COOKING THE BOOKS:

WHAT EVERY ACCOUNTANT SHOULD KNOW ABOUT FRAUD

(NO. 91-5401)

III. LEGAL ELEMENTS OF FINANCIAL STATEMENT FRAUD

The following section is designed to briefly outline the highlights of various legal concepts relating to financial statement fraud. Therefore, this information should not be construed as legal advice. For specific information regarding legal issues, consult with an attorney.

Intent

In order for a fraud allegation to be sustained, the intent of the perpetrator must be established. Intent, as defined by *Black's Law Dictionary*, is:

> *[the] design, resolve, or determination with which [a] person acts.*

We have seen that the definitions of financial statement fraud include the terms intentional, deliberate, or reckless conduct. These terms all help to establish the intent of the perpetrator. In the context of financial statement fraud, the intent is often termed *scienter*— the mental state embracing the intent to deceive, manipulate, or defraud.

Materially Misleading Financial Statements

A financial statement is materially misleading when the presentation contains fictions, improper valuations, inappropriate transaction timing, omissions, and false statements that either individually or in the aggregate are important enough to affect the decisions of its users.

What Is Materiality?

Materiality applies to the numerical data presented in the financial statements, as well as to the accompanying narrative statements. According to the U.S. Securities and Exchange Commission (SEC),

> *[a] fact is <u>material</u> if there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision or [it] would have significantly altered the total mix of information made available. [Emphasis added.]*

The Financial Accounting Standards Board (FASB) does not limit the definition of materiality to the judgment of a reasonable shareholder. Rather, the FASB defines materiality in terms of *any* reasonable person. The FASB defines materiality as:

> *…the magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.*

Note that the SEC's definition relates to whether a reasonable shareholder would have considered the information important in making a decision or whether the information mix would have been significantly altered. On the other hand, the FASB defines materiality in terms of "accounting information" that is either misstated or omitted and, if disclosed, would change any reasonable person's judgment.

Both definitions include a probability or substantial likelihood that if the information had been correct or non-fraudulent, the judgment or decision would have been different. The determination of whether or not a probability or substantial likelihood exists is a question of facts and circumstances, which is the responsibility of the trier of facts (jury) and beyond the scope of this course.

Materiality, for purposes of this workbook, is defined as follows:

> *The omission or misstatement of any accounting data or fact, which, when considered with all other information made available, would have altered the decision or judgment of the user.*

For example, in *Basic Inc., et. al. v. Levinson, et al.*, 485 U.S. 224 (1988), the Supreme Court held that materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. In the three cases outlined in the video, the frauds were of such a magnitude that there is little doubt that a reasonable shareholder would have found the misstatements significant.

Prosecution

There are three basic bodies of federal law which cover the prosecution of financial statement fraud. The first is Title 18 of the U.S. Code (hereafter referred to as 18 U.S.C.), Sections 1001 and 1014. The other two are the Securities Act of 1933 (1933 Act) and the Securities and Exchange Act of 1934 (Exchange Act of 1934).

Criminal Enforcement

Section 1001 of 18 U.S.C. is the general prosecutorial criminal statute for false statements. It prohibits false or fraudulent written or oral statements made to federal agencies and departments. Section 1001 is most frequently utilized to prosecute false statements made to law enforcement and regulatory agencies.

(Although it is often used in conjunction with representations made to the Internal Revenue Service, it is not the primary prosecutorial statute for income tax fraud.) Section 1001 covers the following:

- Known and willful material falsification
- Tricks, schemes, and devices
- False, fictitious, and fraudulent representations

This Section is most often used in the prosecution of false or fraudulent representations to law enforcement agencies, such as:

- Official investigations
- Federal employment applications
- Credit applications
- Visa applications
- Income tax returns

A fine of up to $500,000 (for an organization) or $250,000 (for an individual) may be imposed in addition to a term of imprisonment of not more than five years or, if the offense involves international or domestic terrorism, imprisonment of not more than eight years.

Section 1014 of 18 U.S.C. applies to false statements made on loan and credit applications. Like Section 1001, it also covers known and willful falsification. However, it goes further in defining the type of falsity as an overvaluation of land, property, or security.

Sections 1341 and 1343 of 18 U.S.C. apply to mail and wire fraud statutes, respectively. These Sections may be used to prosecute official or commercial bribes as well as fraud. The use of the mail and interstate wire facilities must be proven to be part of the scheme. The bribes are said to defraud the principals of their right to the honest and loyal services of their agents.

Violations of Sections 1014, 1341, or 1343 are punishable by a fine of up to $1,000,000 or imprisonment of up to 30 years. Fraud is most commonly a criminal offense as well as a civil offense. A person or organization who engages in a fraudulent act may be sued by the victim in civil court for damages. The state or federal government may also sue for the imposition of civil fines or for injunctive relief.

Securities fraud was added as a separate criminal offense under the Sarbanes-Oxley Act passed in June 2002. Section 1348 of Title 18 makes it a felony to execute a scheme to defraud in connection with publicly-traded securities. Violators can be fined and/or imprisoned up to 25 years.

Civil Enforcement

Many financial frauds are disciplined and/or prosecuted civilly by the enforcement section of the Securities and Exchange Commission. The governing laws for these enforcement or prosecution actions are found in the Securities Act of 1933 and the Securities and Exchange Act of 1934. Statutory requirements are found in both laws for the following types of reports:

- Periodic financial reports (Form 10-K)
- Description of business (Form 10-K)
- Timely major events report (Form 8-K)
- Quarterly reports (Form 10-Q)
- Management discussion and analysis of operations, liquidity, and solvency (MD&A)
- Proxy statements
- Major stock acquisitions (Form 13-D)
- Tender offers (Form 14-D)
- Annual reports to shareholders
- Other information not expressly required elsewhere but necessary to make required disclosures not misleading

The anti-fraud sections of the 1933 Act and the Exchange Act of 1934 are found in Sections 17 and 10b, respectively. Rule 10b-5 under the Exchange Act of 1934 is the one most often cited when financial statement fraud is involved. However, according to the court in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 1 (1985), a claim under Section 10b cannot be sustained where full disclosure is made.

Rule 10b-5 is as follows:

> *It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,*
> * *to employ any device, scheme, or artifice to defraud,*
> * *to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or*
> * *to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.*

It is obvious from the above rule that the disciplinary actions brought forth by the enforcement section of the SEC are targeted toward publicly held companies. In fact, the Treadway Commission report limits its scope to publicly held companies. This means that the anti-fraud provisions of the 1933 Act and the Exchange Act of 1934 only apply to publicly held companies; however, 18 U.S.C., Section 1001 and 1014 remain applicable for non-publicly held companies and partnerships. In addition, as we will soon

explore, the auditors, company officers, and accountants can also be held civilly liable for materially misleading financial statements without regard to the ownership of the company.

Statutory liability may arise when financial statements are found to be materially misleading. This liability is generally prosecuted through the 1933 Act. The auditors, company officers, and accountants may be held liable if they cannot show that the audit or their internal accounting responsibilities were conducted with due diligence. Due diligence is the standard of due professional care to which all auditors, company officers, and accountants are held. Generally, auditors, company officers, and accountants will not be able to prove due diligence if the financial statements have not been prepared according to generally accepted accounting principles or some other comprehensive basis of accounting, or if the audit was not performed in accordance with generally accepted auditing standards. The burden of proof of due diligence lies with the defendant auditors, officers, and internal accountants.

When, and if, financial statements are found to be materially misleading, auditors, company officers, and accountants have a liability environment similar to that under common law. Under common law, negligence on the part of the auditors, company officers, and accountants must be proved by the complainant. The defendants can assert a defense of good faith or lack of knowledge, which may be sufficient to sustain an acquittal.

If applicable, external auditors and accountants have, at their disposal, the fact that they did not actively "employ any device, scheme, or artifice to fraud." Generally, this defense will negate a fraud conviction. However, if the external auditor or accountant acted with reckless disregard for his professional standards, then a court or administrative judge may render a finding of fraud on the part of the accountant. A more detailed discussion concerning the responsibilities of management and the auditor, which give rise to this liability, is found in the next section.

In addition to the federal statutes concerning financial statement fraud, many states have their own individual statutes prohibiting false or misleading statements. The reader should refer to laws of his particular state for further guidance.

What Is the Genesis of Accountants' and Auditors' Liability?

In addition to liability under the 1933 Act, an accountant or auditor can also be held accountable under common law. Common law liability arises from:

- Breach of contract
- Negligence
- Gross negligence
- Fraud

Breach of Contract

Breach of contract involves a failure to perform under the terms and conditions of the contract. An example is the failure to perform services under contract for a client.

Negligence

Negligence is the failure to exercise the degree of professional care expected in the particular circumstances. According to the court in *Amoco Chemical Corp. v. Hill, Del. Super.*, 318 A. 2d. 617, negligence is the failure to use such care as a reasonably prudent and careful person would use under similar circumstances; it is the doing of some act which a person of ordinary prudence would not have done under similar circumstances, or the failure to do what a person of ordinary prudence would have done under similar circumstances. Negligence is based on the fact that one ought to have known the results of his acts. As the video illustrates, the auditing firm in the ESM case was adjudged guilty of negligence, and the jury awarded damages against the auditing firm of more than $70 million. It must be stressed that negligence can be extremely expensive for the auditor.

Gross Negligence

Gross negligence is the intentional failure to perform a duty in reckless disregard of the consequences. Gross negligence rests on the assumption that one knew the results of his acts, but was reckless or wantonly indifferent to the results. In other words, gross negligence can be construed as the failure to exercise slight care in the performance of professional work.

Fraud

As compared to gross negligence, fraud is always positive or intentional. It implies active participation in the fraudulent activity. Sometimes the reckless disregard of professional standards, referred to above, can be construed as fraud, as well as gross negligence.

There is a hierarchy to the common law liabilities of the auditor and accountant. The greater the misconduct or negligence, the greater the offense.

The degree of negligence may trigger the liability. Negligence, for example, usually triggers liability to accountants in privity of the contract with another party to the contract and to known third-party beneficiaries. Gross negligence can trigger liability to parties not directly involved in the contract, but who are foreseen or foreseeable as parties. These persons are ones who have relied on the accountants' work product. The third type of liability, generated from fraud, may trigger liability to all third parties who suffer a loss as a result of the fraud.

Examples of these liability issues are as follows:

NEGLIGENCE

Nancy Foster, a certified public accountant (CPA), prepared the financial statements for Norev Company (Norev), pursuant to the loan covenants contained in the debt instrument between Norev and National Bank of Commerce, Norev's lender. In preparing the financial statements, Foster noticed that Norev's only income was from the sale of marketable securities (held for investment). Foster, because she was in a hurry, did not verify which stock certificates had been sold, but rather used Norev's gain/loss calculations. Norev had incorrectly used the basis of the shares of stock sold in the previous year, which were substantially lower than the basis of the shares sold in the current year. Foster failed to discover that Norev did not apply the proper basis for the capital gain calculation. Consequently, Norev's income was substantially overstated for the year at issue.

GROSS NEGLIGENCE

George Dillon, a CPA, audited the financial statements of LaserTech Company, a computer hardware wholesaler. Although Dillon was performing the attest function on the financial statements, he deemed it unnecessary to observe the taking of the annual inventory count. As it turned out, there was no inventory and, in fact, the boxes in the warehouse had been filled with bricks. Consequently, the inventory on the financial statements was grossly overstated. The audit report issued by Dillon was an unqualified opinion. Obviously, the audit was not performed in accordance with generally accepted auditing standards, and Dillon was grossly negligent in the performance of the audit.

FRAUD

Frances Murphy was an internal auditor for Freedom Savings and Loan Association (Freedom). Freedom was having trouble with its earnings per share and capital ratios. In an effort to boost the earnings of Freedom, Murphy conspired with other members of management to restructure several loans to its "better" customers in order to eliminate the need to recognize an increase to the loan loss reserve (an additional bad debt expense for the period). In carrying out this scheme, the restructured loans were reported on the financial statements as market rate loans when, in fact, the management of Freedom had transferred, by way of assignment, the income from Freedom's own investments to several borrowers. The borrowers, in turn, paid the interest they received back to Freedom as if it were interest on the borrowers' outstanding loans. As a result of the assignment of income to the borrowers, there was a sudden decline in Freedom's own investment income. This was explained away as an increase in the administration fees applicable to these investments. However, there was no new contract for the administration of these investments that would substantiate the increase in administration fees.

As these three examples illustrate, the degree of participation by the accountant increases with the degree of negligence. In the first example, Foster's negligence was slightly more than an error. She failed to carry out her duties with the degree of professional care required of an accountant. In her haste, she failed to assure herself that Norev had used the proper basis in calculating the capital gain.

In the second example, Dillon, by not observing the physical inventory, intentionally failed to perform his duty with regard to his attest function. He displayed a reckless disregard for the consequences of his decision.

In the third example, Murphy actively participated in the fraudulent scheme to overstate the income of Freedom. She had both the opportunity and the motive (higher earnings) for committing this fraud. Notice, however, that there was no direct personal gain to Murphy in her commission of this fraud.

In each of the examples above, the accountants may be found liable to different parties. In the first example, Foster could very easily be found negligent with regard to National Bank of Commerce, which was a known third-party beneficiary of the contract to prepare the financial statements.

In the second example, Dillon could be found liable to those persons who were foreseeable as parties who would rely on his opinion to the financial statements; for example, shareholders and other potential investors or creditors of LaserTech Company.

In the final example, Murphy could be held liable to anyone who suffered a loss as a result of the fraud. This could include shareholders, potential investors, creditors, the federal government, depositors, and others.