

THIRD EDITION

ACCOUNTING  
IRREGULARITIES  
AND  
FINANCIAL  
FRAUD

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A Corporate Governance Guide

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MICHAEL R. YOUNG

Foreword by Mario M. Cuomo

# ACCOUNTING IRREGULARITIES AND FINANCIAL FRAUD

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Third Edition

MICHAEL R. YOUNG



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# Accounting Irregularities and Financial Fraud

*by Michael R. Young*

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## Third Edition

In the wake of highly publicized allegations of accounting irregularities and fraudulent financial reporting that are shaking up today's corporate community, *Accounting Irregularities and Financial Fraud* provides a step-by-step guide to how these crises can envelop a company and how to prevent them from happening in the first place. It is directed to almost everybody involved: outside directors, audit committee members, senior executives, CFOs, CPAs, in-house lawyers, and outside law firms.

## Highlights

The Third Edition of *Accounting Irregularities and Financial Fraud* features two new chapters and has been updated to include the following:

- Chapter 1, **"The Origin of Financial Fraud"**—helps put Enron, WorldCom, and other high-profile frauds in perspective by explaining the fundamental causes of financial misreporting.
- Chapter 2, **"From Treadway to Sarbanes-Oxley"**—takes the Sarbanes-Oxley Act back to its conceptual roots and explains the step-by-step progression of how the concepts underlying the Act came to be.
- Chapter 3, **"The Sarbanes-Oxley Act"**—provides a highly readable description of the main features of the act and how an ostensible hodgepodge of statutory subsections actually fit together into an integrated network.
- Chapter 4, **"In the Cross-Hairs: The CEO"**—describes the new perils facing CEOs and practical ways for CEOs to avoid the pitfalls.

- Chapter 5, **“The Audit Committee”**—focuses on an audit committee’s main role and offers sensible guidance for the fulfillment of audit committee responsibilities (while helping audit committees avoid becoming a dumping ground for poorly defined corporate responsibilities).
- Chapter 6, **“What Goes Wrong?”**—explains the external and internal pressures that cause executives to unwittingly become corrupted and financial reporting systems to fail.
- Chapter 7, **“The Aftermath of Detection”**—advises on what to do should accounting irregularities surface and sets out immediate steps to control the damage.
- Chapter 8, **“Getting New Audited Financial Statements”**—explains the practical necessity of getting a new audit report once accounting fraud has been uncovered and how to go about it.
- Chapter 9, **“The Investigative Process”**—gives an overview of the process of investigating financial fraud and what to expect as the investigation unfolds.
- Chapter 10, **“Digging Out the Fraud: The Forensic Accountants”**—explains the critical role of forensic accountants in a fraud investigation and the places where they are most likely to look.
- Chapter 11, **“Dealing with the Regulators”**—gives insight into the workings of the SEC and how best to respond to regulatory inquiry.
- Chapter 12, **“Criminal Investigations”**—explains the increasing frequency with which criminal charges are being brought against corporate malefactors and what a typical criminal investigation will involve.
- Chapter 13, **“Class Action Lawsuits”**—explains the civil litigation side of accounting fraud and approaches to resolution.
- Chapter 14, **“Dealing with the D&O Insurer”**—offers insight into the highly intricate world of D&O insurance and the practicalities of policy coverage.
- Chapter 15, **“Accounting Irregularities and the Future of Financial Reporting”**—explains how the upsurge in accounting fraud is a natural consequence of an antiquated financial reporting system that is not satisfying the real-time demands of financial markets.

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## FOREWORD

*by Mario M. Cuomo*

The unprecedented era of spectacular growth over the last two decades has unleashed cascading new wealth in the financial industry and created a new American world of glorious possibilities and challenges. One of the challenges is the disconcerting outbreak of “accounting irregularities,” a nice euphemism for what amounts to the deliberate manipulation of bookkeeping to disguise regrettable realities with desirable illusions. In my old neighborhood that was usually called “fraud.”

In the pages that follow, you will learn about the corporate environment that causes it, how it spreads, the kind of crises it can create for the company, and the best ways to deal with them. Experts will offer advice on the conduct of the initial investigation and the first meeting of the board of directors. They will give insights dealing with insurance, indemnity, and the possibility of class action lawsuits, and demonstrate how to restore corporate and individual credibility after the event.

There are also helpful ideas about how to strengthen the company against a recurrence of lapses in judgments and ethics. To do that we have to understand the dynamics and temptations that help spawn the manipulations: the corporate pressure that can push honest people into doing dishonest things, how an executive can be trapped by what seems an easy escape from the embarrassment of disillusioned earnings expectations. Business people with firsthand experience show how, in the process, the executive overlooks the possible cost in dollars and reputation and marketability, not just to the offending company and all those implicated by the company, but even to honest competitors in the rest of the industry whose reputations suffer by association.

All of that is described, clearly and vividly, from the cumulative experience of knowledgeable professionals, making this volume the first authentic “how to” book on dealing with accounting irregularities.

It can also prompt some badly needed reflection on the larger economic and fiscal context in which we find ourselves.

A lot has happened to economics and business in the last 30 years. So much so that a new language is being developed to describe our changing world. Words like “transparency” are suddenly and obviously



recurrent in the pages of financial journals, on paper and on the computer screen. Thirty years ago the word “transparency” was used only infrequently and almost never by economists. Today that word means that if you want help from the IMF or the World Bank, or if you want credibility in your fiscal practice here at home, your books and accounting records ought to be clean, honest, and comprehensible.

Most dictionaries still don’t list that particular meaning. But it is found in almost every speech by former Treasury Secretary Robert Rubin and former Chairman of the Federal Reserve Board Alan Greenspan.

And only a few years ahead of “transparency,” the words “interconnectedness” and “interdependence” resurfaced. Wendell Willkie, who ran against FDR in 1941, had used those words over a half a century ago in his book *One World*, while predicting the inevitable emergence of another new word, “globalization.” Four decades later, Mikhail Gorbachev and Vaclav Havel resuscitated Willkie’s words and now they regularly appear when the point is being made that the financial world and the rest of the planet are intensifying dealings with one another all over the globe. Horizons have broadened, borders have become infinitely elastic. Mergers and mega-mergers, joint ventures and affiliations, stretching the reach of companies across seas and over continents, have created tremendous new opportunities and fear-some new competition at the same time.

The message in this book is that, in this world of exciting new options and intense new competition, financial regularity and transparency will be a *sine qua non* to success. Only the enterprise that can be believed and depended upon will survive. Our hope is that the contributions we offer will make that case clearly enough that, before much longer, this kind of fraud will become so rare we won’t need clumsy euphemisms like “accounting irregularities” at all.

## PREFACE

It only takes a phone call. One moment you're a titan of corporate management. You are, among other things, an outside director of a company that has, yet again, reported stellar results. The stock price is up. Senior management is happy with their well-deserved bonuses. And you're basking in the glow of a favorable article that has just appeared in *Business Week*.

Then, with a single phone call, everything changes. You're told that accounting irregularities have surfaced at the company. Inexplicably, the CFO has confessed. An emergency board of directors meeting is being called for the next day. There will be one item on the agenda: How to deal with a crisis.

These days, seemingly innumerable boards of directors, audit committee members, and senior executives are finding themselves in precisely this situation. For virtually all of them, it will be the first time that they will go through it. For that matter, it will probably be the first time for their outside law firm, the certified public accountants who serve as their outside auditors, and almost everybody else involved. Some will choose the proper course of action almost as a matter of instinct. But, experience teaches, many will not.

This book seeks to come to grips with some of the fundamental questions regarding accounting fraud. How does it start? How does it grow? How does it come about that so many educated and well-meaning individuals manage to get caught up in such massive wrongdoing? While taking on these questions, the book also seeks to provide a step-by-step guide to the crises enveloping a company in the wake of fraudulent financial reporting—and how to prevent it from happening in the first place. The discussion is directed to almost everybody involved: outside directors, audit committee members, senior executives, CFOs, CPAs, underwriters, in-house lawyers, and outside law firms. Experience teaches that, where fraudulent financial reporting surfaces, the root causes and effects are almost always the same. Also the same are the strategies for dealing with them.

*Michael R. Young*

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### Foreword

**Mario M. Cuomo**, before he entered public service, had been a law clerk to the Honorable Adrian P. Burke of the New York State Court of Appeals, an Adjunct Professor of Law and a practicing attorney who had appeared in every level of the New York State courts and the Supreme Court of the United States. As Governor of New York for 12 years, he took a leading role in the enhancement of the laws of public disclosure and integrity in public reporting. As Secretary of State, Mario Cuomo helped write the first public disclosure laws in New York State and drafted the first reform of New York's lobbying laws in over 70 years. As Governor, he proposed and signed the first ethics law for public officials; the law requiring the application of generally accepted accounting principles to the state budget; and the first state statute requiring regular and independent audits of all executive agencies, including the Comptroller's Office, the State Inspector

General's Office, and his own Office of the Governor. At Willkie Farr & Gallagher LLP, Mr. Cuomo plays an active role in advising public companies, boards of directors, and audit committees on issues of corporate governance and financial reporting, and has engaged in a broader practice specializing in corporate law. He lectures across the country and abroad and is the author or editor of more than a half-dozen books, including: *Why Lincoln Matters More Today Than Ever*, *The Blue Spruce*, *Reason to Believe*, *The New York Idea: An Experiment in Democracy*, *More Than Words*, *America's Agenda: Rebuilding Economic Strength*, *Lincoln on Democracy*, *The Cuomo Commission Report*, which furthered the national debate on economic policy and trends through the findings of the Cuomo Commission on Trade and Competitiveness, *Diaries of Mario Cuomo*, and *The Forest Hills Diary*.

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