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Corporate Positions and Punishment for Corporate Accounting Fraud

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CORPORATE POSITIONS AND PUNISHMENT FOR CORPORATE ACCOUNTING FRAUD

by

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The accounting industry has changed in many ways during the last few years. These changes have come at many different levels and have had different effects on those in the accounting industry and those without. The biggest change has been the litigation and government involvement in the industry. Changes have been made because of the fraud committed by those in the accounting industry. This has led to the government making laws to restrict those in the industry, making fraud harder to commit. The laws that the government has made have made it very expensive and hard for those in the industry to comply. Many companies have needed to hire more accountants. This leads to an increased need for accountants and could lead to a shortage in qualified accountants. This then would lead to those not qualified in accounting doing accounting work. This would also lead to more litigation and court filings and more laws that limit companies on their ability to complete the required work. It thus becomes a vicious cycle.

There are many factors that have influenced changes in the accounting industry. The biggest changes have come because of the loss of faith from the community in general, concerning the reliability of accounting practices given. The reason that the loss of faith has come is because of fraud within the industry. One reason fraud is committed is to present a rosy picture to the public of a company so that stock will sell. But when someone in the company commits fraud, and it is exposed, it does the opposite.

"A varnished corporate governance model does not actually reflect its business competitiveness, nor can a brilliant financial statement predict the corporate prospects. When decision-makers are confronted with a speculative or risky investment environment, business operators may adopt risk-aversion strategies by policy analysis tools. In recent years, there have been many financial distresses taking place in listed companies. Apart from corporate governance failures, many corporate owners are suspected of embezzling from the corporate assets by 'creative accounting' practices (Schilit, 2001), which not only leads to corporate financial distress but also acutely fluctuates the securities market and affects investors' equities."[i]

Fraud may take place by several different methods. It may also come from many different sources. To help combat the problem of accounting fraud, there have been many different steps taken. The first step has been that the government has imposed conditions and rules on the accounting industry. The second step is that they have changed the consequences for those who have violated these rules. The first step includes the set up of the Sarbanes-Oxley act. Before this act became law, the government did not have much control over the accounting industry. They began to exert more control by setting up the SEC that has the ability to decide the rules about which accounting methods are acceptable and the punishments involved for breaking the rules. The industry previously had a group that would take care of this themselves.

The second step to combat accounting fraud is the punishment and enforcement of the laws regarding accounting. They are meant to discourage people from completing the fraud. The risks would be greater than the gain. The problem with this idea working is that the gain can be so big in accounting fraud that it is hard to find a punishment that would counter that. Another difficulty with enforcement of the laws is that there are so many different types of fraud that could be committed, it is difficult for investigators to be able to find the fraud committed.

There are correlations between the type of fraud committed and the position that the person holds in the company. There is also a correlation between the position of the person committing the fraud and what the punishment is. The reason that this correlation exists is that the position a person holds in the company makes a difference in the activities that a person is involved in. The activities enable a person to create various types of fraud. The type of fraud committed has a direct affect on the type of punishment that a person receives.

The information that is being considered is the litigation releases from the SEC. The type of fraud has been categorized into sections of financial statement fraud, forgery, false advertising, employee theft, financial disclosure violation, reckless conduct, improper conduct, money laundering, racketeering, compliance, securities fraud, falsifying records, disclosure, insider trading, accounting fraud, misrepresentation, illicit payments, and wire fraud. The cases are taken from the SEC website and include AAER release number 719 to 2288. These cases have been classified into sections by the type of fraud committed, the people that were involved in the committing the fraud and the punishment that they are subjected to. These cases are found with other information of the release date, the number assigned, the company, ticker symbol, exchange, and a description of the type of fraud.

The Sarbanes-Oxley Act has had a large effect on the accounting field and the changes that have been made to its regulation. This act was put into place in March of 2003. It has made some major changes in accounting. The first change is that the government now has authority over the restrictions and regulations for the industry. The way this is possible is that the Act set up the SEC, which has the authority to regulate the type of information that is required of companies. The SEC also has the authority to punish those that do not abide by the laws. This paper uses the resolutions and pronouncements that the SEC made against various individuals.

The next change that occurred with the SEC is that the restrictions are more stringent on what specifically has to happen when certain acts of fraud are committed. Before this law took effect, people that committed fraud were not restricted from continuing their practice of accounting in a different company. Some say that these rules are too strong and are hard to follow. "Finkenbrink, 44, said he has heard of several financial executives who have resigned in the wake of Sarbanes-Oxley. Most well-known locally is Bob Merritt, who resigned as CFO of Outback Steakhouse Inc. a year ago largely because of discontent over the new regulations."[ii]

The type of fraud committed can be so varied that it is difficult to be able to classify the information into groups. Within each of the classifications that are being used there are many different sub-classifications. For instance, within the section of financial statement fraud, there can be over or under statement of assets or liabilities or improper classification on the statement of information. But in this paper, the differences and variability in accounting fraud classifications will not be a problem because there are also many similarities.

The information includes the name of the position of the people that participated in committing the fraud. There are some positions that are common and can be compared in a similar manner such as the president of the company, the CEO, the CFO, the accountant, and the internal and external auditors. There are many other positions that are listed in the worksheet but they are not used for this research, as they cannot be compared from company to company. An example is the brother-in-law of the CEO. Within the worksheet there is only one person with this position and it makes a comparison difficult.

The SEC has not completed all of the pronouncements on who is guilty for the fraud and what the punishment should be. This makes our information incomplete by the fact that some of the spaces are left blank without any type of judgment on the subject. The number of pronouncements that have been made can help us make comparisons and create theories about future pronouncements. But the clarification should be made that the information could change and therefore change the theory. The SEC could also have different members in the future that will make different judgments on punishments. The government may change the rules in the Sarbanes-Oxley Act to change what is required of the SEC and what they demand of the people that have committed the crime.

Within the information that we are looking at, there are 1137 records. The records do not exclusively have one type of fraud and one position. Of those records, 69 % of those records contain financial statement fraud, 17.5% are accounting fraud, 11% are disclosure problems, 5% are financial disclosure violation, 11% are falsifying records, 12% of the records are improper conduct, 15% of the records are for misrepresentation, and the rest are under 5%. When describing the positions of the people involved in the fraud, 30% are CEOs, 35% are CFO, 18% are controllers 8% are COOs, 8% are EVPs, 24% are presidents, 29% are VPs, and the rest of the positions are under 5%.

Within these numbers the greatest types of fraud committed is financial statement fraud and accounting fraud. Those are the two sections that the Sarbanes-Oxley Act influenced the most. The Act makes the leaders of the company sign off on the financial statements saying that they know what is stated in the financial statements and that the statements are true. This has made it possible for the government and the SEC to be able to hold the leaders of the company responsible for mistakes in the statements. Seventy-nine percent of the accountants that have committed fraud have made financial statement fraud. Ninety-two percent of the CEOs involved participated in financial statement fraud. This is because the CEOs now are involved with the financial statements and cannot say that they were not involved. Looking from the other way, 28% of th3e people that participated in financial statement fraud were CEOs. Thirty- four percent of the financial statement fraud was from the position of president. When looking at this information, it can be assumed that the reason that these individuals are involved in the fraud of financial statements is because they now have to be responsible for the statements. If anyone was trying to commit that type of fraud they now would need the leaders, such as the president and CEO, to be involved so that the president or CEO would not expose the fraud before the financial statements were published.

A different side of accounting fraud is committed by those that are suppose to validate the information that companies are putting forth in their statements and on their books. This is the job of the auditors. When looking at the fraud committed by auditors, 49.5% of it is improper conduct. When looking at improper conduct, auditors committed 40%. This relationship exists because improper conduct is what auditors can do wrong. Auditors do not create financial statements and so they do not have as much opportunity to create that statement fraud. They do not create books and therefore do not commit accounting fraud as much. Improper and reckless conduct make up most of what they can do wrong because of the fact that they did not look at information or the financial statements and not see a problem or that a fraud had been committed.

There is a correlation between the major types of fraud researched and the reasons for the types of fraud committed. The reason why the presidents, CEOs, and CFOs usually commit financial statement fraud is because that is the section of the business that they deal with the most and they are required to sign off on these documents. Auditors usually have improper or reckless conduct because their job is to search out the information given to them and validate it to make sure the information is correct. The type of punishment related to the position a person has in the company and what type of fraud they committed has the same type of correlation. When a person has committed a certain crime they get the same punishment as others that committed the same crime.

When a person commits corporate accounting fraud the seriousness or size of the fraud is related to the position in the company.

Thirty-nine percent of the cases with financial statement fraud have received a verdict. Fifty-eight percent of those with a verdict have a decision of the commission to make them cease what they were doing. Thirty-eight percent of those with a verdict received a punishment for their deeds. This means that 84% of those that have been caught committing financial statement fraud have not had a verdict on their case or received a verdict to stop what they had been doing in the past.

Only 19% of the cases where financial statement fraud has been committed and the president is involved had any decision at all. Within that 19%, only 3 cases had any type of punishment. Of the 19%, 64% were orders to cease the illegal activities. This is not much of a judgment because they should have ceased doing illegal actions before they were caught. This indicates that presidents of companies that commit financial statement fraud have a very small chance of receiving punishment if they are caught.

One of the difficulties with punishing presidents of companies is that the SEC does not have the authority to put them in jail. Another difficulty is that a person does not need a certain certificate or degree to be a president and therefore the Council cannot take away the misbehaving person's license, as they can with accountants and attorneys. This means that for a president to be punished they must be brought before the law. This is the only way to punish presidents and it is very costly for everyone, including the government. One reason that financial statement fraud is punished less than other types of fraud is because there are so many cases and so many things that people can do to commit fraud, that all examples can't be punished. An example is a small misstatement of the value of an old piece of equipment. However, this type of fraud should be punished to show that financial statement fraud is not acceptable. The problem with trying to punish those individuals involved is that there is no small punishment they could be given to keep them in line and not have a lawsuit. People involved such as those that sign off on the financial statements such as the president, CEO, and CFO; may not understand the statements very well, and some people are reluctant to prosecute them for questionable motives.

Twelve percent of the cases of financial statement fraud involving a CEO had decisions. Eighty percent of the financial statement fraud cases were given a decision to cease the illegal activity. Only 2 of 125 cases were received punishment. This shows that when those with position of CEO commit fraud and are caught most likely do not to be punished for their actions.

Thirty-three percent of the financial statement fraud cases that involved a CFO had a decision. Fifty percent of those that have a decision were a decision to cease the illegal activity. The other 50% decisions were those of punishments. The position of CFO needs special skills to complete the activities required of the position. Those skills go along with receiving a CPA license. Since a person needs a license to have the position, the SEC could take away the license. This shows that there could be a higher amount of decisions with punishments that the other positions within the financial statement fraud.

Sixty-eight percent of the cases involving accounting fraud had a judgment, 39% of those judgments were for the person or company to cease illegal acts. Forty-one percent of those judgments involved punishment, with the most common punishment to be that of denying the person the opportunity to practice as an accountant or lawyer. In these judgments of being denied the opportunity to continue in the profession where the person had just committed fraud, there is an opportunity to apply in 3 years to be reinstated and be able to continue the career in which they had broken the law. This is dangerous because they will be in the same situation they were in before and they will have the opportunity to commit fraud again.

Seventy percent of the cases involving auditors had decisions against them. One of the reasons that this number could be so high is the fact that auditors are suppose to validate the information given by companies to help the public be sure that the company is giving correct information. If those checking the information to ensure honesty commit fraud, then the only ones to investigate or find the fraud is the SEC. There are so many companies, statements, and ways to commit fraud that the SEC cannot find all the fraud cases. In the case of the auditors, they are needed to ensure valid information and therefore if they commit fraud or fail to find fraud committed then they are punished faster to help the public has faith that the other auditors are correctly checking other company's statements. Seventy-two percent of the cases involving auditors that had a decision had a punishment involved. This reason for this high percentage could be the same as the reason that so many cases had a decision, because auditors have more rigid regulations and associated punishments. Another reason that so many cases had a punishment is that auditors have more specific rules and regulations concerning what they are suppose to look for and find in regard to the financial statements. The SEC has more authority over the specific regulations over auditors because their job directly correlates to the area that the SEC governs.

The changes in the accounting industry have come because of fraud within the industry. These changes have come because of the laws passed by the government. The SEC was created to set regulations in the industry and punish those that break those regulations. The position a person holds in a company relates to the type of fraud committed. The type of fraud committed relates to the punishment received. Therefore the position a person holds in a company relates to the punishment.

Twenty-seven percent of all CFO cases had a decision. Fifty-three percent of those cases that had a decision were a cease illegal activity decisions. This is higher than those CFO decisions that relate to the financial statement fraud and CFOs. This shows that the type of fraud is not as important as making decisions. The reason that a greater amount of decisions are not punishments could be that the position of CFO is that most of the cases with CFOs involved also have other positions. The cases with multiple people and decisions are not easily placed with a decision because it is harder to find out who is guilty and how much everyone has a part of the illegal activities.

Twelve percent of the CEO cases had a decision. Seventy-four percent of those cases that had a decision were to cease illegal activity. The reason that the cases with CEOs have a low rate of decisions made could be because there are so many different ways a CEO commit fraud and therefore each case needs to be looked at in detail to understand what has happened. The reason that this is different from the CFO cases is that the CFO has more responsibility over the financial statements. Another way that the CFO and CEO cases are different is that the percent that had a punishment was higher with the CFO. This is again because there is more accounting duties for the CFO and therefore the SEC can regulate the accounting information in a better manner.

Eighteen percent of the president cases had a decision. Seventy-six percent of those cases had a decision of cease illegal activity. The cases involving presidents have the lowest percentage of decisions. This could be because the president is the position that has the smallest requirement on the amount of accounting skill and license. The number of cases that have a decision to cease is also greater than the CEO and CFO because the SEC has fewer types of punishment that they can use to discipline presidents.

Thirty-five percent of the auditor cases had a decision. Sixty-two percent of the cases with decisions had a punishment. The cases involving auditors has the greatest number of cases with a decision. This is because their field has become more stringent in the activities that the auditor must do and what they cannot do. The SEC has made laws that require the auditors to find fraud with certain procedures. The number of cases that have punishment is also the highest in the group. This is caused by the same reason that the SEC has more authority to regulate the auditor and more methods of punishing auditors for committing fraud.

This shows that the job or position in a company correlates to the likelihood of punishment. The reason that this happens is because the position in the company relates to the nature of the work that you do. The nature of the work that a person completes associates with the type of fraud that is committed. The type of fraud that is committed then relates to the amount of punishment that you receive. By the information found we can see that the SEC is most worried about fraud committed by auditors that would lead to financial statements being verified and still incorrect. This is one of the biggest problems that could happen because the verified information would state to the public that the information is correct when it is not. When auditors do their job correctly, a person inside the company can commit fraud but the auditor will find it and the public will know that the information is wrong.

The reason that there is a difference in the cases for CFOs, CEOs, and presidents is because of the responsibility that each position has regarding the financial statements and the relation to the company. The CFO has the largest responsibility to financial information. This means that the CFO should be a final check on the financial statements to keep them accurate. This is why the cases involving CFOs have more decisions. It is easier to look at the financial statements and state whether they are misrepresented than to look at the type of accounting used in a certain aspect and state whether that was the correct method used. The CEO and president are involved in the financial statements by making decisions that are strategic. An example is how the president and CEO could be involved in deciding what the proper value of some inventory is but not involved as much with the day-to-day accounting that the CFO is in charge of.

The reason that there is a difference in the type of fraud committed and the decisions made are because so of the fraud is easier to find and prove. This makes it easier to make a decision. Another reason that there is a difference between the amounts of decisions that had been made in each type of fraud is because of the time taken to commit the fraud. An example is the difference between financial statement fraud and accounting fraud. With financial statement fraud, there are certain requirements that the financial statements must meet to not valid. When creating these statements the fraud is usually committed in an instance or a spot period such as changing the inventory balance. Accounting fraud usually happens over a period of time such as the changing an amount of a journal entry made daily to account for cash. Another reason that there is a difference between the amounts of decisions that had been made in each type of fraud is the types of fraud that can be committed in each category. The different types of improper behavior that could be judged can be greater than the type of accounting fraud committed.

This paper has shown that there are correlations between the type of fraud committed and the position that a person holds in a company, the type of fraud committed and the punishment received, and the position a person holds in a company and the punishment received. This exists because of the relationship between the deeds a person completes with their job and the title. The activity a person completes correlates to the type of fraud that the person is able to commit. The type of fraud you commit is related to the ability to catch and punish the fraud. The SEC is punishing more auditors because they have more rigid rules. This also leads to stricter punishments. The financial statement fraud is different per title because of the amount of responsibility the job has with the financial statements and how much accounting education is required for the position. The CFO has the most responsibility and has more punishments and decisions than the CEO and the president. This will lead to more discovering and reporting of fraud within the industry because the auditors and CFOs will be motivated to not commit fraud because they are more likely to be punished. This would mean that the president and CEO could not commit the fraud because they need the CFO and auditors to validate their information. This leds to the SEC having more time to focus on other problems that are arising in the industry and how to solve problems before they start.

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[i] Information Asymmetry, Creative Accountings And Moral Choice: An Apocalypse Of Procomp Informatics Ltd. Dr. Ling-Feng Hsieh, Yao-Tsung Tsai. The Journal Of American Academy Of Business. Cambridge. Number 2. March 2005. Pg. 64.

[ii] Kris Hundley. Scandals Put Squeeze On CfOs. Copyright 2006 Times Publishing Company. St. Petersburg Times (Florida). 0 Edition. May 17, 2006. 0 Edition. Section: Business; Pg. 1d.