------------------|---------------------------|
| Restating Company | 345 | 47.98 | 92.24 |
| Unrelated Company | 43 | 5.98 | 6.15 |
| Parent Company or Subsidiary | 28 | 3.89 | 6.68 |
| Accounting Firm | 79 | 10.99 | 18.45 |
| Law Firm | 3 | 0.42 | 0.53 |
| Bank | 206 | 28.65 | 11.76 |
| Other organization | 15 | 2.09 | 2.41 |
| Total | 719 | 100.00 | — |

As one would expect, the restating company was the largest category of organizational defendants. However, over half of the organizational entities were firms other than the restating company. Nearly 6% were “unrelated firms” that were linked to the issuing company by some type of fraudulent transactions. Captured here were companies like Homestore, Inc. (see case study below) which was involved in a number of “round-trip” transactions with other vendors. The class action suit against Homestore and its officers named 17 of these unrelated firms as defendants.

Auditors

Of all the control agents surrounding senior managers, one would expect that outside auditors, because of their professional obligations and because of their independence, would exert one of the most forceful constraints on senior executives' ability to file false financial information. Finance economists have applied a theory of "reputational penalty" to predict that active participation by accounting firms, particularly large, prestigious firms would rarely collaborate with their clients in deceiving shareholders. As two prominent proponents of this view put it: "The accountant who certifies the books of many firms has a reputational interest--and thus a possible loss--much larger than the gains to be made from slipshod or false certification of a particular firm" (Easterbrook and Fischel 1991: 282). In other words, to collude with clients would be irrational, since the ultimate costs would be higher than the potential gains. Yet, events of the last few years have cast doubts on this assumption. Even Alan Greenspan, an ardent advocate of corporate self-regulation, was forced to admit, in testimony before Congress in 2002, that the "reputational loss" theory of why accountants would not collude with their clients was seriously damaged.

My view was always that accountants basically knew or had to know that the market value of their companies rested on the integrity of their operations...and that, therefore, their self-interest is so strongly directed at making certain that their reputation was unimpeachable, that regulation by Government was utterly unnecessary and, indeed, inappropriate. *I was wrong* (Senate Committee on Banking 2002: 32) (emphasis added).

A number of writers have described the changes that took place in the accounting industry in the 1990s that led a number of well-known accounting firms to abandon their traditional auditing roles and take a more client-friendly approach. One frequently noted change

was the growth of consulting activities among accounting firms, often times with the same clients to whom they were serving as auditors. As John Coffee has observed: “the Big Five learned how to cross-sell consulting services and to treat auditing services as a portal of entry into the lucrative client...the auditing function was best viewed as a loss leader through which firms could market more lucrative services” (2004: 291). Along with this changed business model came a change in culture at the nation’s largest accounting firms: “the culture of conformity that big accounting firms had traditionally promoted was shifting from stressing adherence to accounting rules to conforming to the new priority of maximizing revenue and pleasing clients” (Tillman and Indergaard 2005: 206). This new attitude was exemplified by Arthur Andersen where, according to a former partner, by the 1990s the organization had become dominated by an “aggressive-win-at-any-cost, make-big-bucks culture” (Holstein 2003).

In our sample, accounting firms that served as auditors for the issuing companies were named 79 times and comprised nearly 11% of all the organizational defendants. Out of the 374 firms in our sample, nearly one out of five (18%) had their auditors named in class action suits or SEC actions (Table 8).

During this time period corporate audits were dominated by five (Big Five) accounting firms. Table 9 shows that these five firms were named as defendants 71 times, comprising the vast majority of all the accounting firms named. The table also shows that despite all the media attention given to one firm, Arthur Andersen, allegations of misconduct were fairly evenly spread among all the Big Five firms.

Table 9. Big Five Accounting Firms Named in Class Action Suits or SEC Actions.

| Firm | No. of Times Named |
|-------------------|--------------------|
| Deloitte & Touche | 12 |
| Arthur Anderson | 17 |
| KPMG | 10 |
| Ernst & Young | 14 |
| Price Waterhouse | 18 |
| Total | 71 |

There are reasons to believe that in cases where auditors were accused of being involved in deceptive reporting, the frauds would be more complex and more costly. It may be that large-scale accounting frauds are difficult to perpetrate without at least the tacit cooperation of auditors. One measure of complexity is the number of individuals/organizations named in class action suits and SEC actions.¹⁵ The data displayed in Table 10 show that in cases where accounting firms were named in class action suits or SEC actions that the mean number of defendants was significantly higher, in fact more than twice as high (12.15 vs. 5.83) than it was where accounting firms were not named. Likewise, the median losses to shareholders, as measured by changes in market capitalization, were approximately twice as great (\$26.09 million vs. \$12.56 million) in cases where accounting firms were named as when they were not.

Table 10. Mean Number of Defendants/Respondents Named and Median Investor Losses at Restating Firms Where Auditing Firm Named and Not Named.

| Auditing Firm Named | Mean No. of Defs./Respond. | Median Loss* |
|---------------------|----------------------------|--------------|
| No | 5.83 | 12.56 |
| Yes | 12.15 | 26.09 |

*In millions of dollars

The finding that in 18% of all the cases in our sample auditors were named can be compared with more recent data. An analysis of securities fraud class action suits filed in 2005 found that only 3% (for a total of 5) named auditors as defendants (Cornerstone Research 2006: 16). One interpretation of this decline is that it reflects the impact of Sarbanes-Oxley on the behavior of accounting firms (Labaton 2006). The more stringent requirements the new law imposed on auditors may have forced them to be more diligent.

Banks

The second largest category of organizational defendants/respondents (28%) was comprised of banks (Table 8). The vast majority of these were investment banks and most of them were named as defendants in class action suits for improprieties in their roles as underwriters for Initial Public Offerings (IPOs) of Internet companies.¹⁶ Many of these suits named multiple investment banks as defendants, so that while a total of 206 banks were named, only 44, or 12%, of the 374 cases involved allegations against banks. Typical of these allegations were those made against Hybrid Networks (see case study below). The suit brought by investors claimed that two of the firm's underwriters--NationsBanc Montgomery Securities

and UBS Securities--had assisted the firm in making false and misleading statements about the company's revenue in the Prospectus and Registration filed before the initial public offering.

Here too, this pattern stands in contrast to more recent data. In class action securities fraud lawsuits filed in 2005, only 4% (a total of 7) contained allegations against underwriters (Cornerstone Research 2006: 16). The difference undoubtedly reflects the sharp decline in suits alleging IPO allocation fraud which frequently named underwriters as defendants.

In sum, our data describe an aspect of financial statement fraud that previous studies have generally not examined: the extent to which involvement in these schemes is spread over relatively large numbers of outside organizations that function in support roles to the principal firm, e.g., accounting firms and investment banks. This pattern is exemplified, at the extreme end, in the class action complaint filed against Enron which named: eight banks, four partnerships of the same accounting firm, and two law firms, along with dozens of individuals within and outside the company. Our findings show that to a much lesser degree, other less serious and less well-known cases of financial statement fraud also involved numerous organizations conspiring, or in some cases acquiescing, in networks of fraud.

Individual Defendants/Respondents

While nearly 26% of the defendants and respondents in the sample were organizations, the majority (74%) were individuals. Obviously, not all employees are in a position to manipulate financial statements, and certain individuals occupying key positions are ideally situated to orchestrate these frauds. In the analysis that follows we focus on the frequency with which individuals in these key positions, both within and outside the principal firm, were involved in efforts to deceive investors with false financial information.

We begin with a look at how individual defendant/respondents were spread across the types of organizations described above.

Table 11. Individual Defendants/ Respondents by Type of Organization

| Organization Type | Number | Percent |
|------------------------------|--------|---------|
| Restating Company | 1655 | 80.90 |
| Unrelated Company | 159 | 7.77 |
| Parent Company or Subsidiary | 146 | 7.14 |
| Unknown | 86 | 4.20 |
| Total | 2046 | 100.00 |

Table 11 shows that, while the great majority of defendants and respondents were from the restating company, up to nearly one-fifth came from external organizations.¹⁷ Next we look at the positions of named individuals within the restating firm.

Within the Restating Company

A. CEOs and CFOs

The key positions, obviously, are to be found within the restating company. Table 12 shows that, as one would expect, the CEO is the most commonly named defendant/respondent, named in nearly 90% of the cases in our sample. Also, not surprisingly, CFOs were named in 78% of the cases.

Table 12. Defendants/Respondents from Restating Company Named and Percentage of Firms With One or More Named, by Title.

| Title | Number of Defendants/ Respondents | Percentage of Firms |
|----------------------------|-----------------------------------|---------------------|
| CEO | 362 | 89.7 |
| CFO | 324 | 78.3 |
| COO | 80 | 20.6 |
| Controller | 73 | 19.3 |
| President | 33 | 8.2 |
| General Counsel | 28 | 7.2 |
| Treasurer | 19 | 5.0 |
| Vice-President | 272 | 36.4 |
| Member, Board of Directors | 394 | 40.0 |
| Chairman of the Board | 69 | 17.9 |
| Board Member | 325 | 28.6 |
| Internal Accountant | 3 | 0.5 |
| Other Employee | 67 | 12.3 |
| Total | 1,655 | 100.0 |

In the Small-N analysis we discuss patterns of collusion among “senior manager cliques”--small groups of insiders who work together to manipulate financial results. One of these cliques consists of CEOs and CFOs.

Table 13. Cases Where CEOs and CFOs are Named as Defendants/Respondents, Row Percents Below and Column Percents to the Right.

| CEO Named | <u>CFO Named</u> | | Total |
|-----------|-------------------|------------------|--------------------|
| | Yes | No | |
| Yes | 275 (94) (82) | 60 (74) (18) | 335 (90) (100) |
| No | 18 (6) (46) | 21 (26) (54) | 39 (10) (100) |
| Total | 293 (100) (78) | 81 (100) (22) | 374 (100) (100) |

Table 13 shows that in 74% (275/374) of all cases, the CEO and the CFO were named. Moreover, it was rare that CFOs were named without CEOs also being named; in only 6% of the cases where CFOs were named, was the CEO not named.

Our finding that 78% of the cases involved CFOs being named in alleged fraudulent schemes is significantly higher than the 43% found by Beasley, et al.(1998) in their study of financial statement fraud in the period 1987 - 1997. The difference may also reflect the changed roles of CFOs during the late 1990s. In earlier decades most CFOs were trained as accountants and their activities were restricted to largely technical accounting matters (Anonymous 2002). But the 1990s “had given birth to wheeler-dealer finance officers, instrumental in such master-of-the-universe activities as negotiating mergers and acquisitions... CFOs tossed aside their

green eyeshades and turned to more creative pursuits. By the late '90s, CFOs were prized for their ability to find new finance and accounting tricks” (Kahn 2002). The new CFO was symbolized by high-flyers like Andrew Fastow (who was awarded a “CFO Excellence Award” by *CFO* magazine) at Enron. More than simply being “number crunchers,” the new breed of CFO was “expected to participate in strategic decision-making as an equal partner” (Howell 2002: 21). In some cases, apparently, this also meant participating in accounting frauds.

B. Directors

The Treadway Commission identified the board of directors, and particularly its audit committee, as performing a critical role in preventing misrepresentations in financial reporting. A more academic statement on control functions of directors comes from Fama and Jensen (1983) who argue that the board of directors is the most important source of internal control in a corporation. They argue, further, that external board members are effective as control agents because the “value of their human capital depends primarily on their performance as internal decision makers in other organizations...and there is a substantial devaluation of human capital when internal decision control breaks down...” (1983: 315). In other words, there is a reputational cost to external board members who allow financial statement fraud to occur on their watch and this cost leads to more material losses, such as removal from other prestigious board positions, or even legal liability. However, recent research by Srinivasan (2006) on the consequences that restatements had for external directors at a subsample of firms drawn from the GAO sample of restating firms, found that while directors often did lose their positions on other boards, relatively few were charged in class action securities law suits, none were charged by the SEC and none were required to pay any portion of a settlement because they were covered by

insurance or by the company itself. These findings are consistent with those of an earlier study which found “little systematic evidence that firms suspected or charged with criminal fraud have unusually high turnover among senior managers or directors” (Agrawal, Jaffee, and Karpoff 1999: 339). These findings raise doubts about the extent to which “reputational costs” can serve as incentives for board members to closely monitor the actions of senior executives.

This doubt is strengthened by the fact that at two-fifths (40%) of all the firms in our sample, one or more members of the board of directors was named in a class action suit or SEC action (Table 12). The overwhelming majority of these allegations were contained in class action suits; only 6 directors were named in SEC actions. Most of those named were external directors. In our coding scheme, if an individual was an officer in the issuing company and a member of the board, he/she was coded as an officer, not a board member.¹⁸ Moreover, in nearly 18% of the cases, the chairman of the board was named. These findings suggest that in large numbers of cases the board of directors was not fulfilling its control function.

One plausible explanation for why so many directors failed to exercise their control is that many had been “bought off” with stock options, and, even worse, many of those options may have been illegally back-dated to increase their value. In this scenario, board members would turn a blind-eye to accounting improprieties if they themselves were the beneficiaries of illegal, or at least improper, financial schemes. Recent research indicates that in addition to large numbers of executives, a significant number of directors may have been awarded back-dated options. In an analysis of options grants to directors at about 6,000 public companies in the period 1996 – 2005, Bebchuk, Grinstein, and Peyer (2006) determined that 9% of those grants were “lucky”--i.e., they fell “on days with a stock price equal to a monthly low”--indicating a high likelihood that they were backdated. They also found a correlation between directors

receiving “lucky” grants and executives receiving grants on the same dates, suggesting a connection between the two events and adding support to the notion that the two groups were often collaborating in these schemes (Bebchuk, Grinstein, and Peyer 2006: 23-25). For the present study it would be very interesting to know at how many of the firms accused of financial statement fraud, either or both executives and directors were awarded “lucky” stock option grants.

As with cases where auditing firms were accused in formal actions against the firms, there is reason to suspect that at restating firms where members of the board were named the schemes to manipulate financial information were more complex and more costly than they were at other restating firms.

Table 14. Mean Number of Defendants/Respondents Named and Median Investor Losses at Restating Firms Where Board Members Named and Not Named.

| Board Members Named | Mean No. of Defs./Respond. | Median Loss* |
|---------------------|----------------------------|--------------|
| No | 5.09 | 14.89 |
| Yes | 10.87 | 15.48 |

*In millions of dollars

Table 14 shows that where one or more board members were named, the average (mean) number of individuals and organizations named in allegations of fraud was over twice the average number in cases where no board members were named (10.87 vs. 5.09). This finding might seem obvious since, board members are often named in addition to others inside and

outside the restating firm. Yet, when we excluded board members from our defendant counts, we found that where board members were named, the mean number of defendants/respondents was 8.23 (not shown in Table 14), still significantly higher than the 5.09 named on average in non-board cases. The table also shows that when board members were named, losses tended to be slightly higher than when they were not (\$15.48 million vs. \$14.89 million). One explanation for this finding is the simple fact that more complex and more costly frauds often taken place over long periods of time and are difficult to hide from others like members of the board of directors. In these cases, class action suits typically allege that directors either colluded in or were aware of the misreporting of financial results and did nothing to prevent it.

It would have been useful to have gained more information about the relationships between board members and the CEO and other officers of the company and conflicts of interests among board members. In their analysis of AAERs, Beasley, et al., (1999) found that at 38% of the companies they examined there was some type of family relationship among board members and officers of the company. They also found that for 66% of the firms, the CEO was also the chairman of the board, indicating diminished board independence. Gathering that type of information, however, would have involved an effort that exceeded the time and resources allocated to this project.

Within Unrelated, Parent or Subsidiary Firms

Just as significant numbers of firms outside the restating companies were implicated in cases of financial statement fraud, so too were individual employees of those outside firms. In Table 15 we classify all individual defendants/respondents who were not in the restating firm into two categories: (1) firms that were formally unrelated to the firm--included here are firms

that were connected to the restating firms by transactions or who provided a service to the firm, e.g., accounting firms; and (2) organizations that were formally related to the restating firm as subsidiaries or parent companies. A significant number (305) of defendants/respondents fell into one of these two categories, representing nearly 16% of all 1,960 individual defendant/respondents whose titles were known.

Table 15. Individual Defendants/Respondents at Unrelated Companies and Parents or Subsidiary Companies, by Title.

| Title | Unrelated Company | Parent or Subsidiary |
|-----------------|-------------------|----------------------|
| CEO | 15 | 27 |
| CFO | 6 | 20 |
| COO | 1 | 3 |
| President | 11 | 25 |
| General Counsel | 1 | 0 |
| Controller | 3 | 21 |
| Vice President | 20 | 23 |
| Treasurer | 0 | 2 |
| Board Member | 2 | 12 |
| General Manager | 1 | 0 |
| Accountant | 66 | 0 |
| Other employee | 33 | 13 |
| Total | 159 | 146 |

One of the things that stands out in this table is the large number of accountants (66) who were named. Most of them were charged by the SEC. Combined with our earlier findings about the number of auditing firms named, we find that in more than one out of five (21%) firms in the fraud sample either an individual auditor or auditing firm was named as a defendant/respondent in class action suits or SEC actions. On the other hand, one could argue that this also shows that in nearly four-fifths of the cases, auditors or auditing firms were not alleged to be involved. Nonetheless, 21% of the cases is not an insignificant proportion and this finding undermines the argument that auditors are deterred from collaborating with their dishonest clients out of fear of reputational penalties.

V. Small-N Sample Analysis

Sample Description

The aim of the Small-N Analysis is to provide a more detailed understanding of financial control overrides among a small subset of firms against which the SEC took actions. From the 166 companies named in these actions, we had SPSS generate a random sample of 17 firms. The result was a sample containing firms of greatly varying sizes, in terms of employment at the time of restatement. As shown in Table 16, seven of the firms had less than 500 employees (five of these had less than 100) while four firms had in the range of 500 to 5000 employees and six had 5000 or more (including three with 20,000 or more). The smallest firm in our sample, NexPub, had 31 employees; the largest, Waste Management, had 75,000.

Table 16. Small-N Sample Firms, Restatement Dates, and Size.

| Firm | Restatement Date | Size (in employees) |
|----------------------------|-------------------|---------------------|
| Anika Therapeutics | August 14, 2001 | 64 |
| BroadVision | April 2, 2001 | 2,412 |
| CyberGuard | July 26, 1999 | 86 |
| First Merchants Acceptance | April 16, 1997 | 627 |
| Genesco | October 31, 1997 | 4,050 |
| Guilford Mills | October 26, 1998 | 6,836 |
| Homestore.com | December 21, 2001 | 2,800 |
| Hybrid Networks | June 1, 1998 | 87 |
| IBP | November 8, 2000 | 50,000 |
| Medaphis | March 31, 1997 | 9,375 |
| NexPub | February 20, 2001 | 31 |
| Parcelsus Healthcare | April 17, 1997 | 8,800 |
| Transcript International | March 27, 1998 | 464 |
| US Lime & Minerals | January 31, 2002 | 200 |
| US Wireless | May 26, 2001 | 67 |
| Warnaco | March 29, 2001 | 21,440 |
| Waste Management | August 3, 1999 | 75,000 |

For firms in the Small-N Sample, we read SEC documents and class action suits thoroughly to determine the nature of the frauds involved, the individuals and organizations involved, and their relationships, and the ways in which all of these individuals responded to instances of financial statement fraud.

The Relational Dynamics of Fraud

Assessing the roles of senior managers, outside auditors, and other control agents in financial report fraud requires that one examine their relationships in various settings. That necessitates going beyond the formal categories of law and regulation and the stylized accounts of mainstream economics. Economic sociology, insofar as it focuses on the relational dynamics of markets, offers a special vantage point for approaching the problem of financial fraud. We follow sociological leads as we seek to generate taxonomies (systems of categories) that are both theoretically-meaningful and grounded in the data.

Economic sociology proposes that transactions are embedded in social structure and cultural frameworks; for instance, networks and group cultures aid financial market actors in dealing with uncertainties (Baker 1984; Abolafia 1996; Carruthers and Stinchcombe 1999; Knorr-Cetina and Bruegger 2002; Preda 2005). Sociologists have also explored a dark side where networks and cultural forms abet illegitimate exploits. Until recently, work here focused on misdeeds within hierarchical organizations possessing oligopolistic power. One theme concerned wayward agents who exploited the access their positions provided to information and used organizational complexity to hide their actions (Shapiro 1980). A second focus was “normalized corruption”--frauds committed by managerial cliques whose positions provide information advantages as well as “institutional levers” allowing them to compel others to follow suspect orders or, more subtly, to shape organizational cultures, routines, and sensibilities about which procedures are “normal” (Ashforth and Anand 2003). Finally, some analyzed the role of networks in organizing fraud across firm boundaries (e.g., in price-fixing schemes) (Baker and Faulkner 1993).

Analysts have found that in the wake of deregulation and financialization, the terrain for fraud in corporate governance has shifted over the last two decades. Accounts of the S&L scandals of the 1980s noted that white-collar criminals often were motivated by personal gain and treated organizations as if they was expendable (Pontell and Calavita 1993; Tillman and Pontell 1995; Calavita, et al. 1997; Black 2005b). In the 1990s, the economic landscape was further roiled by striking changes in business organization, regulation, models, and status systems and in the interest positions and roles of business professionals (DiMaggio 2001; Fligstein 2001; Preda 2005; Powell 2005). Most basic was a transformation in corporate organization from self-contained hierarchies to assorted network arrangements. This “network economy” with its vague organizational boundaries and novel types of coordination presents “dilemmas” for corporate governance. The “valuation of companies increasingly must take into account the worth of assets held outside the firm” while “the acute flexibility that facilitates adaptiveness and innovation” may make “accountability” problematic (DiMaggio 2001: 226-228).

Researchers also reported that the governance system was being altered by larger institutional and cultural trends--namely, deregulation and the rise of new business doctrines. So-called “New Economy” doctrine, as promulgated by the financial media, business schools, and business professionals, encouraged a break with the “old rules” for business development and investing. Espousing a narrative about the rise of a new kind of firm, they advised would-be New Economy enterprises to become a “first-mover” who could command a new market niche, especially, in the telecom, dot-com and energy trading sectors. To this end, enterprises should “line up a chain of high status business intermediaries to help the firm gain credibility” as an innovator that was achieving high growth rates (i.e., revenue increases). That would “boost the

share price so that the stock could be used as a currency”, enabling firms “to acquire talent, capital, and other firms at less cost, fueling a spiral of growth, that, in turn, would reinforce the stock’s standing” (Tillman and Indergaard 2005: 17-18). A final aim in raising stock prices was to make options an enticing form of compensation for executives--one that supposedly aligned their interests with those of shareholders.

At the same time, deregulation was leading corporate governance to increasingly rely on monitoring by business intermediaries--banks, accountants, financial analysts, rating services and lawyers. Consequently, the corporate governance system itself has taken the form of networks--of “reputational intermediaries” (Gourevich 2002; Tillman and Indergaard 2005).

With changes in regulation, increased competition for traditional revenue streams, and the emergence of new revenue opportunities interest positions also shifted for business professionals such as analysts at large investment banks and accountants at large accounting firms. Analysts found themselves drawn to be part of the investment banking team while consulting became more lucrative than audits for accounting firms (Hallett 2003). While 13 percent of revenue for Big Five accounting firms came from consulting in 1981, by 1999 the figure was 50 percent. Change in organizational cultures was reinforced by corporate expectations that service providers maintain collaborative relationships with clients. Thus, “the basis for an accounting firm’s reputation” began to shift “from guardian of professional and legal rules to a creative collaborator of corporations” (Tillman and Indergaard 2005: 205). Many business professionals used their strategic positioning in governance networks to become “carriers” of New Economy doctrines and specific models--for example, “swapping” models that accounting firms provided to telecom firms.

In sum, accounts of a new network economy have critical implications concerning the relational dynamics among senior managers, outside auditors, and other control agents. Senior management expect that middle managers will cooperate with central office agendas even as they delegate more responsibilities to them; managers at all levels are enjoined to develop collaborative relationships with their counterparts in other firms that are customers, suppliers or some other kind of partner; and business professionals (e.g., accountants, financial analysts) who now are relied on to monitor firms, encounter pressures and incentives to develop collaborative relations with the same firms. It follows that a key analytic task is to determine the circumstances in which collaboration turns into “collusion” in fraudulent financial reporting.

Grounded Typologies

The data from the Small-N Sample provides striking evidence of the importance of relational dynamics in the organizational contexts of financial statement fraud. By virtue of positions that leave others dependent on them for information executives at both the middle and senior management levels had the ability to override controls even when acting alone. More noteworthy was the fact that they rarely were alone. In a majority of cases they colluded with other senior managers; moreover, in twelve of our seventeen cases CEOs were involved (Table 17).

Table 17. Number of Corrupt Senior Managers by Position and Firm

| <u>Corrupt Senior Managers</u> | | | | | | | | | |
|--------------------------------|---------|-----|-----|-----------|---------|------------|----|-----------|-------|
| Firm | General | | | | | | | | Total |
| | CEO | CFO | COO | President | Counsel | Controller | VP | Treasurer | |
| Aniko | 1 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 2 |
| Broad Vision | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 1 |
| Cyber Guard | 1 | 2 | 1 | 0 | 0 | 1 | 0 | 0 | 5 |
| First Merchants | 1 | 1 | 0 | 0 | 0 | 0 | 1 | 0 | 3 |
| Genesco | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Guilford Mills | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Homestore | 1 | 1 | 1 | 0 | 0 | 0 | 2 | 0 | 5 |
| Hybrid Networks | 1 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 2 |
| IBP | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Medaphis | 1 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 3 |
| NexPub | 1 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 2 |
| Paracelsus | 1 | 1 | 0 | 0 | 0 | 1 | 1 | 0 | 4 |
| Transcrypt Int'l | 1 | 0 | 0 | 0 | 0 | 0 | 1 | 1 | 3 |
| US Lime & Mineral | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 1 |
| US Wireless | 1 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 2 |
| Warnaco | 1 | 1 | 0 | 0 | 1 | 0 | 0 | 0 | 3 |
| Waste Mgt. | 2 | 1 | 0 | 0 | 1 | 1 | 1 | 0 | 6 |

We will see evidence that these clusters of senior managers had the effect of normalizing corruption: in these firms there was little consistent resistance to corruption from either senior managers or outside auditors. Relational dynamics mattered much more than size of a firm--a classical organizational variable. Across firms of different sizes we see: the frequent involvement of CEOs in fraud, the formation of corrupt managerial cliques, inadequate internal controls, and the ability to deceive outside auditors. Size of firm was of decisive significance in one respect--the infrequent, but devastating instances (two cases) when the lure of keeping a large corporate client undermined the resistance of accounting firms and drew them into collusion. Focusing on organizational circumstances that shaped interactions among senior managers, other internal control agents, and external auditors we developed typologies of fraud, senior management response, and outside auditor response. In important respects, types of fraud and types of control agent responses mutually influence each other.

Types of Fraud

We discerned three types of financial fraud in the cases studies: 1) isolated, 2) senior management cliques, and 3) boundary-crossing (Table 18). In *isolated* frauds (six cases), one to two senior managers collude in executing simple embezzlements or one senior manager tries to manipulate financial results. In only one of these cases was a CEO implicated and no CFOs were involved. The cases of US Lime and Mineral and US Wireless illustrate simple embezzlements. At the former, an Executive VP (who also served as treasurer and controller) embezzled \$2.2 million over a four-year period by forging signatures on checks (see US Lime and Mineral narrative); at the latter the former CEO and former General Counsel conducted a fraudulent scheme in which they transferred stock worth \$3.2 million and cash totaling \$428,000

to several offshore entities that they secretly owned and controlled (see US Wireless narrative). Broad Vision is an example of manipulation of financial results by a lone senior manager. Here an Executive VP used a deception to try to book revenue from software licenses that the outside auditor said could not be booked because the sales agreement bundled the licenses with services (which can only be recognized as performed); she sent three phony order changes to the finance department purporting that the customer had agreed to pay separately for the services. Then she tried to cover up her fraud by falsifying emails from the customer and forging a signature (see Broad Vision narrative). Isolated frauds illustrate the ability of lone senior managers to use positioning to deceive those who lack direct access to the specific information gained at the position. At the same time, without peer collusion, manipulation of financial results is more likely to be revealed quickly (e.g., the Broad Vision case).

Table 18. Firms by Type of Fraud.

| Isolated | Senior Management Clique | Boundary-Crossing |
|--------------------|--------------------------|-------------------|
| Broad Vision | Anika Therapeutics | CyberGuard |
| Genesco | NexPub | First Merchants |
| Guilford Mills | Paracelsus | Homestore.com |
| IBP | Transcript International | Hybrid Networks |
| US Lime & Minerals | Warnaco | Medaphis |
| US Wireless | Waste Management | |

In *frauds by senior management cliques* (six cases), a number of managers (usually 3 or more) colluded in manipulating financial results. In contrast to isolated frauds, CEOs and CFOs were heavily implicated here; the former in all six cases and the latter in four: the collective mustering of information advantages and institutional levers by these cliques can greatly extend the scope and duration of fraud--and neutralize or corrupt other internal control agents and external auditors who find it difficult to fend off pressure delayed emanating from multiple directions. Within the sphere of influence of the corrupt power clique, corruption itself can become normalized. For example, after outside auditors uncovered flaws in the inventory control system at Warnaco in 1996 the firm's CEO, CFO and General Counsel, colluded to fend off the auditors and internal staff--and delay public admissions of the true problem--until midway through 2000. Along the way they made false and misleading statements about losses which amounted to \$145 million. In the case of *boundary-crossing fraud* (five cases), senior managers were able to use their collective information advantages and institutional levers to draw in middle-level managers (from divisions, subsidiaries, or other subunits) and/or managers from other firms (e.g., customers).¹⁹ In some respects, this type of fraud is an extension of the corrupt senior clique type: CEOs and CFOs again were heavily involved--CEOs in all five cases and CFOs in four. And there were indications that corruption also became normalized--the novel aspect being that its effect extended across boundaries.

This can be seen in the case of Homestore.com, where a clique of corrupt senior managers enlisted many collaborators from middle management and from other firms. After its auditor stated that the firm could no longer recognize revenue from swaps of ad space, Homestore's VP of Business Development enlisted the CEO, the COO, and CFO to back a scheme where the firm engaged in "round-trip" transactions involving more than two parties in

order to disguise swaps and deceive the auditor. The CFO handled transactions so as to hide them from his staff and had his personal assistant do collections; he also instructed employees to only use private firms as vendors so as to attract less scrutiny; vendors were asked to sue separate entities as a conduit to conduct purchases of advertising from AOL (Homestore's regular partner in roundtrips); the CFO lied to the auditor; and the VP of Transactions ordered a subordinate to "scrub" websites that contained evidence of ties between the vendor and conduit entities, backdated documents and also lied to the auditor. Ultimately, over a dozen Homestore managers and seven officers at other firms were implicated (see Homestore.com narrative).

Types of Senior Manager Responses

We identified three types of senior management responses to financial reporting fraud: 1) resistance; 2) inconsistent resistance; and 3) no resistance (Table 19). We deemed a case to be one of *resistance* when senior managers were consistent in their resistance. There were only four cases, all of which occurred in response to *isolated* frauds (which says much about the power of collective corruption). The Broad Vision case provides an illustration. After the VP sent phony change orders, Broad Vision's Finance Department asked lower level staff for help in gaining documentation as no new purchase orders arrived. The Finance Department then asked the VP to get the purchase orders from the customer; to cover her deception, the VP told other employees that the customer had cancelled both the original and changed orders--which led the auditor to press her for documentation (see Broad Vision narrative). *Inconsistent resistance* (four cases) occurred when a senior manager, at some point, expressed objections to dubious courses of action, but later went along with demands or enticements of other senior managers. These four cases occurred in more organized frauds (two were senior manager cliques, two were boundary-

crossing). The Homestore case provides a vivid example: When the VP of Business Development informed the CFO that the firm should use round-trips on a continuing basis, the CFO replied that “it was his team that had to look PwC in the eye and lie” and he could not do it much longer. However, as we documented above, the CFO later played multiple active roles in hiding transactions (see Homestore narrative).

Table 19. Firms by Types of Senior Management Resistance

| Resistance | Inconsistent Resistance | No Resistance |
|----------------|-------------------------|-------------------|
| Broad Vision | Homestore | Aniko |
| Genesco | Medaphis | CyberGuard |
| Guilford Mills | NexPub | First Merchants |
| US Wireless | Warnaco | Hybrid Networks |
| | | IBP |
| | | Paracelsus |
| | | Transcrypt Int’l |
| | | US Lime & Mineral |
| | | Waste Management |

Finally, in nine cases there was “no resistance” by senior managers: four of these involved senior management cliques while three were boundary-crossing frauds.

Types of Outside Auditor Responses

Focusing on how external auditors responded to efforts to override controls, we identified four types of external auditor responses: 1) no resistance; 2) resistance, 3) inconsistent resistance/collusion; and 4) consistent collusion (Table 20).

Table 20. Firms by Type of External Auditor Response.

| No Auditor Collusion in Fraud | | Auditor Collusion in Fraud | |
|-------------------------------|-----------------|-----------------------------------|----------------------|
| Resistance | No Resistance | Inconsistent Resistance/Collusion | Consistent Collusion |
| Broad Vision | CyberGuard | Warnaco | Anika |
| Homestore | First Merchants | Waste Management | |
| Transcrypt | Genesco | | |
| US Lime & Minerals | Guilford Mills | | |
| | Hybrid Networks | | |
| | IBP | | |
| | Medaphis | | |
| | NexPub | | |
| | Paracelsus | | |
| | US Wireless | | |

The most common response, seen in 10 cases, was *no resistance*. In five of these cases the auditors were deceived by their clients. We found only four cases of *resistance*. Interestingly, two of these came in response to isolated frauds--the type of fraud that also drew resistance from senior managers. At Broad Vision, for example, the auditor was diligent *vis a vis*

a lone corrupt VP. After the VP created phony change orders to get around the auditor's opinion, and then lied that the customer had cancelled the order, the auditor asked for written proof. She responded by forwarding an internal email which the auditor rejected since it did not originate with the customer. The VP then submitted an email which she claimed came from the customer; the auditor rejected the email as too vague. The VP then obtained a blank fax coversheet on the customer's letterhead on which she wrote up a forced cancellation notice and forged a signature. The auditor finally accepted this (and the VP soon left Broad Vision). There were two cases of *inconsistent resistance/collusion*. Although rather rare, it was catastrophic in its consequences--both for the firms and the auditors. In these cases, auditing firms resisted attempts at overrides, but eventually gave in, which meant signing off on financial statements that they knew were inaccurate. Both of these cases came in response to frauds by senior manager cliques at large corporations.

The misfortunes of Warnaco's outside auditor--PricewaterhouseCoopers (PwC)--are instructive. This is all the more so as PwC had deemed Warnaco to be a risky client early on: its management tried to achieve aggressive and unrealistic forecasts; was dominated by a small group; had excessive interest in maximizing the company stock price through "unreal, aggressive accounting; and had excessive interest in delaying the recognition of losses". Although PwC was diligent in pointing out unacceptable actions by Warnaco, the accounting firm's continued backpedaling in the face of senior management intransigence, left it on a slippery slope. In its 1996 audit, PwC discovered the flawed inventory system in a Warnaco division and PwC consultants subsequently uncovered at least \$66 million in inventory overstatements. After the division staff reported that the overstatement might be as high as \$83 million, PwC recommended that the adjustment be amortized over several years; Warnaco rejected this. In

July 1998 a new PwC audit partner informed Warnaco board members of the potential overstatement. Warnaco's CEO complained to PwC that the matter had not been raised with management prior to the meeting; PwC then recalled the partner and assigned a new audit team to the account. In November 1998 the CFO asked PwC if it could write off the inventory restatement as part of "restructuring costs"; PwC said no. The CFO and CEO then claimed the overstatement must be due to "start-up costs". PwC responded that it would have to observe another inventory count. In February 1999, PwC determined that the inventory overstatement--now \$159 million--could not be restated as start-up costs. Warnaco's CFO and CEO rejected PwC's opinion. The CFO submitted a schedule attributing the overstatement to start-up costs. PwC then informed the CFO and CEO that it "would not certify financial statements" that attributed the entire overstatement to start-up costs. On March 1, 1999, the CEO gave PwC a draft of a press release that attributed the inventory error to start-ups costs; PwC replied that it was inaccurate and inconsistent. The next day Warnaco issued the press release unchanged. One month later Warnaco issued its annual report, restating results for fiscal 1996-98, reducing inventory by \$145 million which it attributed to start-up costs. PwC issued an audit report with an unqualified opinion which offered no objection to Warnaco's mischaracterizations of the inventory overstatement as start-ups costs. Warnaco and PwC did not reveal the truth until May 2000 (see Warnaco narrative). The final type of auditor response, *consistent collusion*, only occurred in one case: an Arthur Andersen partner engaged in improper professional conduct by colluding with efforts at improper revenue recognition by the CEO and CFO at Anika Therapeutics.

The Relationship between Types of Fraud and Control Responses

One of the leads we took from economic sociology concerning the relational dynamics of financial statement fraud was that we should try to determine the circumstances in which collaboration turns into collusion. Organizational size, a classic factor in the past, turned out to be a circumstance that did not matter much: fraud and ineffective responses by inside and external control agents were common across the range of firm sizes. A good starting point to identify circumstances that do matter is to examine the differences between types of fraud. Table 21 displays the firms in the Small-N Sample categorized by the three types of fraud presented above and by the number of corrupt senior managers (with CEOs and CFOs broken out and the other positions collapsed into a single category).

Table 21. Firms by Senior Manager Corruption and Fraud Type.

| | Corrupt Senior Management | | | |
|---------------------------|---------------------------|-----|-----------------------|-----------------------|
| | CEO | CFO | Other Senior Managers | Total Senior Managers |
| <i>Isolated Fraud</i> | | | | |
| Broad Vision | 0 | 0 | 1 | 1 |
| Genesco | 0 | 0 | 0 | 0 |
| Guilford Mills | 0 | 0 | 0 | 0 |
| IBP | 0 | 0 | 0 | 0 |
| US Lime & Mineral | 0 | 0 | 1 | 1 |
| US Wireless | 1 | 0 | 1 | 2 |
| <i>Senior Mgt Cliques</i> | | | | |
| Ankia | 1 | 1 | 0 | 2 |
| NexPub | 1 | 0 | 1 | 2 |

| | | | | |
|---------------------|---|---|---|---|
| Paracelsus | 1 | 1 | 2 | 4 |
| Transcrypt Int'l | 1 | 0 | 2 | 3 |
| Warnaco | 1 | 1 | 1 | 3 |
| Waste Mgt | 2 | 1 | 3 | 6 |

Boundary-Crossing

| | | | | |
|--------------------|---|---|---|---|
| CyberGuard | 1 | 2 | 2 | 5 |
| First Merchants | 1 | 1 | 1 | 3 |
| Homestore | 1 | 1 | 3 | 5 |
| Hybrid Networks | 1 | 0 | 1 | 2 |
| Medaphis | 1 | 2 | 0 | 3 |

The most striking difference came with regard to the numbers and rank of those involved in “isolated” frauds on the one hand compared to “senior management cliques” and “boundary-crossing” frauds on the other hand. Only one CEO and no CFOs were involved in isolated frauds while CEOs were implicated in every one of the other cases and CFOs were involved in most. Thus, we see the number one circumstance in which collaboration turns into collusion in fraud is when the CEO is corrupt: in such cases there is usually a corrupt cluster in management (within and/or across firms).

Case Narratives and Selected Illustrations of Fraud

This section provides narratives outlining basic facts in each case in our Small-N Sample. In three cases, extended analyses are provided to illustrate each type of financial fraud.

Anika Therapeutics Narrative

On March 15, 2000, Anika Therapeutics, a firm in the medical products and devices industry, announced it was restating its financial results for 1998 and the first three quarters of 1999 due to improper revenue recognition of “bill-and-hold” sales (sales where the seller remains in

possession of the goods until a later delivery date). On October 30, 2000, investors filed a class action alleging that the CEO (chairman, president) and CFO had signed materially false and misleading financial statements.

On January 13, 2003, the SEC filed a complaint alleging that the CEO and CFO had caused the firm to violate reporting and internal accounting control requirements through: 1) improperly recognizing \$1.5 million in bill-and-hold sales, 2) failing to make adequate disclosures in filings, and 3) making false statements in press releases. On January 13, 2003 the SEC filed a complaint alleging that the Arthur Andersen partner had engaged in improper professional conduct, causing Anika to improperly recognize revenue and to make an improper restatement. In sum, evidence exists that the CEO and CFO actively colluded in fraud and that the outside auditor actively colluded as well.

Broad Vision Narrative.

On April 1, 2002, Broad Vision, a firm in the software industry, announced it was restating its financial results for the third quarter of 2001 due to improper revenue recognition amounting to \$3.5 million for sales of bundled software and engineering services. On January 6, 2006, the SEC filed a complaint alleging that a former Executive VP 1) made untrue statements to the firm's internal accountants and outside auditors, 2) circumvented internal accounting controls, and 3) falsified and forged documents provided to outside auditors causing Broad Vision to improperly recognize revenue in its financial statement. The evidence was that the VP acted alone.

*****Extended Analysis*****

Broad Vision exemplifies a case of isolated fraud which both internal controls and the external auditor were diligent in resisting. The fact that the corrupt manager was a lone wolf seems to contribute to the fact that the control agents proceeded in a diligent fashion. This resistance, along with the lack of accomplices, helped limit the fraud to one quarter and appeared to cause the corrupt senior manager to leave her position when detection was imminent. Still, this best case scenario is somewhat sobering as the perpetrator was able to deceive the controls for a time despite the latter's diligence.

The case begins with a December 29, 2000 sales agreement wherein Broad Vision was to provide a \$4 million package of software licenses and annual maintenance over a four year period to a customer. The deal was negotiated by a Broad Vision Executive VP who was also General Manager of Worldwide Products and Services.

Broad Vision's external auditor--Arthur Andersen--ruled that neither the revenue from the licenses or the services could be recognized for the first quarter of 2001. Although license revenue can normally be recognized upon delivery while service revenue can only be recognized as performed, the deal bundled the two together. In response to Andersen's adverse opinion, the Ex VP devised a scheme to have the license revenue booked: she send three phony change

orders to the finance department in which the customer purportedly agreed to pay an extra \$3.55 million for Broad Vision engineering and additional consulting services.

When purchase orders failed to arrive, the finance department asked lower level staff for help in obtaining the necessary documentation. When that did not work, the finance department asked the Ex VP to get the purchase orders from the customer. To cover her tracks, the Ex VP told other employees that the customer had cancelled both the original services order as well as the changed order.

Andersen asked the Ex VP for written proof that the order had been cancelled. She responded by forwarding an internal e-mail that she had purportedly written in which she remarked that the customer had cancelled the order due to budget issues.

Andersen rejected the e-mail since it did not originate with the customer. The Ex VP then submitted a copy of an e-mail which she claimed came from the customer's employee.

Andersen rejected the e-mail as too vague. She then procured a blank fax coversheet on the customer's letterhead on which she wrote up a formal cancellation notice and forged a signature.

Andersen accepted this. Shortly thereafter, the Ex VP left Broad Vision.

The fraud was revealed in January 2002 when the customer asked for an invoice for the 2002 service work. The finance department found that Broad Vision employees had actually delivered services to the customer--and that the orders had never been cancelled. Broad Vision's outside counsel and Andersen conducted an investigation and concluded that all of the license revenue should not have been recognized for the third quarter of 2001, forcing the \$3.5 million restatement.

CyberGuard Narrative

On August 24, 1998, CyberGuard, a commercial network security products firm, announced it was restating its financial results for the fiscal year ending March 31, 1998. On July 21, 1999 it announced further restatements of results for the fiscal year ending June 30, 1997 and for the first three quarters of the fiscal year ending June 30, 1998 due to improper write-off of software capitalization costs and improper revenue recognition of contingent sales. The restatements reduced revenue for FY 1997 by \$1.4 million and for the first three quarters of FY 1998 by some \$2.1 million. On August 25, 1998, investors filed a class action alleging that CyberGuard, its former CEO/Chairman, its former CFO, its CFO, its COO, and its external auditor, knowingly or recklessly published materially false and misleading financial statements, causing an artificial inflation of the stock price. On January 30, 2002, the SEC filed a complaint alleging CyberGuard's former CEO/Chairman, former CFO and former Controller 1) knowingly falsified the books, records, and accounts and 2) knowingly circumvented or failed to implement adequate internal controls. The SEC also ordered the current CFO and COO to cease and

desist from violations of reporting and internal controls requirements. In order to make revenue targets, CyberGuard senior managers, accounting staff, and shipping staff as well as employees of customers, colluded in making side agreements with resellers for contingent sales and in keeping deceptive documents. In sum, the evidence is that five different senior managers and other staff at CyberGuard colluded with customers in committing fraud.

First Merchants Acceptance Corp. Narrative

On April 16, 1997, First Merchants Acceptance Corp., a firm in the auto finance industry, announced that it was restating financial results for 1996 due to improper accounting for delinquent and non-performing loans. On April 18, 1997 investors filed a class action suit alleging that the CEO, a VP, four other parties, and Deloitte and Touche provided materially false and misleading financial statements and press releases, causing the artificial inflation of the stock price. On September 27, 1999, the SEC filed a complaint alleging that the CEO and VP engaged in a scheme to mislead auditors and to make delinquent and uncontrollable accounts appear current and directed two lower-level staffers to alter payment and balance information on the accounts: consequently, the firm understated its allowance for credit losses by \$43.4 million (or 252%) and overstated its net income by \$76.7 million (or 729%) . The SEC also alleged that the firm's CFO discovered the scheme and instead of reporting it, took action to further the scheme and prevent its detection. The SEC's formal complaint alleges the CEO, VP, and CFO 1) caused First Merchants to make untrue statements of material fact, 2) falsified books, records, or accounts, and 3) knowingly failed to implement a system of internal accounting controls. In sum, evidence exists that the CEO, VP, CFO and two lower-level staffers colluded in fraud.

Genesco Narrative

On December 18, 2001, Genesco, a footwear and accessories firm, announced it was restating financial results for FY 2001 and the fourth quarter due to improper revenue recognition of \$2.8 million in sales in advance of customer's requested shipping date. On December 17, 2003, the SEC filed a complaint alleging that in order to meet sales targets for the fourth quarter of 2001, the president of a Genesco division directed three other mid-level managers to do "whatever is necessary" to ensure that the sales target was met. In the course of booking revenue from contingent sales, the managers 1) participated in a fraudulent scheme, 2) aided and abetted Genesco in violating requirements for reporting and internal controls, 3) they knowingly circumvented internal accounting controls or failed to implement systems of internal controls, and 4) falsified and caused to be falsified Genesco's books, records, and accounts. In sum, the evidence is that these four middle managers colluded in committing fraud.

Guilford Mills Narrative

On November 24, 1998, Guilford mills, a manufacturer of knits and knit lace fabric, announced it was restating its financial results for the first three quarters of its fiscal year ending in September 28, 1998 due to accounting irregularities at its Hofmann Laces subsidiary which resulted in the overstating of operating income for the first, second, and third quarters by \$2,675,000, \$3,625,000, and \$2,725,000, respectively. On October 29, 1998, investors filed a class action alleging that Guilford's CFO/Exec VP and the General Manager of Hofmann Laces had caused the stock price to be artificially inflated by improperly understating the costs of goods and account payable and through corresponding overstatements of operating income. On July 24, 2000, the SEC filed a complaint alleging that Hofmann Laces' Controller had made false entries that materially understated accounts payable and materially overstated earnings for Hofmann Laces, which, in turn, caused Guilford's consolidated operating results to be materially overstated in financial statements. The SEC found that the Hofmann Laces' Controller violated internal controls and record-keeping requirements and that Guilford has failed to implement and maintain adequate internal controls following its January 1996 acquisition of Hofmann Laces, which allowed the false entries by the Controller to go undetected. The evidence is that the controller acted alone.

Homestore Narrative

On December 21, 2001, Homestore, an Internet provider of residential real estate listings and related content, announced it was restating its financial results due to improper revenue recognition of \$1.5 million for the third quarter of 2000 and \$119 million for the first three quarters of 2001 achieved through "roundtrip" transactions. On December 28, 2001, investors filed a class action alleging that the CEO/Chairman, Executive VP, COO, and CFO engaged in a scheme to deceive the investing public, inflate and maintain share prices and cause investors to purchase the shares at inflated process. In the course of this scheme, the above senior managers allegedly made materially false and misleading representations in financial statements. By 2005, the amended class action extended the allegations of participation to thirteen firms and selected officers who participated in Homestore roundtrips as well as Homestore's outside auditor, alleged to have violated its professional responsibilities in audits. Starting on September 24, 2002, the SEC filed multiple complaints against a total of 14 senior and mid-level managers from Homestore as well as senior managers of other firms who participated in the roundtrips. The September 24, 2002 complaint alleges that that Homestore's COO, CFO/VP of Finance and a mid-level manager engaged in a fraudulent scheme that inflated Homestore's revenues through orchestrating roundtrip transactions wherein Homestore paid inflated sums to various vendors of products and services, and, in turn, the vendors used these funds to buy ads from two media companies, which, in turn, purchased ads from Homestore--completing a circular flow of money in which Homestore, in essence, recognized its own money as revenue. On April 27, 2005, the SEC filed a complaint alleging that Homestore's former CEO/Chairman, and former VP of Business Development: 1) engaged in a fraudulent transaction, 2) made false and misleading financial statement; 3) failed to comply with requirements on keeping books, records, and

accounts, 4) circumvented or failed to implement a system of internal controls, and 5) made false statements to auditors. In sum, the evidence is that there was collusion of Homestore's senior and mid-level managers with senior managers of other firms to commit fraud.

*****Extended Analysis*****

The Homestore.com case illustrates a boundary-crossing fraud where there was extensive collusion among not only its senior and middle managers, but also with senior managers of customers who participated in “roundtrip” transactions. The SEC charged over a dozen Homestore managers and 7 officers at other firms for participating in the scheme. Homestore’s external auditor--PricewaterhouseCoopers (PwC)--was diligent in resisting overrides, but its efforts were rather ineffective due to extensive organized efforts to deceive it. As a result, the fraud grew in scope and endured for some time.

Homestore had been engaging in “swaps” wherein it traded advertising space with other media firms in exchange for ad space of an equal value; the main aim was to book revenue. In early 2001, shortly after new accounting rules were implemented to restrict such practices, PwC informed Homestore’s finance department that it lacked the documentation to show that revenue generated from swaps was legitimate; the finance department reluctantly agreed not to recognize revenue from challenged transactions. However, PwC’s increased scrutiny and conservative opinion prompted Homestore’s VP of Business Development to develop a scheme to engage in “round-trip” transactions involving more than two parties in order to disguise swaps and mislead PwC.

To ensure that the finance department did not know the nature of the transactions, the VP negotiated and executed the first round-trip in. As the market for online ads began to slide in late 2000, he advised the CEO and CFO that round-trips should be used as a continuing revenue source. This brought him into tension with both the CFO and the finance department. In July, 2001, the CFO told the VP that “it was his team that had to look PwC in the eye and lie” and he could not do it much longer. To deceive finance and his own staff, the VP handled many of the deals personally and had his personal assistant handle collection issues instead of finance staff. When PwC questioned large transactions coming at the end of quarters, he had orders backdated.

Despite his resistance, the CFO joined the COO and VP of Transactions in carrying out and concealing the scheme. The CFO instructed Homestore employees to use as vendors only privately-held entities, hoping to attract less attention. He also told them to ask the vendors to use separate entities as a conduit to conduct purchases of advertising from AOL--Homestore’s regular partner in round-trips. And he made false representations to PwC that there were no side agreements or special revenue arrangements and withheld documents from the auditors. The VP of Transactions instructed a subordinate to “scrub” particular websites to remove evidence of relationships between the vendor and conduit entity. He also helped backdate documents and also made false representations to PwC--as did senior managers at other firms which participated in the swaps.

Hybrid Networks Narrative

On May 18, 1998, Hybrid Networks, a manufacturer of broadband access equipment, announced it would postpone filing its quarterly statement due to accounting issues. On June 18, 1998, Hybrid announced that its outside auditor was withdrawing certification for financial statements for FY 1997 and the first three quarters of 1997; subsequently, Hybrid's restatement reduced 1997 revenue by \$10.2 million and increased its net loss by \$8 million due to improper recognition of revenue from contingent and fictitious sales. On July 10, 1998, investors filed a class action alleging that Hybrid's CEO, CFO, founder/ director, two audit committee members, two other directors, and two underwriters had participated in: 1) the making of false and misleading statements in an IPO registration, 2) failed to perform due diligence for the IPO, and 3) had failed to disclose materially adverse information and made misleading statements. A consolidated class action added allegations that the outside auditor had been negligent in its role in materially false and misleading statements causing the stock price to be artificially inflated. On June 29, 2000, the SEC filed a complaint alleging that Hybrid's former CEO had failed to implement sufficient internal controls and that its former VP of sales and former regional sales director had made materially false financial statements. It also alleged that the former Executive VP of a customer had been a cause of the fraud by misleading Hybrid's senior managers and auditor. Revenue had been improperly booked for shipments customers had a right to return, on shipments "parked" with third parties until customers were ready to purchase them, and shipment of products customers did not order or that did not function. In sum, senior and middle managers colluded with customers in committing fraud.

IBP Narrative

On November 8, 2000, IBP, a meat producer, restated its results for the fourth quarter of 1999 and the first three quarters of 2000 due to improper treatment of expenses at DFG, a subsidiary that caused it to overstate its earnings. On February, 12, 2001, investors filed a class action alleging that the CEO/Chairman and CFO artificially inflated stock prices by issuing misleading public statements about IBP's earnings and revenue in its financial statements and press releases, including its belated disclosure that the SEC had sent it a letter on December 29, 2000 identifying 45 instances of improper accounting in financial reports filed by the company; also, IBP announced it would take a \$47 million charge against its 2000 earnings. On July, 29, 2004, the SEC filed a complaint alleging that DFG's former president, its former CFO (in 1999), its former Controller, and its former CFO (2000)--motivated by personal compensation tied to financial performance-- engaged in accounting improprieties that inflated DFP's earning. In the course of doing so, they: 1) failed to implement or circumvented internal controls or falsified books, records, and accounts, 2) aided and abetted IBP in making false financial statements, and 3) in failing to keep accurate books, records, and accounts. The evidence is that subsidiary officers colluded in fraud.

Medaphis Corporation Narrative

On October 22, 1996, Medaphis Corporation, a supplier of business management services that later changed its name to Per-Se Technologies, announced it was restating its financial results for FY 1995 and the last quarter of that year due to improper revenue recognition of \$3.5 million for a service fee to be paid after the reporting period ended; it later also restated results for 1996 for improper treatment of costs and reserves. On November 26, 1996, investors filed a class action alleging that the Medaphis CEO/ Chairman, CFO and former CFO misrepresented or omitted material factors on the company's business condition, causing its stock to be artificially inflated. On November 16, 2000, the SEC filed a complaint alleging that Per-Se Technologies, formerly known as Medaphis Corporation, engaged in improper actions in recognition revenue based on contingent fees, reducing expenses, creating unjustified reserves, and failing to record losses. Thus, the firm violated requirements regarding: 1) representations of material facts, 2) keeping accurate books, records, and accounts, and 3) devising and maintaining a system of internal accounting controls. Given that the CEO, CFO and previous CFO all resigned, there is evidence of collusion between senior management and accounting staff at a subsidiary.

NexPub Narrative

On June 15, 2000, PrintontheNet.com, an Internet firm later known as NexPub, filed a restatement of financial results for the nine month period ending September 30, 1999 due to improper statement of net income of \$96,000 when in fact there was a net loss of \$245,000. This restatement came in the wake of the resignation of the President, CEO, and board members. On November 1, 2000, it filed a second restatement for the same period, revealing that the net loss was actually \$430,101 and disclosed that in a merger completed with PrintAmerica in January 2000, PrintontheNet had assumed loan guarantees for debt that had gone into default. On October 18, 2001, the SEC filed a complaint against the firm for 1) disseminating a memorandum to investors that contained false and misleading statements, 2) filing a financial statement that contained false and misleading information, and 3) for failing to maintain books, records, and accounts, and failing to maintain a sufficient system of internal accounting controls. Thus, the evidence indicates that the President, CEO, and Board members colluded in fraud.

Paracelsus Healthcare Narrative

On October 9, 1996, Paracelsus, a healthcare company, announced it would restate its financial results for the quarters ending December 31, 1995, March 31, 1996, and June 30, 1996 due to improper use of reserves and improper recognition of expenses; it reported that the amount to be restated would be determined at the end of an internal inquiry. In August, 1996 Paracelsus had used stock to acquire Champion Healthcare Corporation and held two related stock offerings. On

October 11, 1996, investors filed the first of numerous class actions against Paracelsus. The federal consolidated complaint alleged that the Chairman, CEO, and CFO of Paracelsus and former CEO and former CFO of Champion, three underwriters and outside an auditor, participated in disseminating materially misleading statements and omitted disclosing material facts about the company's reserves and expenses which resulted in the stock price being artificially inflate. In addition, they failed to make a reasonable investigation concerning the truthfulness of various financial statements and registrations for stock offerings. On June 20, 2001, the SEC filed a complaint alleging that under the direction of the former CEO of Paracelsus, the former VP of financial operations, former CFO, and former controller had engaged in various earnings management schemes, causing Paracelsus to overstate its annual and quarterly earning in periodic reports and registration statements; the scheme accumulated and improperly used \$16 million in "cookie jar" reserves to conceal a decline in earnings, failed to write off \$15 million in uncollectible accounts receivable, and supplied auditors with false and misleading information. In sum, the evidence is that four senior Paracelsus managers colluded in committing fraud.

Transcript International Narrative

On March 27, 1998, Transcript International, a manufacturer of information security products, announced that it might have to restate financial results for 1997 due to revenue recognition issues. On April 13, 1998, investors filed a class action alleging that the former CEO/Chairman, CEO/director, VP of Sales, VP of Operations, and VP of Engineering, who had sold off large amounts of stock, had participated in a fraudulent scheme in which they 1) made false and misleading statements, 2) filed materially false financial reports, 3) failed to implement and maintain adequate internal controls, and 4) engaged in insider trading. On January 4, 2001, the SEC filed a complaint alleging that Transcript officers had overridden revenue-recognition decisions made by its internal accountants, resulting in inappropriate recognition of revenue and materially misstated financial results in the fourth quarter of 1996, 1996 year end, and second, third, and fourth quarters of 1997 and year end, a 1997 registration, and press releases. This constituted, 1) false and misleading statements, 2) false books, and 3) deficient internal controls. On February 5, 2001, the SEC filed a complaint alleging that Transcript's former CEO and its former Treasurer improperly recognized revenue and failed to respond to "red flags" signaling improper accounting (including concerns expressed from the accounting department) and that they sold stock in a 1997 secondary offering under a registration statement which included false financial information. It also alleged that the two, along with the former VP of Sales, misrepresented or omitted important information in communications with auditors and internal accountants. Thus they 1) engaged in fraud, and 2) violated record-keeping requirements. The evidence is that three senior managers colluded in committing fraud.

U.S. Lime and Minerals Narrative

On January 29, 2002, United States Lime and Minerals, a manufacturer of lime and limestone products, announced it would restate its financial results for 2001 due to embezzlement and fraud by its former financial VP (who also served as treasurer, corporate controller, and secretary) who had resigned earlier in the day. On October 29, 2002, the SEC filed a complaint alleging that the former financial VP had, in the course of embezzling \$2.2 million over a four-year period by forging signatures on checks, committed financial fraud and violated a number of other securities laws: 1) circumventing internal controls, 2) falsifying books and records, 3) lying to auditors, and 4) violating periodic reporting and records requirements. The SEC found that he acted alone.

U.S. Wireless Narrative

On May 26, 2001, US Wireless, a content provider for wireless carriers and Internet providers, announced it probably would have to restate financial results due to embezzlement by its former CEO/Chairman and former General Counsel in the form of undisclosed related party transactions for which the firm received nothing in return. In July, 2001, it restated financial results for fiscal 2000 that increased its annual net loss from \$11.4 million to \$17.7 million. On July 11, 2001, investors filed a class action alleging that US Wireless and its former CEO/Chairman engaged in a fraudulent scheme that inflated share prices through false and misleading statements, including nondisclosures of related party transactions. On July 14, 2003, the SEC filed a complaint alleging that the former CEO/Chairman and former General Counsel had engaged in a fraudulent scheme to transfer stock worth \$3.2 million and cash totaling \$428,000 to several offshore entities that they secretly owned and controlled. In the process, they 1) engaged in fraudulent transfers, 2) caused US Wireless to keep false internal records and make materially false and misleading statements in its 1998, 1999, and 2000 annual and periodic reports, 3) and made false statements to auditors. The evidence is that the two senior managers engaged in collusion.

Warnaco Group Narrative

On July 31, 2002, Warnaco, an apparel manufacturer, restated financial results for the years 1999, 2000, and 2001 reducing net income and increasing net losses by a total of \$51 million because of accounting problems at several subsidiaries. This followed an April 2001 restatement of financial results for 1998, 1999, and 2000 that reduced shareholder equity by \$26 million--and the filing of an amended 10-k form and amended audit opinion revealing that flaws in inventory control had been the real reason for an April 1999 restatement of \$145 million for 1996, 1997, and 1998 that were originally attributed to "start-up related costs." On April 20, 2001, investors filed a class action alleging that the CEO, CFO, general counsel, and recently retained outside auditor had failed to divulge charges related to reserves, operation shortfalls, restructuring, changing inventory, and a restatement for prior years. On May 10 and 11, the

SEC filed a series of complaints alleging that the former CEO, former CFO, and former General Counsel of Warnaco had 1) made false and misleading statements in financial statements, including the false explanation for the April 1999 restatement, and had 2) aided and abetted the firm's violation of requirements concerning the maintaining of books, records, and accounts and 3) the maintaining of internal controls. The SEC charged the outsider auditor with aiding and abetting violation of reporting provisions. The evidence is that the CEO, CFO, former general counsel and outside auditor colluded in fraud.

*****Extended Analysis*****

Warnaco illustrates a case of fraud orchestrated by a senior management clique abetted by the inconsistent resistance by its auditor--PricewaterhouseCoopers (PwC). We see the extraordinary pressure that a small group of high-ranking senior executives can exert on a resistant auditor, which it eventually is able to draw in as a participant. It also illustrates how the collusion of senior management and an outside auditor can result in a prolonged fraud and the incapacitation of the accounting system: consequently, the period 1996 to 2002 witnessed a parade of restatements at Warnaco .

One notable aspect of this case, is that from early on, PwC knew that Warnaco was a very risky client. In early 1995, PwC identified Warnaco as employing "aggressive" accounting practices. Its 1998 assessment of audit risk assessed the risk of Warnaco engaging in fraudulent accounting as "5" on a 6 point scale where "6" represented the highest level. This was due to 1) management practice of committing to analysts and seeking to achieve unduly aggressive and unrealistic forecasts, 2) domination of management by a single person or small group, and 3) management's excessive interest in maximizing the company stock price through "unreal, aggressive accounting", and 4) management's "excessive interest in delaying the recognition of losses."

Early PwC diligence in performing its duties at Warnaco provided little hint that it would descend into fraud. In hindsight, it seems that minor concessions to Warnaco management lead PwC to a slippery slope. In its 1996 audit, PwC identified serious flaws in the internal controls at a Warnaco unit--the Intimate Apparel Division (IAD)--especially in the area of inventory cost accounting. In late 1997, Warnaco followed PwC's suggestion that it hire PwC consultants to review, update, and correct the IAD cost system. The consultants found that the inventory cost system was severely outdated and inadequate given the size of operations; they told Warnaco management and the PwC auditing team that inventory accounts had been overstated by at least \$66 million. However, no immediate adjustment was made to the inventory accounts.

IAD staff, working with PwC, confirmed the consultant's finding in June 1998 and informed Warnaco management that the overstatement might be as high as \$83 million. PwC recommended that the adjustment be amortized over a period of years; when Warnaco rejected this, PwC acceded to its decision.

In July 1998, the PwC engagement partner retired; in an August 1998 meeting, his successor informed the Warnaco audit committee and other board members of the potential overstatement. Warnaco's CEO expressed displeasure to PwC that the matter had not been raised with

management prior to the meeting; PwC recalled the engagement partner and assigned a new audit team. Though the audit team would resist a series of dubious management moves, this incident may have signaled that if Warnaco pushed hard enough, PwC would back down. And, that is what happened.

In March 1998, the IAD controller advised the CFO that flaws in the unit's cost accounting system had caused overstatements of inventory. The CFO dismissed the controller's findings and did not investigate further or inform PwC of the findings.

In November 1998, the CFO informed PwC of a discrepancy at IAD and asked if Warnaco could write off an inventory restatement as part of restructuring costs; the PwC audit team said no. Citing a recently-introduced accounting rule, the CFO and CEO then asserted to PwC that the overstatement must be due to "start-up costs" that had been erroneously capitalized and recorded as inventory.

PwC responded that given the magnitude of the inventory discrepancy, it could not rely on Warnaco's books or records to determine the correct value of the IAD inventory. It required Warnaco to complete another physical inventory observed by a PwC auditor.

In February 1999, PwC identified the same flaws in the IAD cost accounting system previously reported by the IAD controller. It determined that Warnaco's inventory was overstated by \$159 million and that this could not be restated as due to start-up costs.

The Warnaco CFO and CEO rejected PwC's opinion. After two days of meeting with PwC, the CFO provided a schedule attributing the entire overstatement to start-up costs.

PwC rejected the schedule, replying that at most only \$14 million of the overstatement could be written off as start-up costs. The remaining inventory overstatement of \$145 million could not. PwC informed the CFO and CEO that it "would not certify financial statements" that attributed the entire overstatement to start-up costs.

The next day, PwC informed the Warnaco Board of its conclusions and said the firm would have to file a restatement; the Board voted to file a restatement.

On March 1, 1999, the CEO gave PwC a draft of a press release announcing "record" earnings for 1998 and falsely attributing the inventory error to start-up costs; it also did not mention that Warnaco would be writing down its inventory by \$145 million.

The PwC engagement partner advised the CEO that the press release was inaccurate and inconsistent with the way financial statements would be presented in the upcoming 1998 annual report. Warnaco issued the press release, substantially unchanged, the next day.

On April 1, 1999, Warnaco's annual report for FY 1998 restated results for fiscal 1996-1998, reducing inventory and increasing cost of goods sold by \$145 million; it attributed the restatement to start-up costs.

Despite its repeated rejections of the start-up costs rationale, PwC issued an audit report with an unqualified opinion in which it offered no objection to Warnaco's mischaracterization of the inventory overstatement as start-up related costs. PwC also incorporated the misleading description of the restatement into its own audit report.

In May 16, 2000 Warnaco corrected the misleading disclosure with an amended 1998 form 10-k while PwC filed an amended auditor's report disclosing that the real reason for the 1998 restatement was inventory accounting problems. The SEC then ruled that PwC had "willfully aided and abetted" Warnaco's violation of requirements regarding accurate financial reporting and disclosures. It censured PwC and fined it \$2.4 million.

Waste Management Narrative

In February 1998, Waste Management, a provider of solid and hazardous waste services, energy recovery services, and environmental technologies and services, announced it was restating its financial statements for the five-year period 1992 through 1996 and the first three quarters of 1997. The company admitted that through 1996, it had materially overstated its reported pre-tax earnings by \$1.43 billion and that it had understated its tax expense by \$178 million. On June 19, 2001, the SEC settled a complaint alleging that Waste Management's outside auditor and three of its partners violated antifraud provisions of securities law and that a practice director had engaged in improper professional conduct in the course of auditing Waste Management's financial statements. Specifically, the SEC argued that: 1) the 1993-96 audit reports were materially false and misleading, 2) the 1993-96 financial statements had been presented as conforming with GAAP, 3) the 1993-96 audits were not performed in accordance with GAAS, and 4) the auditing firm, through its partners, had engaged in improper professional conduct. On March 26, 2002, the SEC filed a complaint alleging that Waste Management's CEO/Chairman, COO-former CEO/director, CFO, Controller, General Counsel/Secretary and VP of Finance had orchestrated and implemented a scheme to enrich themselves and keep their jobs through falsifying and misrepresenting financial results, manipulating financial result to meet predetermined earnings targets through deferring current period expenses to inflate earnings. In the course of this scheme they violated and aided and abetted violations of 1) antifraud, 2) reporting, and 3) record-keeping provisions. The evidence is that these six senior managers colluded with multiple members of the outside auditing firm in committing fraud.

VI. Conclusions and Policy Recommendations

Many of our findings are consistent with those of other studies: financial statement fraud, in its various forms, takes place at large number of firms; deceptive reporting was more common at New Economy firms than at Non-New Economy firms; and these frauds result in many billions of dollars in losses to investors. At the same time, our study brought to light aspects of financial statement fraud that previous studies have missed.

One of the main themes that emerged from our data was the extent to which networks of organizations and individuals were involved in many instances of financial statement fraud. Among our key findings was that for the firms in our sample accused of fraud, the average number of defendants/respondents was 7.2. Another important finding was that among all organizational defendants and respondents named in class action law suits or in actions taken by the SEC, over half were companies other than the restating firm; many of these were accounting firms and banks. These findings support the criminological perspective on control frauds which argues for the importance of understanding the ways in which network forms of organizations contribute to complex corporate frauds.

In our case studies, however, we found that the relationship between senior managers at restating firms and their auditors was not easily captured with a simple collusion-or-no-collusion characterization. Rather, an important dimension in these relationships was the extent to which external auditors resisted efforts by senior managers to engage in fraudulent financial reporting and whether that resistance was consistent or inconsistent.

The results of our study also have implications both for academic theories of corporate behavior and for policies aimed at controlling that behavior. At several points in the above

discussion we referred to theories of “reputational penalty” that predict that control agents-- directors and auditors--are unlikely to cooperate with senior managers in their efforts to deceive shareholders because to do so would tarnish their reputations and lead to a decline in their value in the marketplace for their services. While certainly many control agents are deterred by this threat, our data show that many others are not. The fact that allegations of fraud against two out of five of the firms in our sample named external auditors as participants in those frauds is evidence that this form of control failed to operate as predicted by the “reputational penalty” theory. Why this is so is a complicated question whose answer lies beyond the scope of this report. But one persuasive argument focuses on the shift in recent years in the organization of large accounting firms from general partnerships to limited liability partnerships. According to Macy and Sale, when accounting firms were organized as general partnerships, partners were “jointly and severally liable for the professional negligence and malfeasance of their partners,” but the limited liability form “protects the partners from personal liability.” As a consequence, “partners have significantly lower (and perhaps negative) incentives to monitor their peers” (Macy and Sale 2003: 1170).

The possibility that financial statement fraud is widespread calls into question a fundamental assumption about the way that equity markets function: that those markets are essentially “efficient.” According to Fama, a capital market is efficient when “prices provide accurate signals for resource allocation; that is, a market in which firms can make product-investment decisions, and investors can choose among securities that represent ownership of firms’ activities that security prices at any time ‘fully reflect’ all available information” (1970: 383). After reviewing the literature, Fama concluded: “the evidence in support of the efficient markets model is extensive and ... contradictory evidence is sparse” (1970: 416). Our research

adds to the “contradictory evidence.” If a significant number of firms are intentionally distorting these “signals” by falsifying their financial statements then the validity of the “efficient market model” is seriously undermined and this article of faith among many economists may deserve rethinking.

Policy Recommendations

The results of our study can inform policy discussions in several specific areas. In response to the devastating scandals at Enron, WorldCom and other corporations, in 2002 Congress passed the Sarbanes-Oxley Act which placed new requirements on public corporations, their executives and their auditors, holding them more accountable. Almost immediately after its passage, there emerged a counter-movement of individuals and organizations that argued that Sarbanes-Oxley had gone too far and its provisions were seriously handicapping American businesses. Recently, there has been a resurgence of criticism of the law as well as other legal mechanisms designed to curb corrupt business practices, coming from both the business community and regulatory agencies.

Critics have argued that the provisions of Sarbanes-Oxley that require CEOs and CFOs to certify annual and quarterly report and provide criminal penalties for those who violate the requirement, are unnecessary and can criminalize what may amount to honest mistakes by senior executives or hold them responsible for the errors of others. Second, there have been recent calls to limit the liability of accounting firms in securities fraud suits. Two recent reports that received wide publicity, one from the Committee on Capital Markets Regulation and another sponsored by the City of New York and U.S. Senator Charles Schumer, stressed the need to protect the Big-Four accounting firms from “catastrophic liability” and recommended legislative

and policy changes that would place caps on the judgments against auditing firms in securities fraud cases (Committee on Capital Markets 2006: 14; City of New York 2007: 102). Consistent with this argument, the Chief Accountant at the SEC recently called for measures that would shield auditors from legal liability in securities fraud cases involving their clients (Taub 2007). In a similar vein, the Committee on Capital Markets Regulation recommended that the SEC permit companies to indemnify outside directors against out-of-pocket losses in securities fraud litigation (Committee on Capital Markets 2006: 73).

Finally, a number of critics, including many of those referred to above, have argued that U.S. capital markets are becoming less competitive because of the costs of “excessive litigation” and have called for measures to rein in shareholder lawsuits. The SEC has recently joined this movement. In a brief filed in a case before the U.S. Supreme Court, the SEC argued for a higher pleading standard in securities fraud cases, stating that the law should require evidence of a “high likelihood” that defendants acted with the intent to violate the law (Labaton 2007). If accepted, this standard would make it more difficult for shareholders to file securities fraud lawsuits.

The recommendations from this report run counter to these arguments and urge continued oversight of the financial reporting process and the maintenance of policies that require accountability on the part of senior managers, board members and auditors. Specifically, our recommendations include the following.

- Our findings show that CEOs and CFOs were named as participants in the great majority of fraud allegations. Therefore, the requirement that CEOs and CFOs certify reports to shareholders, as mandated by the Sarbanes-Oxley Act, should be maintained.

- This report has shown that many instance of suspected financial statement fraud were never acted upon by the SEC. Of the 374 firms in the fraud sample, less than half (44%) were the subject of formal actions by the SEC. Even with the possibility of “frivolous” lawsuits, class action securities fraud suits remain a vital mechanism for detecting and remedying financial statement fraud. Therefore, we would argue against efforts that would make it more difficult for shareholders to file these suits.
- Our analysis found that in a significant proportion (21%) of cases of alleged financial statement fraud, external auditors were named as participants. In addition, where auditors were named, investors losses were over twice as high as they were in cases where auditors were not named. Given their significant involvement, we would deem as unwise measures designed to limit the liability of auditing firms.
- Similarly, our data show that at two-fifths of the firms where financial statement fraud allegedly took place, one or more members of the board of directors was named as a participant in the fraudulent activities. This finding suggests that attempts to reduce corporate board members’ liability would not be consistent with the goals of deterrence.

Measuring the Impact of Reform

In sum, our recommendations focus on maintaining the reform measures implemented by the Sarbanes-Oxley Act as well as resisting efforts to change the legal environment surrounding class action securities law suits. The events captured by our data largely ended prior to the passage of the Act and comparisons with more recent data suggest that the reform measures have had a positive impact. A recent update by the GAO of its restatement study to include restatement announcements in the period 2002 - 2005 found that the number of restatements

announced annually had increased significantly over the previous period (GAO 2006). On the other hand, average declines in market capitalization following restatement announcements were significantly smaller (2%) among these firms than they were among firms in the earlier study (10%) (GAO 2006: 23). At the same time measures of accounting fraud have shown declines. The number of securities fraud class action suits filed in 2006 (114) represented a 58% decline from the number filed in 2002 (Securities Class Action ClearingHouse 2007). In 2005, the number of actions taken by the SEC for financial fraud and issuer reporting issues had declined by 9% from a peak of 199 in 2003 (GAO 2006: 43). As mentioned above, more specific measures of change indicate the potential positive impacts of reform measures. Among class action securities fraud lawsuits filed in 2005, only 5 auditors were named, suggesting that auditors may have become more vigilant since the implementation of Sarbanes-Oxley.

A methodology for evaluating the impact of these reform measures of financial statement fraud could involve taking the sample of firms in the GAO study that announced restatements in the period 2002 – 2005 and determining what proportion were accused of fraud in class action law suits or by the SEC, and whether or not that proportion has been decreasing. Among those allegations of fraud, how many named control agents--auditors and board members? Is the trend towards fewer auditors and board members being named as participants in these frauds? Finally, given GAO's finding that investor losses following restatement announcements were smaller than in the earlier period, one could examine trends in changes in the impact of restatement announcements on market capitalization among the sub-sample of firms accused of fraud since Sarbanes-Oxley to determine if the perceived (by investors) scope of the frauds had decreased.

Notes

¹ The GAO derived the 16 percent figure by taking the total number of firms that announced restatements in the period and then dividing by the average number of firms listed on the three major exchanges at the beginning of the year. The actual proportion is probably lower for two reasons. First, firms are added and dropped from the exchanges during any year, meaning that the total number of firms listed during the entire period was higher than the number listed at the beginning of any year. Second, some of the firms filing restatements and counted by GAO were not listed on the three major exchanges but on the OTC Bulletin Board and the Pink Sheets.

(General Accountability Office 2006)

² One exception to this pattern is found in an excellent analysis by Kedia and Phillipon (2006) of the impact of accounting fraud on employment at the firms where the frauds took place.

³ Fannie Mae provides a good example of how organizations are able to manipulate the “rules of the game.” In their report on corrupt practices at the entity, investigators at Fannie Mae’s regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), stated: “Senior management expected to be able to write the rules that applied to Fannie Mae and to thwart efforts to regulate the Enterprise...Writing their own rules included deciding when to comply with GAAP, engaging in and concealing earnings management, and failing to cooperate with and trying to interfere with OFHEO’s special examination.” (Office of Federal Housing Enterprise Oversight 2006: 3)

⁴ An often-cited article expressing this view is Alexander (1991).

⁵ The Class Action data base often contains numerous lawsuits for each company in the data base. We decided to code the suit designated there as the “Reference Complaint.” These suits often consolidated other suits and were the most comprehensive in scope. On the Securities Fraud website, Joseph Grundfest describes the data base as follows:

“A record in our database is a case that identifies a defendant or defendants that are being sued in Federal Court by shareholders (plaintiff) of the same issuer, or issuers, for the first time in violation of Federal Securities Laws. In other words, if two or more securities class action complaints against the same defendant, or defendants, have the same underlying allegations, there is only one record in our database. Accordingly, when a case arises out of the same subject matter as one of the actions first filed and is brought by shareholders of the same issuer, or issuers, it is hereafter part of that record.

In addition, a record (case) in our database generally describes only one complaint of all the filings against the same defendant. As a general rule, we select the first complaint we have identified. If multiple complaints are filed at one time, we choose the complaint that appeared to contain the most detailed allegations. However, if we locate the amended and/or consolidated complaint, we update the case summary and other information as needed.” (Grundfest 2004)

⁶ The specific NAICS codes used to designate New Economy firms are as follows.

Energy Production and Distribution

221—Utilities

Computer/Information/Information Industries

334—Computer and Electronic Product Manufacturing

5112—Software Publishers

516—Internet Publishing and Broadcasting

518—Internet Service Providers, WebSearch Portals,
and Data Processing Services

5415—Computer systems Design and Related
Services

Telecommunications

517

⁷ A recent study of stock option manipulation by Bebchuck, Grinstein, and Peyer, however, found that, 80% of the “manipulated” stock options they analyzed were awarded by “old economy” firms, leading the authors to conclude that “grant manipulation was not a ‘new economy phenomenon,’ and that most grant manipulation took place in the old economy firms, which constitute most of publicly traded firms.” Yet, when they analyzed the incidence of stock manipulation *within* New Economy and *within* Old Economy firms in their sample, they found “the incidence of manipulation is somewhat smaller among old economy firms than among new economy firms...” (2006, 26-28).

⁸ This technique is frequently referred to as an “event study” --“a statistical technique designed to determine whether a particular piece of new information had an impact on the price of a stock and, if so, the amount of that impact.”(Fischer 2005: 872)

⁹ In their review of such measures, Moriarty and Livingston conclude: “...the three day window seemed more likely to present the effect of the restatement with as little accompanying noise as possible.” (Moriarty and Livingston 2001)

¹⁰ More specifically, share prices were measured on the last trading day before the restatement announcement and the first trading day after the announcement. So, if the announcement was made on a Monday, the day-before price was taken on the preceding Friday. If the announcement was made on a Friday and the following Monday was a holiday, the day-after share price was taken on the following Tuesday.

¹¹ The GAO reached similar conclusions in its analysis (General Accounting Office 2002a: 78)

¹² For a more detailed discussion of “round-trip” trades see Tillman and Indergaard (2005).

¹³ Berenson provides an excellent cautionary note on interpreting these figures:

“When numbers like \$14 billion for Cendant or \$80 bill for Enron or \$150 for WorldCom are tossed around, take them with more than a grain of salt. In one way they are real. Cendant had 900 million shares outstanding, and each of those shares lost more than \$15 in value on April 16, 1998. It’s therefore true that Cendant’s shareholders suffered a paper loss of \$14 billion as the company’s stock fell, but the key phrase is *paper loss* (emphasis in original). Cendant’s investors, as a group, could never have cashed out all their shares for \$30 billion even before the fraud was admitted. If they had tried, Cendant’s stock would have fallen sharply, and they would not have received \$30 billion...In the years prior to the fraud, most of Cendant investors were buying and selling shares from each other. Many of those investors bought at a price lower than the \$35 a share at which Cendant traded before it disclosed the fraud. Yes, they suffered paper losses when the stock fell, but those were offset in part by their previous paper gains...I don’t mean to say that paper loss figures are totally irrelevant. They are the simplest way to compare the scope of losses at different companies.” (Berenson 2002: 121-122)

¹⁴ There is a fairly large literature within the law and economics field on estimating “damages” from securities fraud. Classic articles on the topic include: Easterbrook and Fischel (1985) and

Fischel (1982). For a particularly clear discussion of the logic behind strategies for determining shareholder losses based on changes in share price see Alexander (1994).

¹⁵ In their well-known study of sentencing of white-collar defendants Wheeler, et al. (1982) developed a composite measure of complexity, one component of which was the number of participants in the offense.

¹⁶ Many of these investment banks became part of a massive consolidated class action suit against 309 high-tech firms that alleged that the banks were instrumental in IPO-related schemes to defraud investors (Tillman and Indergaard 2005: 167-168).

¹⁷ We believe that the vast majority of the individuals whose titles could not be determined came from outside the restating company.

¹⁸ However, it is possible that in some cases a board member was described in a class action suit or SEC action as a board member and no other title was mentioned, even though he/she was also an officer at the restating company.

¹⁹ In deeming division or subsidiary executives to be “mid-level” management, we follow the convention used in the SEC study of accounting enforcement releases (SEC 2003).

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