“Classic Case Studies in Accounting Fraud”

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by

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ABSTRACT

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Over the past several years, accounting fraud has dominated the headlines of mainstream news. While these recent cases all involve sums of money far in excess of any before, accounting fraud is certainly not a new phenomenon. Since the early days on Wall Street, fraud has consistently fooled the markets, investors, and auditors alike. In this thesis, an analysis of several cases of accounting fraud is conducted with background information, fraud logistics, and accounting and auditing violations all subject to study.

This paper discusses specific cases of fraud and presents the issues that have been and must continue to be addressed as companies push the envelope of acceptable accounting standards. The discussion and findings demonstrate the ever-present potential for fraud in a variety of accounts, companies, industries, and time periods, while also having a powerful influence on an auditor’s work and preconceptions going forward.
“Classic Case Studies in Accounting Fraud”

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INTRODUCTION

Over the past several years, corporate fraud has dominated the headlines of mainstream national news. Accounting errors are now occurring all too frequently, forcing earnings restatements, and are having a huge effect on companies’ books, the financial markets, and most critically, on the overall economy. “Although it is not a new phenomenon, the number of corporate earnings restatements due to aggressive accounting practices, accounting irregularities, or accounting fraud has increased significantly during the past few years, and it has drawn much attention from investors, analysts, and regulators” (Wu 3). While these recent cases all involve sums of money far in excess of any before, accounting fraud is certainly nothing new and since the early days on Wall Street, it has consistently fooled the markets, investors, and auditors alike.

Accounting frauds can be classified as either fraudulent financial reporting or misappropriation of assets, or both. Fraudulent financial reporting is commonly known as “cooking the books.” The Treadway Commission defined fraudulent financial reporting as the intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements. In presenting inaccurate financial statements, fraudulent financial reporting will have significant consequences for both the organization and for the public’s confidence in the capital markets. Misappropriation of assets is simply using assets and resources for unintended purposes. Such fraud includes thievery, embezzlement, and cash skimming.

This paper will discuss specific cases and present the issues that have been and must continue to be addressed as companies push the envelope of acceptable accounting
standards. In addition, with the goal that “a CPA who recognizes how these fraudulent manipulations work will be in a much better position to identify them” (Wells *Ghost Goods*), this paper will describe how the frauds were perpetrated and how the auditors erred. As evidence of the ubiquitous potential for fraud, the cases profile companies in a range of industries, profit and non-profit companies, a number of accounts, and span nearly the past century.
MCKESSON & ROBBINS

“In the business world, the rearview mirror is always clearer than the windshield.”  Warren Buffett

Stock market fraud was once a perfectly respectable way to achieve wealth and much of America's industrial and financial colossus was built on such actions. In fact, “some of the greatest names in American history made their fortunes through shameless chicanery, including Vanderbilt, Morgan, Rockefeller, Stanford, Gould, and Kennedy” (Carlson). Regulation was limited and ethics were not even considered as “insiders benefited from price fixing, stock manipulation, and various schemes of questionable legality…Mergers, cutthroat competition, railroad rebates, and bribery were some of the techniques used by businesses” (Giroux) in these early days. Given this situation and the culture that it fostered, auditors faced a number of challenges in performing their work.

A milestone case in fraudulent financial reporting occurred in the 1930s, soon after the Great Depression, at McKesson & Robbins (McKesson), a pharmaceutical giant. The case would drastically affect the auditing profession, which was completely blind to the fraudulent activity at McKesson. The fraud went on for over ten years and through forged invoices, purchase orders, shipping notices, contracts, debit and credit memos enabled the company to collectively overstate its inventory and sales by over $19 million, incredible amounts for the time.

BACKGROUND

With a lengthy rap sheet, Philip Musica had a colorful background in rising to his position as President at McKesson. Philip Musica was the oldest of four sons of Assunta Mauro Musica, born in 1884 in the Lower East Side area of Manhattan. Within this
district, the family grew up in the Mulberry Bend neighborhood, known for some of the toughest gangs in New York. At age 14, Philip followed his mother’s orders and dropped out of high school.

By 1901, Philip’s father had managed to save enough from his barbershop to open A. Musica & Son, a small shop selling Italian pastas, sausages, and dried fruits. Under his self-educated mother’s guidance, Philip learned the business and began wholesaling. Philip made contacts and was able to import his own goods and then act as a distributor to other shops. Philip’s younger brothers, George and Robert, also entered the family business.

New York detectives soon got word that Philip was bribing cheese inspectors, writing down the goods he received to skirt import tariffs. At the same time, he was keeping two sets of financial records. Following his mother’s recommendations, one set reflected the true inventory and one was according to the bribes.

After the detectives moved in, Philip took the entire blame, clearing his father, mother, and brothers of criminal charges. At age 25, Philip was sentenced to one year in prison. At the Elmira Reformatory, he lied, telling the guards that he had a degree in accounting, and earned a position in the warden’s house. After serving just five months of his one-year sentence, President Taft mysteriously pardoned Philip Musica.

After Philip was released, the family returned to father Musica’s barbershop business for their next series of exploits. With hair extensions extremely popular in 1910, mother Musica was able to raise $1 million in capital for the US Hair Company from Italian businessmen. Within 18 months, US Hair was trading on the New York Curb
Exchange with market capitalization exceeding $2 million. Hair assets were recorded at $600,000 and offices were located around the world in London, Berlin, St. Petersburg, and Hong Kong. After two years, US Hair was a $3 million corporation and Philip was living lavishly, indulging in the luxuries of New York City.

This fraud was exposed when a sudden sell off of US Hair stock prompted an investigation. Regulators halted the shipment of nine US Hair cases of product and discovered nothing but newspaper inside. US Hair was exposed as a shell company used to launder money through the family’s international offices. Philip and the entire Musica family managed to escape before being arrested. While mother Musica fled to Naples, Philip, his brothers George and Robert, sisters Louise and Lucy Grace, and father jumped from train to train on their way to Mobile, Alabama. A private investigator ultimately tracked them to New Orleans where they were arrested on board a ship bound for Panama. After the arrest on the ship, Philip and his family were found to be in possession of thousands of dollars in cash, insurance certificates, and expensive jewelry. Philip again claimed sole responsibility and cut a deal to become a prison informant, ratting out fellow prisoners at The Tombs.

After his release, Philip Musica was able to create a new life, living under the alias Bill Johnson. Remarkably, he served as an investigator in the New York Attorney General’s office. While aware of Philip’s background, Deputy US Attorney General Alfred Becker was able to dismiss the criminal activity in his past and was convinced that Philip had repented on his many misdeeds. Although not very ethical, Musica was
effective in fighting crime during the notorious Poultry Wars. However, he was forced out of his position when his own criminal background was publicly exposed.

Adelphi Pharmaceuticals (Adelphi) was the front for the next set of charades. Adelphi manufactured a few hair tonics and, as a consequence of Prohibition, received a government allowance of 5,000 gallons of alcohol. Now using the alias of Frank Costa, Philip Musica “learned how to deploy dummy corporations and a closed circle of insiders to make his business look completely real. He manufactured just enough legit product to show around, dumping the rest of the alcohol into tanker trucks for the mob” (Wells Frankensteins 120). Brothers George and Robert now assumed the last name of Dietrich and joined the venture. During this time, Costa stole a former co-worker’s wife and created a series of hoaxes to send the man to prison.

Outgrowing Adelphi and now going by Dr. Frank Donald Coster, Philip and his influential mother set up Girard & Company (Girard), naming the latest business after her maiden name. Like Adelphi, Girard also sold hair tonics. In 1925, Girard went public. George Dietrich (Musica) bragged, “on paper, we sold enough shampoo to wash every head in the world. But 90% of it we sold to bootleggers” (qtd. in Wells Frankensteins 117). In 1926, with considerable success at Girard, Coster was able to acquire McKesson, a company founded in 1835 that was struggling.

At McKesson, Coster was able to convince independent drug stores to join his network of other independent drug stores to avoid the inevitable acquisition by Walgreens or other national chains that were dominating the industry. “By 1929, the
McKesson & Robbins umbrella covered 66 regional wholesalers, posting $140 million in annual sales” (136).

In 1927, Coster created his “pet project,” W.W. Smith & Company, a phantom Canadian subsidiary. The Canadian arm of the business went so far as to employ a secretary, who mailed papers to New York sporadically, but did nothing more. Additionally, “anticipating that Prohibition couldn’t last, Coster began setting up a liquor subsidiary of McKesson & Robbins in 1931. As Franklin Delano Roosevelt was announcing the repeal of the Volstead Act in 1933, Coster’s trucks were already pulling away from the docks” (138). In 1937, McKesson sales reached $174 million.

After realizing he had received several fabricated reports, Julian Thompson, the company’s treasurer, began to question Coster about the Canadian business. Coster repeatedly dodged the questions with unconvincing replies and requests for more time. The treasurer ultimately felt a duty to the shareholders and pressed Coster for answers. When cornered, Coster insisted that there was a conspiracy to oust him that explained the missing information from the subsidiary. Soon thereafter, Coster put the company “into receivership. The gates of the factory were chained; all bank accounts were frozen; all records were impounded” (141).

Within the week, federal, state, and local agencies began investigating McKesson. Coster was charged and released on bond. A short while later, when federal officials were on his doorstep, Coster correctly sensed that his bond had been revoked and shot himself. He left a four-page letter professing that he was a victim of Wall Street plunder and blackmail.
Clearly, Musica/Johnson/Costa/Coster was a perpetual fraudster, continually returning to a life of crime. Many of his businesses took on illegal activities and the financial reporting of these businesses did as well. Musica and his two brothers went to great lengths to hide the fraud. They produced “every last piece of documentation – from raw materials and processing through packaging, shipping, and selling – which would be generated by a typical American business of the time” (Wells Frankenstein's 120-121). Occasionally, they would even pay bills late, just as a completely legitimate business would.

Through the Canadian subsidiary, phony sales documents were created and inventory at this business alone was overstated by millions. Warehouses were purchased, yet sat empty as the company merely used the address as evidence of its facility. An investigation later determined that the fraud resulted in at least $9 million of fictitious inventory counts and over $10 million in sales from fictitious customers.

While Coster guided McKesson through the Great Depression, he also maintained several bulletproof aliases, shielding himself from a string of corrupt businesses and allowing himself to draw several McKesson paychecks. Nevertheless, Coster had been personally invited to run for the US presidency with the Republican Party against FDR. Coster declined the nomination citing personal commitments.

WHERE WERE THE AUDITORS?

Paralleling the recent accounting scandals, a February 1939 article on the McKesson fraud in the Journal of Accountancy read:
Like a torrent of cold water the wave of publicity raised by the...case has shocked the accounting profession into breathlessness. Accustomed to relative obscurity in the public prints, accountants have been startled to find their procedures, their principles, and their professional standards the subject of sensational and generally unsympathetic headlines.

Until early in the 20th century, use of the balance sheet was paramount. Although the concept of earnings power began to emerge in the years after World War I, the income statement was still largely neglected because it was easily open to abuse, as no accounting standard existed to govern its creation. As a result, the benefits of the income statement to determine profitability, value for investment, and credit worthiness were all ignored. Additionally, insider trading was both common and legal; corrupt activity was frequent and acceptable.

The McKesson fraud came following the collapse of the stock market in 1929, which spurred the Great Depression. The “Great Depression demonstrated problems with capital markets, business practices, and...considerable deficiencies in accounting standards. Many aspects of current accounting practices started with the flood of business regulations from the Roosevelt administration” (Giroux).

Before the Great Depression, regulations existed...federal laws, state Blue Sky Laws on securities regulation, and so on. Companies issued prospectuses that typically (contained) audited financial statements and attorney review. However, these were not very effective. Lawyers, auditors, and brokers worked for the companies, not the potential investors. State laws were ineffective for regulating interstate commerce. The federal laws were still inadequate (Giroux).

In response to a fraud involving Ivan Kreuger, the Swedish Match King, political support led to the passage of the US securities acts in 1933 and 1934, which required companies to publish audited financial statements before going public. These landmark
securities laws established antifraud and liability regulations that increased the legal responsibilities of accountants, who now became liable to the public.

Following the direction of the securities laws to create regulation, the Committee on Accounting Procedure (CAP) was a part-time committee of the American Institute of Certified Public Accountants (AICPA) that circulated Accounting Research Bulletins (ARBs). Subsequent to the McKesson fraud, CAP coined the term “generally accepted accounting principles” (GAAP) and the Securities and Exchange Commission (SEC) formally delegated authority to create accounting standards to the private sector. Accordingly, CAP began to issue the aforementioned ARBs, which determined GAAP from 1939 until 1959. While CAP is now nonexistent, its work and the ARBs are lasting, with many of the bulletins becoming a part of GAAP. Currently,

> generally accepted accounting principles are those accounting principles that have substantial authoritative support. Substantial authoritative support is a question of fact and a matter of judgment. The power to establish GAAP actually rests with the Securities and Exchange Commission; however, except for rare instances, it has essentially allowed the accounting profession itself to establish GAAP and self-regulate (Brunner 3).

The auditing firm Price Waterhouse & Company inspected the McKesson books in fiscal 1937, yet did not verify the existence or amount of physical inventory and did not question the existence of numerous new customers over the previous fiscal year. As a result of the auditing firm’s limited work, ample opportunity to commit the fraud was present. However, on behalf of the auditors, it must be stated that, at the time of the case, they were required to neither count nor observe physical inventory. Thus, while perhaps satisficing, the auditors were compliant with the standards at the time.
When auditing inventory an auditor should employ a number of analytical procedures. Phantom inventory, essentially a shell fraud, is recurring in the subsequent analyses that follow. The scheme may throw a company’s books out of balance and, compared with previous periods, the cost of sales will be too low; inventory and profits will be too high. Other signs may also be apparent when analyzing a company’s financial statements over time. Consequently, the auditor should use analytical procedures to look for the following trends:

- inventory increasing faster than sales
- decreasing inventory turnover
- shipping costs decreasing as a percentage of inventory
- inventory rising faster than total assets move up
- falling cost of sales as a percentage of sales
- cost of goods sold on the books not agreeing with tax returns.

Current auditing standards (AU 329.04) hold that analytical procedures be performed “as an overall review of the financial information in the final review stage of the audit.”

**CONCLUSION**

After over 100 years of successful business, McKesson plunged into bankruptcy. The chief fraudster, Philip Musica, committed suicide rather than face prison again. As a result of the McKesson fraud, auditors’ roles were expanded. They were forced to increase their responsibility for the financial statements and adopted measures that required a physical inventory count and an increased emphasis on the company’s new clients.

Inventory is typically a large account on a company’s balance sheet, often accounting for a considerable portion of a company’s working capital. As a result,
following the McKesson fraud, the SEC recommended that non-officer members of the client’s board appoint the auditors and also directed auditors to address their reports to the company’s shareholders. In 1939, the AICPA established its first committee on auditing procedures, CAP, who drafted Statements on Auditing Procedure No. 1 “Extensions of Auditing Procedure,” now known as Statement on Auditing Standard (SAS) 1 (AU 331) to require inventory observation and account receivable confirmation.

In closing the accounting loophole, the standard states:

It is ordinarily necessary for the independent auditor to be present at the time of count and, by suitable observation, tests, and inquiries, satisfy himself respecting the effectiveness of the methods of inventory-taking and the measure of reliance which may be placed upon the client’s representations about the quantities and physical condition of the inventories.
ALLIED CRUDE VEGETABLE OIL REFINING

“In the modern world of business, it is useless to be a creative original thinker unless you can also sell what you create.” David M. Ogilvy

While regulators and the public demanded government regulation early on, “historically, the corporate tendency has been to react to fraud after the fact than to be proactive in its prevention. In most cases, blame is directed at accountants and auditors” (Davia). This reactive attitude certainly has and continues to promulgate the opportunities for fraud. Nearly three decades and many frauds after McKesson went bankrupt, another large-scale inventory fraud would impact the financial markets.

The Salad Oil King, who executed this fraud, finally got caught in November of 1963, and was led from his home in the Bronx, New York to face criminal charges in nearby Newark, New Jersey. The actions of Anthony “Tough Tino” DeAngelis, a 5’5” 240 pound brilliant salesman, and extensive phantom inventory throughout the company fueled this fraud, affectionately known as the Salad Oil Swindle. The fraud nearly bankrupted two large brokerage houses, while adding to the growing fortune of Warren Buffett.

BACKGROUND

Anthony DeAngelis, a former New Jersey meatpacker, ran Allied Crude Vegetable Oil Refining (Allied), a major player in the commodities markets of the 1950s and 1960s. DeAngelis was well known for his ability to orchestrate terrifically intricate deals. However, before Allied, “he had previously run a solvent business into bankruptcy, had attempted to cheat the government on several occasions while carrying out government contracts…and had been expelled from two New York banks on the
suspicion that he was running check kiting schemes” (Wells Occupational Fraud 415). Between 1940 and 1952, he was forced to pay $100,000 at least three times for inferior products and short deliveries. Despite his spotty background, both lenders and investors willingly accepted his word throughout his salad oil shenanigans.

Allied specialized in soybean, cottonseed, and edible oil. The business was designed to take advantage of the US Government’s Food for Peace program, which subsidized the export of certain US crop surpluses. However, due to Tino’s criminal background, he was not an approved exporter.

The company regularly delivered legitimate shipments of vegetable oil to large vats in a warehouse in New Jersey. For each shipment, warehouse receipts were issued, indicating the amount of oil that had been stored and essentially fueling the company’s accounting records. DeAngelis received certificates of authenticity from a prominent banking subsidiary of American Express, with executives vouching for the validity of the salad oil. Tino would then issue the American Express certificates of authenticity to his investors and lenders. Several large banks and brokerages relied on these certificates to secure their loans to Allied. Investors were eager to cash in on the fortune that the Salad Oil King was making and didn’t question their investments, instead relying on the faith of DeAngelis and American Express.

By late 1963, Allied was holding warehouse receipts indicating and legally verifying the existence of $60 million worth of salad oil. Allied used the warehouse receipts, evidence of its inventory, as collateral for $175 million in loans, which
DeAngelis then used to speculate on vegetable oil futures in the volatile and risky commodities market.

Tino offered such low prices that exporters bought the oils from Allied and then exported the Allied oils that they had just purchased. In fact, although Tino was not an authorized exporter, he accounted for 85% of the country’s edible oil exports. Some of the countries that then accepted the goods soon complained that they were receiving drums of water. Allegations of fraud and falsified shipping documents soon followed.

As a supplier of salad oil, a short position would have hedged the company’s exposure to price variations and guaranteed a sale at a given price. However, Tino’s speculative moves and long position culminated in 1962 when vegetable oil prices plunged. Unable to meet the mark-to-market and settling up provisions of the futures market, DeAngelis lost all the money he had borrowed. The loans fell back to American Express, who now owned a warehouse full of vegetable oil.

**Fraud Logistics**

Although the speculative moves had failed, proved unwise, and bankrupted Allied, the actions certainly were legal. Yet, after Allied went bankrupt, the fraud now suddenly began to become apparent, with inventory a prime area of fraudulent activity.

American Express soon discovered that the vats contained not salad oil, but mostly seawater. Tino DeAngelis had filled many of the oil tanks with seawater and added just a small amount of salad oil to the top, just enough to fool the auditors when they would peer inside to confirm the salad oil’s existence. Secondly, DeAngelis had his henchmen direct an auditing team through the warehouse’s maze of rows of oil tanks,
changing the numbers on the tanks that did contain salad oil so the auditors would erroneously count the same vat twice. Finally, through a complex network of pipes and valves, Allied could easily direct the vegetable oil to the needed tank for the auditor’s search.

While much of the inferior inventory was sold, the inventory manipulation was also necessary for DeAngelis to secure the loans and obtain the funds that he needed to make his speculative moves. With a small number of insiders at American Express in his pocket receiving kickbacks, DeAngelis had no problem executing the fraud. Using the inflated financial statements, he was able to market investment in his company as a profitable move.

Phantom inventory fueled the Salad Oil King’s success. In addition to selling a bad product and overstating the assets, the phantom inventory provided the means for DeAngelis to finance his loans. In this case, inventory was virtually nonexistent, with seawater often taking the place of salad oil, the desired asset. Inventory was also double counted, boosting the quantities on the auditor’s records.

WHERE WERE THE AUDITORS?

Although Allied had countless investors, it was not a public company and thus, not required to file audited financial statements with the SEC. However, American Express was subject to the SEC’s provisions. Like American Express, the many other investors also failed to perform effective due diligence relating to their investments.

Although both American Express’s internal and external auditors, Price Waterhouse, investigated the Allied inventory and did sometimes find water in the tanks,
they failed to properly pursue the matter. Tino convinced them that the water was merely from broken steam pipes. Samples were even sent to Allied’s own chemist and not an independent party.

The independence of American Express’s internal auditors was certainly compromised. In addition to many receiving individuals kickbacks, those who didn’t take bribes were not free to choose their own audit procedures. Instead, they reviewed the inventory that Allied led them to.

A total of 51 brokerages, banks, and export companies invested in Allied and suffered huge losses. At all of these companies, the auditors accepted the American Express certificates as evidence of the assets and the corresponding receivables. In contrast to these actions, further investigations should have been performed. Based on the reliance of the American Express name, many of the banks involved ignored their collateral and loan requirements and skirted their own internal control procedures for lending.

A simple investigation would have shown that the amount of salad oil offered for sale was collectively larger than the total amount of salad oil in the entire country. None of the investors examined the salad oil reserves and tanks they had invested thousands of dollars in. Consequently, DeAngelis was able to engineer sale after sale. In fact, the only ones questioning Allied’s success were its competitors, who were convinced that DeAngelis’s deals at such low prices were impossible.
CONCLUSION

With a company, its chief executive, accountants, and even its chief lender all acting to trick the auditors, the Salad Oil King and Allied Crude Vegetable Oil Refining were able to orchestrate one of America’s classic frauds. As a result of the fraud, the 51 involved banking and brokerage firms sustained losses totaling $200 million. Anthony DeAngelis was sentenced to 10 years in prison. Coincidentally, the news of the fraud broke on the same day as President Kennedy’s assassination and was largely ignored by the public. Much later, the magnitude of the fraud finally became understood. Price Waterhouse was dismissed as American Express’s auditors and Arthur Young was hired.

As a result of its actions, American Express's stock fell 45%, from $60 a share down to $35 a share by early 1964. Interestingly, Warren Buffett, the American billionaire and legendary investor, was just beginning a small investment partnership and boldly purchased five percent of American Express’s outstanding stock with 40% of his available capital. This purchase would result in a $20 million profit just two years later.
“Complexity is a formal academic discipline with a focus on complicated organizations such as corporations.” Larry Elliott and Richard Schroth. How Companies Lie.

As has been especially evident in recent years, “periodic high profile cases of fraudulent financial reporting raise concerns about the credibility of the US financial reporting process and call into question the roles of auditors, regulators, and analysts in financial reporting” (Beasley Fraudulent 1). The consequences of fraud can be unnerving. Frauds not only affect the fraudsters, auditors, and investors, but also communities, industries, and financial markets, while also influencing both accounting and auditing standards.

In addition to the savings and loan scandal of the 1980s, the decade was also plagued by several other notorious scandals. Barry Minkow, a flamboyant entrepreneur, founded ZZZZ Best in his parent’s garage as a high school junior. A hyperactive youth, compulsive teenage achiever, and adult charmer, Minkow fits the classic mold of both an entrepreneur and a fraudster. He grew his business into one of the nation’s largest carpet cleaning and renovation services businesses in the 1980s and within five years of founding the venture, ZZZZ Best maintained a recognized position on Wall Street. Unfortunately, the multi-million dollar business’s growth would not prove to be genuine and Minkow would be exposed as the architect of one of America’s most outrageous accounting frauds.
BACKGROUND

In 1982, Barry Minkow established ZZZZ Best at age 16. In the carpet cleaning business, “there are essentially no barriers to entry: no licensing requirements, no apprenticeships to be served, and only a minimal amount of start-up capital is needed…Minkow quickly learned that carpet cleaning was a difficult way to earn a livelihood…Customer complaints, ruthless competition, bad checks, and nagging months of striking out on his own…” (Knapp 5th Ed. 120-121). Additionally, local banks refused to lend the young entrepreneur any working capital. Nevertheless, Minkow was resourceful and knew how to network.

After discovering how tough business was, Minkow resorted to several fraudulent schemes to raise the needed funds to grow his business. He started with credit card forgeries, insurance fraud, and check kiting, but “soon became even bolder and began reporting fictitious revenues from ‘insurance restoration’ contracts” (Knapp 4th Ed. 28) to coerce banks into approving his loans. He ultimately expanded the insurance restoration activities so much that they accounted for nearly 90% of the company’s annual revenues. The success let him take the company public in 1986 and “in the three-year period from 1984 to 1987, the company’s net income surged from less than $200,000 to more than $5 million on revenues of $50 million” (Knapp 5th Ed. 119). The company peaked with a market capitalization of $200 million in 1987. As a result, Minkow lived the high life, appearing on *Oprah* and driving a Ferrari.

During the five-year span between 1982 and 1987, Minkow maintained financial records embellished with inflated numbers and phony accounts, serving to impress Wall
Street investors and stock analysts. However, a look at the numbers would have shown that they were completely unreasonable for a business of ZZZZ Best’s size and for any carpet cleaning business for that matter. For example, ZZZZ Best claimed to serve more insurance projects than the entire US industry supported at the time. The company alleged that some of the renovation accounts cost incredible, irrational amounts, far greater than the cost to entirely construct such structures, let alone merely renovate the sites. In reality, ZZZZ Best was losing millions annually.

**FRAUD LOGISTICS**

Rather than working to restore profitability, Minkow dreamt elaborate schemes to cover the company’s growing debt. The initial public offering (IPO) collected $13 million of investor’s capital that would be used solely to pay previous lenders and to support the young entrepreneur’s extravagant lifestyle, following the pattern of pyramid deceit erected by the infamous Charles Ponzi so many years earlier. Minkow held over half of the company’s outstanding stock, maintained a “sky is the limit attitude,” and had friends and employees willingly help him to grow the business.

ZZZZ Best was “a growth-oriented firm dominated by its young and aggressive entrepreneur” (Knapp 4th Ed. 29). Minkow was able to plan the fraud with painstaking detail, going to great lengths and spending millions to cover the fraudulent actions. The fraud was convincing as “management generated fake receivables and then arranged for payments on those receivables to make it appear that a normal cycle of transactions was occurring” (33).
Minkow was adamant about refusing to allow the auditors access to his customers, incredibly restricting their ability to perform any external confirmations. In addition to confirming the material amounts due, what a company’s principal customers say about them can be a key indicator of the company’s ethics and operating style. Furthermore, the auditor must understand a company, its culture, and its operating style to plan and perform an effective audit. In fact, SAS 99 (AU Section 311) requires the audit “to be adequately planned (with) knowledge of an entity’s business…ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity.”

After the audit partner in charge of the ZZZZ Best engagement insisted on inspecting a restoration site, Minkow ordered two of his employees to take action. The two employees acted as leasing agents and were able to convince a manager at a Sacramento area construction site to give them the keys to the building for a weekend to show the site to a prospective tenant. They dressed the site with ZZZZ Best signs and presented their work to the Ernst & Whinney partner. The fabrication worked and the auditors were duped. Although the auditors at Ernst & Whinney demanded to visit selected insurance restoration job sites, they misguidedly agreed to sign a controversial confidentiality agreement that kept them from obtaining further evidence from independent third parties to confirm the insurance restoration contracts.

The scheme blew open when an LA Times reporter, at the urging of a cheated housewife, ran an article exposing Minkow as a credit card fraudster. To counter the negative press, Minkow drafted and submitted his own press release proclaiming record
profits at ZZZZ Best, without the counsel of his auditors. At the same time, an informant approached Ernst & Whinney with information of the fraud at ZZZZ Best. With evidence of the fraud mounting, Ernst & Whinney resigned as auditors. Subsequently, securities investigators probed ZZZZ Best’s financials, finding countless fictitious accounts. The company immediately fell into bankruptcy and Minkow faced criminal action. While the company’s market capitalization reached $200 million, its assets were liquidated for just $62,000.

WHERE WERE THE AUDITORS?

After the fraud was exposed, much of the criticism fell on the auditors for failing to uncover the fraud and the numerous multi-million dollar insurance restoration contracts. The company’s first auditor was George Greenspan, a one-man operation. He confirmed ZZZZ Best’s material insurance restoration contracts through Tom Padgett, Minkow’s close friend. Minkow had earlier convinced Padgett to establish both Interstate Appraisal Services and Assured Property Management to generate the fake business for ZZZZ Best. Greenspan performed confirmations, analytical procedures, and reviewed key documents. All of his procedures showed nothing out of the norm.

Following the IPO, Ernst & Whinney took over. After ZZZZ Best went public, stock underwriters had encouraged Minkow to hire a national Big 8 accounting firm. Accordingly, Minkow hired Ernst & Whinney, who initially performed a review of the company’s quarterly financial statements for the three months ending July 31, 1986. In early 1987, before completing its audit and prior to issuing an opinion, Ernst & Whinney resigned amid growing concern over the legitimacy of ZZZZ Best’s accounts.
Considering the limited duties and scope involved in a review, the review was not likely to uncover the fraud. After all, “the purpose of a review engagement is to obtain a reasonable basis for providing ‘limited assurance’ that a given client’s financial statements have been prepared in conformity with generally accepted accounting principles” (Knapp 4th Ed. 31). In contrast, the objective of an actual audit is more affirmative and is expected to provide a reasonable, versus limited, basis for expressing an opinion about the fairness of the financial statements.

Ernst & Whinney was publicly chastised following the fraud. They allegedly missed several red flags, including the following facts:

- virtually all of the insurance contracts were from the same party
- a large number of contracts occurred immediately prior to the IPO
- ZZZZ Best’s margins were not proportional to the industry averages
- the internal controls of ZZZZ Best were limited and ineffective.

In addition, prosecutors would also argue that Ernst & Whinney likely “was not completely familiar with certain key business practices prevalent in the insurance restoration industry” (29).

The confidentiality agreement severely limited the auditors’ scope. While it is unclear if they even wanted to, the auditors were unable to contact the building’s owner, insurance company, or any other third party involved. When such a scope restriction occurs and the auditor is unable to overcome the limitation through additional procedures, the auditors should issue a disclaimer of opinion. A disclaimer of opinion is a report issued by the auditor when they have not been able to obtain satisfaction that the overall financial statements are fairly presented.
Additionally, the third audit standard of fieldwork mandates that an auditor must “obtain sufficient competent evidential matter to support the opinion ultimately rendered on a client’s financial statements” (31). It is expected that the evidence be both relevant and valid to provide proper assurance. While external confirmations are generally very reliable evidence in support of the existence assertion, they failed to provide the proper support because Minkow had established the businesses that returned the confirmations.

Likewise, physical examination is also generally very reliable in support of the existence assertion. Although the auditors did prove some degree of existence with their site inspection, the client lacked the legal right to the particular assets. As a result, the auditors should have pursued the rights and obligation assertion, as dictated in SAS No. 31. Had the auditors pursued the contracts and the sites slightly further, in addition to the documents they had already received, they would have satisfied this assertion and discovered the fraud.

ZZZZ Best contracted with three different auditing firms during their five years, and the communication between the first and second, and second and third auditors was questioned. SAS No. 7 “Communications between Predecessor and Successor Auditors,” later superseded by SAS No. 84, outlines the requirements for a change of auditors. The successor auditor is responsible for contacting the previous auditor after gaining permission from the prospective client, but before accepting the audit engagement. Further, the client should authorize the previous auditor to respond to the new auditor’s inquiries. The communication efforts allow the new auditor to gain knowledge of the
client’s integrity, any potential accounting conflicts or issues, audit committee relations, and the reasons for the auditor change.

Despite these requirements of generally accepted auditing standards (GAAS), the first auditor, George Greenspan, held that Ernst & Whinney did not contact him at all. Ernst & Whinney alleged otherwise. After Ernst & Whinney resigned, Price Waterhouse assumed the auditing duties and made the standard inquiries of the previous auditors. Ernst & Whinney was perhaps less than forthcoming in their disclosures, claiming that no prior disagreements with management existed and that they resigned simply because they did not want to be associated with ZZZZ Best’s financial statements. Ernst & Whinney made no mention of the potential fraud.

**CONCLUSION**

Soon after the ZZZZ Best debacle, the Treadway Commission was appointed in 1987 to study fraud and the current accounting environment. The commission would ultimately issue reports recommending changes that largely went unaccepted. However, both in the past and the present some contend, “the reality is that regulation can only do so much – unlimited wants are tempered by limited means. Since the SEC lacks omniscience, the onus of returning public trust to corporate financial reporting rests, ironically, with the people who prepare and use financial statements – namely, the accountants, analysts, and executives” (qtd. in Brown). Nevertheless, despite the apparent lack of success in forcing changes, the American Institute for Certified Public Accountants (AICPA) did use the word “fraud” for the first time in a 1988 auditing
standard and would build on this move years later when expanding the auditor’s responsibility for detecting fraud.

Following the fraud’s discovery, Minkow was convicted on 57 counts of securities fraud and sentenced to 25 years in federal prison. The ex-con was released in 1994 and now serves as a pastor in California. His work also includes lectures and seminars on fraud where he frequently challenges the government to step up their prosecution efforts and challenges auditors to be more critical. “Like many other daring financial frauds, the ZZZZ Best scandal caused Congress to reexamine the maze of rules that regulate financial reporting and serve as the foundation of the US system of corporate oversight” (Knapp 5th Ed. 120).

Ernst & Whinney was found not liable on the largest of the civil suits that arose. Other suits were settled out of court for undisclosed sums. From an auditing perspective, the case reinforces the need for an attitude of professional skepticism by the auditors. When the client places substantial constraints on the auditor, their ability to adequately perform the audit is limited and the associated risks are certainly raised, requiring the auditor to respond with increased procedures.
CRAZY EDDIE

“Honesty pays, but it doesn’t seem to pay enough to suit some people.”  F.M. Hubbard

Currently, the accounting profession is undergoing a debate concerning the application of the Sarbanes-Oxley Act and the auditing standards established by the Public Company Accounting Oversight Board (PCAOB) to private companies. One argument holds that many private companies will eventually seek financing in the public capital markets and thus, should follow the same provisions as public companies. The Crazy Eddie fraud can be used as an excellent illustration of these arguments. In the 1980s, Crazy Eddie was a growing electronics retailer and sought to inflate their books for a better IPO.

The Crazy Eddie fraud is also an example of both fraudulent financial reporting and misappropriation of assets. The company skimmed cash, overstated inventory, and used a number of memorandum entries to appear more financially lucrative prior to the IPO, and then continued and even expanded the fraud to boost its CRZY stock price after going public.

BACKGROUND

Eddie Antar grew up in his father’s retail business in a Syrian Jew neighborhood in Manhattan. Eddie was destined to follow his father in the retail business. Antar dropped out of high school at age 16 and began peddling electronics in his neighborhood. After dabbling in a number of sales positions on his own, Eddie teamed with his father and another family member to launch Sight and Sound, an electronics store. His aggressive sales techniques soon earned him the nickname “Crazy Eddie.”
Accompanying his odd behavior, “his quick temper caused repeated problems with vendors, competitors, and subordinates. Antar’s most distinctive trait was his inability to trust anyone outside of his large extended family” (Knapp 5th Ed. 110).

Eventually, Sight and Sound turned into Crazy Eddie’s, a big box electronics retailer. Eddie’s exuberant personality and charisma guided the company, its culture, and fueled the business’s growth, known for their INSA-A-A-A-ANE! prices and their pledge not to be undersold. Even without the fraud, Eddie’s business was legitimately successful and he was the first to prove that a freestanding electronics store could work profitably. Despite the stores’ success, Eddie was compelled to steal from the beginning, just as his father and all the other Antars had done with their previous retail businesses.

The fraud began simply enough, paying some employees off the books, just as one would do a babysitter. In fact, tax records show that one store manager, Allen Antar, claimed that his entire compensation was $300 weekly. Of course, he managed to drive a Jaguar, while supporting a wife and three kids, “two of whom were in private school with a tuition of approximately $25,000” (Wells Frankenstein 225). Eddie personally skimmed cash from the beginning, choosing not to report some sales and distributing the excess cash to his family members.

The schemes grew as the company did. The company went public in 1984, garnering capital to finance an aggressive expansion plan. In its first year as a public company, Crazy Eddie’s sales grew by 55% from $29 million to $46 million. Net income soared from $538 thousand to $1.141 million. As a result, investors loved the
company and it’s 17-cent per share dividend. Its price-to-earnings ratio was the highest in the industry and not in 15 years had one single store in the company reported a loss.

Yet the IPO came a full year late. After discovering that the financial records were careless and incomplete, the underwriters delayed the IPO. The underwriters also expressed concern over the number of related-party transactions, amount of unqualified family members acting as executives, “interest-free loans to employees, and speculative investments unrelated to the company’s principal line of business” (Knapp 5th Ed. 111). The underwriters encouraged Eddie to hire a national accounting firm and an experienced CFO. Eddie hired the national accounting firm Main Hurdman as the auditors, but chose to tab his younger brother, Sammy, as the CFO. “Eventually, Antar’s father, sister, two brothers, uncle, brother-in-law, and several cousins would assume leadership positions with Crazy Eddie, while more than one dozen other relatives would hold minor positions with the firm” (110). Despite the concerns, the IPO was successful and, in fact, was even oversubscribed.

By 1987, the company reported annual revenues of $350 million with 43 stores. Throughout the early 1990s, the VCR was fueling electronics sales. At the same time, “ Antar blanketed this region with raucous, sometimes annoying, but always memorable radio and television commercials” (111). The consumer electronics industry experienced considerable growth between 1981 and 1984. However, in 1986, the growth plateaued and sales dipped. As Crazy Eddie’s growth trend continued, the auditors should have grown increasingly suspicious.
A bitter divorce between Eddie and his wife divided the family and resulted in the forced removal of a number of executives. Additionally, the tripling of the sales volume in three years added significant complications to the company’s books and to the amount of work needed to maintain the fraud. In a fit of rage, Eddie relinquished his role as company president and then completely dropped out of sight weeks later.

Larger companies began to catch wind of Crazy Eddie’s remarkable success and sudden organizational woes, and a number of takeover threats soon emerged. Ultimately, a hostile takeover led to a proxy fight that resulted in the Oppenheimer-Palmieri Fund assuming control and immediately led to Eddie’s permanent ouster. CFO Sammy Antar, with the fraud becoming increasingly difficult to manage, left immediately and gave the new owners a prophetic greeting on his way out. The fraud was uncovered soon thereafter and the new owners, despite efforts to reform the troubled business, were forced to close the stores and declare bankruptcy. During this time, Eddie was on the run, using a number of aliases and the foreign funds he had accumulated over the years to maintain his prolific lifestyle overseas. However, he, along with several other Antars, was soon sentenced in a federal court.

**Fraud Logistics**

Dishonest organizations usually use a combination of several methods to commit fraud and ultimately, the SEC and FBI were able to document several areas of fraudulent activity, claiming that the Antars had:

- listed smuggled money from foreign banks as sales
- made false entries to Accounts Payable
- overstated inventory by breaking into and altering audit records
taking credit for merchandise as “returned,” while also counting it as inventory

sharing inventory from one store to another to boost each store’s inventory count

arranging for vendors to ship merchandise and defer billing

claiming phony discounts and advertising credits

selling large lots of merchandise to wholesalers, then spreading money to individual stores as retail receipts.

After taking the company public at an initial $8 a share, Eddie, through a combination of legitimate sales growth and complete chicanery, had boosted the company stock to a peak of $80 per share. Thus, the schemes’ motive was to maintain the stock’s growth and as principal shareholders, Eddie and his family benefited as a result. Furthermore, the lackluster effort of the auditors provided an opportunity to carry out the inventory fraud.

Cash

Throughout the early years, Eddie and the family skimmed cash, taking money from the business to line their own pockets. Much of the money ended up in international banks, principally the Bank of Leumi in Israel. Gradually, and sometimes not so gradually, funds were moved to Israeli banks, often physically transferred by the Antar family who either carried suitcases full of cash or boldly taped wads of bills around their chest aboard overseas flights. Skimming the cash initially enabled the Antars and the company to avoid taxes.

The actions violated federal law, which defines money laundering as “the concealment of the existence, nature, or illegal source of illicit funds in such a manner that the funds appear legitimate if discovered” (Murphy). Additionally, congressional testimony explains:
If the money can be gotten into a bank or other financial institution, it can be wired to any place in the world in a matter of seconds, converted to any other currency, and used to pay expenses and recapitalize the corrupt business. The problem for the tax evader then, is how to get his money into a form in which it can be moved and used most effectively without creating a ‘paper trail’ that will lead law enforcement authorities to the illegal business. The process of doing that is money laundering. There are many ways it is done (Keeney).

After going public and needing to maintain the impressive sales growth, Sammy Antar created what came to be known as the Panama Pump. This fraud scheme manipulated the family’s international banking connections to bring the skimmed money back to the US and into the company as a method of managing earnings. The money was brought back to the US from the Israeli bank through a Panamanian bank using “double secrecy jurisdiction.” The money would then be recorded as sales revenue to help boost Crazy Eddie’s same-store-sales ratio, a critical growth measure used by stock analysts. Thus, the Antars, an extended family who all owned stock, were giving up the money they had illegally taken to increase the CRZY stock price, and of course in turn, increase their own wealth.

Inventory

In one of the most audacious parts of the fraud, Crazy Eddie employees literally broke into the auditor’s records and falsified their numbers, specifically increasing inventory counts. These actions illustrate to auditors the importance of properly securing records. Continuing, they would further maximize their inventory levels by shipping merchandise overnight from one store to another in preparation for the auditor’s count the next day.
Inventory was also said to have been “returned to manufacturer” that was actually still sitting in the warehouse. These moves allowed Crazy Eddie to book a credit from the manufacturer, while also still counting the merchandise as inventory. At one point, desperate for a better balance sheet, Crazy Eddie was able to convince a vendor to ship merchandise just prior to year-end, while deferring billing until the following year, ignoring the matching principle. The company’s assets were then even further overstated, while liabilities were understated. When auditors would question any of the transactions, Crazy Eddie would conveniently lose the needed report and the naive auditors would be unable to pursue the matter.

The inventory hijinks continued, further implicating manufacturers. For certain items, Eddie was able to negotiate terms to be the sole provider of a product in his market. Eddie would place an order larger than he needed at the negotiated reduced rate and then conspire to ship the excess off to a distributor who would move the product to another retail market outside the NYC area. Conveniently, Eddie was able to arrange for the distributor to settle the account in a number of small $10,000 checks that he could then sprinkle around to the stores as sales revenue without attracting attention, again fraudulently increasing the essential same-stores-sales ratio.

Finally, Crazy Eddie improperly valued its inventory through a number of schemes that overstated inventory by $65 million. Although the company used appropriate values for each inventory item, the company clearly used completely inaccurate quantities for inventory, thereby overstating its assets and consequently equity.
By sharing inventory between stores, inventory was double counted. In addition, after breaking into the auditor’s records, Crazy Eddie easily altered the quantities involved.

In its first year as a public company, inventory and gross profit were overstated by $2 million. In its second year, inventory was overstated by $9 million and accounts payable was understated by $3 million. In the end, inventory would be overstated by $65 million.

Liabilities

As the New York metro area’s premier electronics retailer, the largest consolidated retail market in the nation, Eddie was able to leverage his suppliers to his advantage. Eddie would simply vow not to carry a manufacturer’s products if they didn’t succumb to his terms. As a result of his coercion, suppliers gave Crazy Eddie considerable discounts and advertising rebates.

The Antars further used the aforementioned discounts to their advantage. As needed, the company would split a payable on its books, claiming as much as half was resolved through bogus discounts and ad credits, thereby fraudulently decreasing the company’s liabilities. As some of the discounts were legitimate and some weren’t, it was “tough to know what was smoke and what was fire” (qtd. in Wells Occupational Fraud 442).

Often due to pressure to meet goals, the timely recording of expenses and liabilities is compromised, despite GAAP’s requirement to “match” accounts in the same period. The matching principle is one of the fundamental assumptions underlying accrual accounting. Eddie had the inventory on hand just before year-end and appropriately
included it in the year’s inventory count. However, Crazy Eddie failed to accrue the corresponding liability until after year-end. As a result, the company’s liabilities and expenses were understated and equity and income were both overstated.

The understatement of liabilities was continued to make the company appear more profitable. The company did have legitimate vendor discounts and advertising credits, yet created phony credits to erase significant levels of liabilities. As a result, the balance sheet was improved. Because some of the credits were genuine, the auditors assumed all were justifiable. External confirmation with vendors may have brought these fraudulent moves to light.

Revenue

Compliance with GAAP and especially with revenue recognition rules is not easy and can produce fatal errors. However, both Crazy Eddie and their financial statement auditors demonstrated a complete lack of both concern and conformity with the applicable accounting and auditing standards. The company deliberately set out to inflate its earnings through a number of fraudulent financial measures.

“Revenue recognition has perennially been one of the hottest of the SEC’s buttons” (Basile). Indeed, with loose rules, revenue recognition provides perhaps the greatest opportunity for fraud and “studies of detected accounting irregularities have found that more than half of the fraudulent financial reporting cases involved overstated revenues” (Basile). As a result, SAS No. 99, which recently superseded the AICPA’s 1997 statement SAS No. 82, specifically labels revenue recognition a fraud risk that must be appropriately addressed by auditors. Staff Accounting Bulletin 101, issued by the
SEC, offers additional guidance on revenue recognition and states that the SEC considers improper revenue recognition as the major cause of fraudulent financial reporting.

In this case, Crazy Eddie booked numerous fictitious revenues. The money that was obtained by squeezing manufacturers was split between the stores. In addition, the skimmed cash was brought back to the US and recorded as sales revenue, again sprinkled between stores. These actions failed to meet the definition of revenue as outlined by Statement of Financial Accounting Concepts No. 3, which defines revenue as “actual or expected cash inflows that have occurred or will eventually occur as a result of the enterprise’s ongoing major or central operations during the period.” Of course, recording revenue that does not meet this definition is not in accordance with GAAP. The money received from manufacturers should be reported as a gain, a separate component of income from continuing operations, and should be adequately disclosed.

With the goal of increasingly outperforming the previous year, the frauds enabled Eddie to create fantastic comparable numbers. In fact, the company’s earnings per share doubled during its first year as a public company. Stock analysts fawned over the company, enthusiastically giving it consistent “buy” ratings, largely based on these fabricated comparable numbers.

WHERE WERE THE AUDITORS?

The auditors ignored several signs of potential risk. For instance, Crazy Eddie lacked strong internal controls, Eddie dominated all leadership activities, the electronics industry was especially volatile, and several key account balances exhibited unusual relationships (Knapp 4th Ed. 45).
Inventory is a significant asset for a retailer and received considerable attention from the auditors as a result. Inventory grew from $23 million in 1984 to $110 million in 1987. Additionally, inventory turnover slowed and the average age of inventory rocketed in 1987. Both measures increased the risk of inventory obsolescence and created potential valuation problems for the auditors. Of further concern, although inventory grew, accounts payable fell during 1987. Continuing, although assets grew each year, accrued expenses fell in 1987. Likewise, accounts receivable turnover plummeted in 1987. Thus, the account balances showed some unusual relationships and fluctuations that should have prompted additional investigation.

Crazy Eddie employed four different auditors during their chaotic history. The first auditor, a local firm, was dismissed at the urging of the underwriters. Main Hurdman was then hired. Main Hurdman would then merge with Peat Marwick to become the third auditor. After the takeover, Peat Marwick was terminated and Touche Ross was brought on board. Despite the number of auditors or perhaps because of, the fraud was never uncovered by any of them.

Main Hurdman had allegedly “lowballed” their initial bid to win the audit, charging a meager $85,000. Consequently, they were more likely to limit their tests to the minimum. Main Hurdman’s independence and objectivity were also criticized. Some of Eddie’s accountants were former Main Hurdman auditors. In addition, Main Hurdman developed Eddie’s inventory system, the very system it was supposed to audit. Despite the high-tech inventory system, Eddie refused to utilize it, instead relying on an old-fashioned, manual system that he could more easily manipulate.
CONCLUSION

The sheer magnitude of the Crazy Eddie fraud is daunting. Likewise, it took years for the federal government to build their case to prosecute the Antars after digging through the financial data. This case again shows the extent that fraudsters go to simply to cover their con.

In June 1989, following the takeover, the new owners of Crazy Eddie filed for Chapter 11 bankruptcy. Eddie was finally arrested in June 1992 in Israel. He was convicted in July 1993 on 17 counts of financial fraud, including racketeering, conspiracy, and mail fraud. He was sentenced to prison and ordered to repay some $121 million to his stockholders and creditors. Likewise, Sammy Antar and several other family members and executives were also convicted. Years later, after being released early from prison, Eddie joined two nephews in reviving the Crazy Eddie business. The company largely operates through the Internet with telephone sales as well. For their involvement, both Peat Marwick and Crazy Eddie’s first auditor, the local firm, contributed to a $42 million settlement pool.
PHAR-MOR

“The art of capitalism at work is getting to the edge without going over.” Larry Elliott and Richard Schroth. How Companies Lie.

Akin to the Crazy Eddie fraud, the Phar-Mor case again involves a retail enterprise, inventory overstatements, and both fraudulent financial reporting and misappropriation of assets. Indeed, the adage held true and history was bound to repeat itself. Despite the remarkable similarity between the two well-known cases, the auditors again completely failed to discover the fraud, missing the many warning signs and ignoring the high-risk elements of the engagement. Yet again, the scrupulous, yet dedicated, fraudsters showed that they were capable of fooling everyone for an extended period of time.

Based in the industrial town of Youngstown, Ohio, also appropriately known as “Crimetown USA,” Phar-Mor was a deep discount retailer that, during its heyday, took on the likes of Walmart. Under the direction of high-rolling entrepreneur, hometown hero, and COO, Mickey Monus, the company, which was formed in 1982, quickly expanded, locating some 310 stores in 32 states with over $3 billion in sales. After the fact, Phar-Mor was named a “white-hot commodity in a sizzling industry” by PBS’s investigative show “Frontline.” From his prominent position, Monus lived lavishly with his half million-dollar salary. Rather than just playing corporate hardball as he claimed, Monus managed a corporate fraud that soon got out of hand and, until recent years, remained one of the largest US corporate frauds of all time.
BACKGROUND

During a period of rampant growth, Phar-Mor grew from just 15 stores in 1985 to 310 stores spanning 32 states in 1992. The deep-discount retail chain marketed its “power buying” as a way to achieve lower prices. The promotional message held that Phar-Mor’s “power buying” led to consumer’s “buying power.” Yet, while Phar-Mor did offer many products at incredibly low prices, the prices were actually too low to register a profit. The low prices led to huge losses, which in turn spurred the accounting shenanigans. Under the guise of a growing, profitable retail venture, investors, such as Sears Roebuck & Co. and the Corporate Partners Investment Fund, willingly contributed capital to further the growth. However, 1987 was the last year the company would actually earn a profit.

FRAUD LOGISTICS

Earning its stripe as one of America’s classic frauds, the Phar-Mor case was widespread in the accounts it affected and significant in the amounts involved. Using both fraudulent financial reporting and misappropriation of assets, Phar-Mor committed the fraud by issuing fake invoices for merchandise purchases, making phony journal entries to increase inventory and decrease cost of sales, recognizing inventory purchases but failing to accrue a corresponding liability, and over-counting merchandise.

Poor internal controls and a lack of appropriate management information systems (MIS) provided an opportunity for the fraud to occur. While the company did have an audit committee, Monus spearheaded it and disbanded the internal audit department after they voiced their concerns over controls. Shapira, Monus, and Finn all maintained a
“hands-off” management style that allowed each to maintain their business, while shutting others out. Although several members of senior management colluded on the fraud, Monus and Finn dominated the accounting, giving little access to others. In turn, Shapira chose not to inquire or interfere with their work.

*Fraudulent Financial Reporting*

With prices that were too low, the company’s profit margins were quickly eroded, resulting in a loss of millions. Rather than announcing and recording the losses, Monus merely sought more time to correct the problems. Monus, along with the company’s CFO, Pat Finn, and two other executives, proceeded to cross out the correct figures and insert much inflated numbers on internal documents, setting the course for a series of lies to the company’s owners and financial statement users.

After four months of similar actions, the Pat Finn, took over the task of altering the numbers from Monus, while also maintaining a subledger to keep track of the correct numbers. With losses totaling nearly $18 million, Phar-Mor tried to leverage its suppliers, seeking up-front, exclusivity payments. In fact, through such actions, the company collected $10 million alone from Coke.

By June 1990, well into the fraud and with Monus refusing to raise prices, the CFO was regularly faxing phony reports to the board and to David Shapira, the CEO, at the parent company’s corporate headquarters in nearby Pittsburgh. The Accounting Manager and Controller were both admitted to the conspiracy and also worked to manage the fraud. The collective effort of the senior executives resulted in financial statements that were misstated by over $500 million.
“Phar-Mor’s executives had cooked the books and the magnitude of the collusive management fraud was almost inconceivable. The fraud was carefully carried out over several years by persons at many organizational layers, including the president and COO, CFO, vice president of marketing, director of accounting, controller, and a host of others” (Beasley Auditing 27).

Inventory

Overstating inventory was at the heart of the Phar-Mor fraud. To hide the losses and make the books balance, inventory was grossly overstated. The company used the complex retail method of accounting for inventory. Although the auditors recognized the high-risk nature of this treatment, they failed to thoroughly investigate this accounting procedure.

Accompanying the chain’s rapid expansion, inventory grew from a paltry $11 million in 1989 to $36 million in 1990 to $153 million in 1991. Despite the considerable growth and reflective of the company’s limited use of MIS, Phar-Mor did not utilize a perpetual inventory system. The company relied on the retail method to value inventory. Typically the retail method is used by businesses that sell a large volume of items with relatively low unit costs. The retail method records inventory at the retail price and then converts it to GAAP cost by applying a cost complement percentage.

When in a competitive situation, Phar-Mor would lower a price and then lower the gross margin. The company ignored the lower of cost or market guidelines. Inventory was shared between stores as the audit fieldwork progressed. Thus, the
inventory overstatement was a result of being both incorrectly valued and incorrectly
counted.

When an inventory discrepancy arose in the audits, inventory would be
appropriately credited to reduce the amount. However, rather than debiting the expense
cost of goods sold, Phar-Mor debited a “bucket” account that collected all of the
fraudulent entries. The “bucket” was then emptied at year-end by “allocating a portion
back to the individual stores as inventory or some other asset” (35). These entries were
labeled “Accrued Inventory” or “Alloc Inv” and, although both large and unusual, failed
to draw the attention of the auditors.

*Misappropriation of Assets*

In addition to all of the losses that were masked and the accounts that were
altered, the same executives misappropriated Phar-Mor’s assets, directing over $10
million to Monus’s now defunct World Basketball League (WBL). Initially, Monus
squeezed Phar-Mor suppliers for sponsorship funding in the league, its 6’5” and shorter
players, and the All-American Girls dance squad. Yet, despite the obvious appeal of the
All-American Girls, fans simply didn’t want to see short guys playing basketball. With
the league failing and fan attendance dwindling, Monus was forced to use Phar-Mor
funds to cover numerous WBL expenses. When a Phar-Mor check was sent directly to a
WBL vendor, the fraud began to unravel. CEO David Shapira announced the fraud in
Related Parties

Phar-Mor maintained 91 related parties, as identified after the fraud. These related parties, many set up in a network by Shapira and Monus, created a complex situation that Coopers & Lybrand (Coopers) would later claim prevented them from detecting the fraud. Notably, a highly material settlement with Tamco, a related party, over inventory shortages was largely ignored.

Monus’s involvement with both Phar-Mor and the WBL also created a related-party situation that should have been disclosed in the notes to the financial statements. The auditors should have performed a review for related-party transactions at year-end that may have uncovered some of the transactions. At the very least, a simple inquiry of management should have unearthed the WBL related party. After all, the WBL and Monus were well known throughout the region. Monus’s involvement with the WBL certainly was not hidden from the auditors.

The omission of the note disclosure violates the full disclosure principle and Statement of Financial Accounting Standard (SFAS) No. 57 “Related Party Disclosures,” which holds that related party transactions deemed to be material must be adequately disclosed. The standard states, “relationships between parties may enable one of the parties to exercise a degree of influence over the other” and that “the financial position (may be) significantly different from that which would have been obtained if the enterprises were autonomous.”

Inadequate disclosure of related-party transactions is one of the most serious of financial statement frauds. It is also one of the most difficult to detect. AU Section 334
outlines measures to determine the existence of related parties, including reviewing filings, stockholder listings, and requesting information from management. The auditors should then examine the transactions, including invoices and tests for reasonableness, to determine materiality and the “extent and nature of business transacted.”

Thus, it is clear that the executives led Phar-Mor in a series of faulty endeavors over a number of years. Covering losses, creating fictitious inventory, misstating financial statements, and misappropriating the company’s dwindling assets, fraud was significant, to say the least.

WHERE WERE THE AUDITORS?

Phar-Mor easily skirted the annual audit by Coopers. The Coopers partner leading the audit had previously came under scrutiny for missing audit budgets, and thus, was under increased pressure to maintain audit costs. Continuing, the fact that Monus was likely to contribute additional business to the accounting firm led to a desire to please him.

Eager to cut costs and in the first year of their engagement, Coopers chose to audit the inventory of just four of the company’s 133 stores, certainly not enough to gain a reasonable assurance of the inventory count’s accuracy. Furthermore, typically, when “under cost pressure, firms put less senior auditors in charge of tasks more suitable for experienced auditors” (Frieswick). Phar-Mor knew in advance which stores would be targeted. Of course, Phar-Mor was then able to ensure that these stores maintained the correct inventory level and was able to avoid further scrutiny from the auditors. To top off the oversights, the accounting firm consistently proclaimed a profit for Phar-Mor.
The same inept procedures by the auditors and corrupt moves by Phar-Mor management occurred repeatedly throughout the nearly five-year fraud.

The impressive growth levels went unquestioned. The consistent entries involving the “bucket” account were surely conspicuous on each store’s books, yet were not investigated. The significant exclusivity payments received from vendors should have also been a cause for concern and a source of further inquiry. Finally, Coopers failed to follow the appropriate auditing standards of fieldwork governing inventory.

In auditing inventory, the auditors performed their procedures during the fiscal year. Consequently, it was necessary to the roll the numbers forward to the June 30 year-end. The roll forward procedures produced a large increase in the ending inventory numbers. Phar-Mor justified the spike by saying that they loaded up on inventory just prior to the July 4th holiday due to anticipated demand and significant discounts offered by vendors this time of the year. Coopers accepted this explanation without dispute.

Clearly, many of the auditor’s efforts were easily compromised. Some members of the Phar-Mor fraud were former auditors, including one who had even worked for Coopers on the Phar-Mor engagement. As a result, these former auditors were able to easily disguise the fraud to skirt the auditor’s materiality levels, tests, and procedures. The auditor’s independence was certainly impaired.

CONCLUSION

Although revenue recognition’s importance has also been underscored, in “a 1999 study, the Committee of Sponsoring Organizations of the Treadway Commission found misstated asset valuations accounted for nearly half of the cases of fraudulent financial
statements” (Wells *Ghost Goods*). In this case, armed with only his gift of gab and a set of highly inflated numbers, Monus became a local icon and Phar-Mor gained cult-status in Northeastern Ohio. Despite Phar-Mor’s consistent losses, Monus pumped $10 million of Phar-Mor’s money into the World Basketball League. Altering numbers and misappropriating assets, Monus led the company to bankruptcy. The ineffective and limited audit work of Coopers & Lybrand allowed the fraud to continue for so long.

Monus was ultimately convicted of accounting fraud and sentenced to 19 years and seven months in prison. Pat Finn was also sentenced to prison, while others received hefty fines. The combined five-year fraud inflated equity by $500 million, while also causing $1 billion in losses and bankrupting Phar-Mor, then the 28th largest private company in America. Consequently, Phar-Mor laid off 16,000 employees, and closed 200 stores.

Auditing firms must now recognize that their integrity, key to providing their services, rides on every engagement and must take appropriate actions to ensure that this integrity is upheld. Currently, accounting firms, with the leverage provided by Sarbanes-Oxley, are shifting from the cost-pressured audit situation of the past to more quality audits.

The massive “fraud was a collusive effort of multiple individuals within the upper management at Phar-Mor who continually worked to hide evidence from the auditors” (Beasley *Auditing* 29). Although the fraud itself did not indicate that the audits had failed, the investors and creditors held that Coopers failed to follow GAAS throughout their audit. Consequently, these plaintiffs felt the auditors were responsible for the
losses. The five-month trial concluded that a five-year fraud should have become evident
to an attentive audit team. Initially, 38 suits were filed against Coopers. Many settled
out of court for undisclosed sums, but eight chose to pursue their claims in a jury trial
where Coopers was found guilty under both state and federal law.
“Any fool can tell the truth, but it requires a man of some sense to know how to lie well.” Samuel Butler

Although many of the previous cases have focused on inventory fraud, this definitely is not the only account that can be manipulated. Likewise, both profit and non-profit, public and private, service and retail companies can all falsify their financial records. Given these circumstances, the following description of a recent non-profit fraud is certainly appropriate. In fact, with the breadth of such actions continually growing, the current cost of fraud is estimated at $600 billion annually by the Association of Certified Fraud Examiners.

John “Jack” Bennett was certainly ambitious. While he claimed his intentions were worthwhile, his actions failed to back up these assertions. He failed to deliver on a number of promises and commitments to his clients and investors. While currently there are no definitive, “empirical studies on the frequency of fraudulent acts committed by charities, existing data strongly suggests that a wide range of criminals are stealing more than $21 billion from charities in the United States each year” (Mizel 98-99).

BACKGROUND

After taking seven years to complete his undergraduate education at Temple University, Jack landed a teaching job and then surprisingly was granted admission to medical school. He flunked out in his third year and, through his wife’s obstetrician, landed a position as a drug counselor. Social work was just gaining popularity and Jack and a few others formed the non-profit Community Organization for Drug Abuse Control (CODAC). CODAC secured some government funding and set up seven chapters
throughout Philadelphia. The success landed Jack a position on Pennsylvania’s Council
on Drug Abuse. Despite the position’s prominence, the disparity between traveling
throughout the state and the needs of his family forced Jack to resign.

Jack remained committed to public service and formed Nova Institute
International (Nova). Nova’s mission was to collect funds for other non-profits in
exchange for a small percentage of the funding obtained. Grant-making agencies were
suspicious and shunned Nova. While Nova was failing and his family struggling
financially, Jack was making important connections in the religious and political arenas.

Nova collapsed in 1982, falling into bankruptcy. Jack responded by creating
Human Services Systems (HSS) and the Foundation for New Era Philanthropy (New
Era). HSS had the support of several notable businessmen and city council members.
HSS contracted with large corporations to provide their employees with mental health
services. New Era operated to raise and distribute grant money.

Funds were scarce and Jack frequently switched money between the two ventures
in a check-kiting scheme. Often, employee paychecks bounced. When writing such
checks, Jack knew the funds failed to exist, but insisted that he acted on faith and that
God would take care of it. One prominent executive resigned from his New Era post
after discovering that Jack had wrote himself a $300,000 check, misappropriating grant
money for his personal use.

In 1989, the check-kiting scheme had created huge debts. In the inner circle of
Philadelphia business, political, and religious executives, Jack professed to have an
anonymous donor ready to match donations dollar for dollar. Jack then collected twenty
$5,000 donations and used this money to pay his liabilities. Fortunately for Jack, he soon received a $250,000 grant that he used to pay the donors back.

The scheme grew and Jack claimed that his anonymous friend was prepared to match donations again, now at a minimum of $50,000. New Era collected $360,000 in 1990 in contributions, $1.3 million in 1991, $9 million in 1992, and $41 million in 1993. The enormous volume required expanding to six the number of “anonymous benefactors” who were paying the matches.

**FRAUD LOGISTICS**

The Foundation for New Era Philanthropy was not even really foundation. New Era had no endowment. New Era did not even have a board of directors. Yet, New Era collected $160 million in 1994, easily matching the $41 million they had collected in 1993 from donors. The Ponzi scheme now stretched across several years and continued to balloon. Jack was robbing Peter to pay Paul.

With so many excess funds, New Era transferred enough to HSS to keep it alive. Jack knew that if HSS went bankrupt the negative attention would be detrimental to New Era. Jack also ignored New Era’s mission and casually donated $1.1 million to his friend’s fledgling Multi-Media Publishing Company.

While Jack publicly announced that he received no compensation from New Era, some $2.5 million was diverted from New Era to Bennett Group International from 1993 to 1995. Bennett Group International was merely a shell company, paying Jack’s salary. As a result, Jack and his wife lived lavishly, as did his daughter and son-in-law who also drew New Era paychecks.
New Era operated solely through its Ponzi scheme, akin to Charles Ponzi’s fraud in Boston in 1919. “By constantly robbing Peter to pay Paul, Ponzi schemes are able to pay generous returns to some investors” (Mizel 102), but require an ever-growing number of contributions to keep it afloat. In addition to a hundreds of other non-profits, many wealthy individuals fell for the scheme. Former Treasury Secretary William E. Simon, Laurance Rockefeller, and John C. Whitehead, former cochairman of Goldman Sachs, all contributed millions.

New Era filed for bankruptcy in May 1995. At the time, the non-profit had liabilities of $551 million and assets of just $80 million. The collapse threatened “hard times and even extinction for many schools, museums, ministries, libraries, and other groups that had entrusted their futures to the foundation” (102). In orchestrating the fraud, Bennett misappropriated over $55 million during the first four months of 1995 alone. Additionally, much of the fortune was diverted to private businesses that Jack Bennett owned. The foundation also violated tax laws. New Era’s 1993 IRS tax return claimed the foundation donated $34 million in charitable gifts that year, yet those who were to receive the gifts had never heard of New Era, let alone received funds from them. Although the auditors just performed a review, New Era distributed an audit report. While New Era did not have a board, they maintained a list of members that they referred to as the board when pressed.

An accounting professor from Michigan exposed the fraud. After reviewing the financial statements and its glaring inaccuracies, the professor sought out both the auditors and Jack himself for answers. The professor recognized the Ponzi scheme
immediately. While New Era claimed to invest $100 million a year, they earned just $33,000 in interest dividends in 1993. If the investment account were even just $10 million, yearly dividends would have ranged from $600,000 to $1 million. Clearly, they weren’t holding the funds to earn interest.

The professor was finally able to attract the attention of a Wall Street Journal reporter who took the story national. New Era employees could not believe the allegations and Jack himself insanely claimed that he thought the anonymous donors really did exist.

**WHERE WERE THE AUDITORS?**

McCarthy & Company (McCarthy) served as the financial statement auditors for New Era throughout the fraud. The audit engagement began soon after Bennett donated $15,000 to McCarthy’s campaign for a failed run for Congress. Already, the auditor’s independence and objectivity were impaired. Independence is an essential characteristic of an auditor, providing the basis for public confidence in the integrity of the auditor’s opinion. McCarthy directed Andy Cunningham to lead the audit with the instructions to keep Bennett happy. Indeed, over one third of the accounting firm’s business would be from Jack’s New Era group.

In 1994, Cunningham questioned $100,000 in personal loans on the New Era financial records. Jack urged Cunningham to call it a “deposit in transit” and promised to write a check for the amount immediately. Likewise, Jack insisted on ignoring any related-party transactions and the board meeting minutes, which of course did not exist.
Even more concerning was the $41 million in donor’s contributions. The money was called “charitable contributions” and listed as revenue. No liability existed for the amount that New Era had to repay. Jack assuaged the concerns, stating that the donor’s had already been repaid.

When Cunningham mentioned to Jack his personal financial troubles, Jack immediately wrote a $50,000 check. Ironically, the check bounced and Jack had to write another from his personal account. Cunningham would later collect an additional $25,000 check with the understanding that Jack would not have to answer any more tough questions.

The auditors failed to maintain a level of independence, objectivity, or professional skepticism in their audits. They lacked the audacity to stand up to their high-profile client and were muscled into succumbing to Bennett’s demands. Their audits were limited, indeed, only a review was performed, and were completely ineffective.

**Conclusion**

In defrauding investors and donors of some $135 million, Jack Bennett was sentenced to 12 years of prison, convicted of 82 counts of fraud and related charges. Cunningham was convicted for knowingly issuing false financial information. He was able to testify against Bennett in exchange for a reduced sentence.

Today, and perhaps as a result of such fraudsters as Jack Bennett, non-profits are more heavily scrutinized. The organizations are regulated at both the federal and state level through reporting requirements and tax regulation. Financial statement,
compliance, and performance audits may be performed. In addition, a number of extensive watchdog groups, such as Charity Navigator, GuideStar, and Charity Watch, all help consumers to evaluate non-profit organizations, monitoring their activity and ensuring that donors’ funds are used for appropriate purposes.
Despite the many shocking frauds through history, accountants have largely succeeded and have “helped develop the capital markets...brought credibility to complex business practices...and are central to the information revolution that is now transforming the global economy” (Giroux). Just as the advent of the information age has made it easier and faster to store and manipulate large amounts of data, it has also made it easier and faster for criminals to commit fraud. To hide falling profits, some managers are increasingly seeking out the gray area within GAAP to bolster their financial reports. As a result, regulators must consistently respond to the fraud. Many of these frauds have created permanent changes in client-auditor relationships and accounting and auditing principles and statements, affecting the way companies do business now and into the future.

The Sarbanes-Oxley Act has recently emerged to change the way auditors and their clients interact, imposing a number of new limitations and mandates in an attempt to restore investor trust, as a direct result of the Enron fraud. Currently, the Financial Accounting Standards Board (FASB) employs a full-time research staff, while issuing countless statements in calling for firms to abide by GAAP. Recent events have forced widespread changes, altering both the accounting and auditing landscapes. As both auditing and accounting standards continue to improve, the chance of these frauds going unnoticed for so long is greatly reduced.
BACKGROUND

Enron evolved from a series of mergers and acquisitions. Its roots can be traced to the Northern Natural Gas Company (Northern), which was founded in 1930. During the Great Depression, the cheap cost of natural gas spurred Northern’s growth. The company created a network of pipelines to transport natural gas to its markets. The company went public in 1947 with a listing on the New York Stock Exchange.

The company was a key player in the development of the Alaskan pipeline throughout the 1970s. In 1980, Northern became InterNorth, Inc. The company began to diversify its operations, seeking investments in oil exploration, chemicals, coal mining, and fuel-trading operations. In 1985, InterNorth acquired Houston Natural Gas Company, giving InterNorth control of some 40,000 miles of pipeline.

In 1986, InterNorth changed its name to Enron and Kenneth Lay, former chairman of Houston Natural Gas, became CEO. Lay relished the growth strategy and the aggressive exploration of new revenue sources that InterNorth adopted in the early 1980s. Lay brought Jeffrey Skilling, a former McKinsey & Co. consultant, on board. Together, propelled by the deregulation of the electrical power markets, the executives led Enron’s move to an energy-trading company, acting as an intermediary between producers and users of energy products, such as electricity and natural gas.

The new Enron focused on four business segments. Energy Wholesale Services was the largest, maintaining EnronOnline, a business-to-business commodity trading site. Enron Energy Services, Enron Transportation Services, and Enron Broadband Services completed the company’s product line. No longer was Enron stuck in a stagnant
industry. In contrast, the company’s 2000 annual report boasted that it was now “a marketing and logistics company whose biggest assets are its well-established business approach and its innovative people.”

“At its peak, Enron owned a stake in nearly 30,000 miles of gas pipelines, had access to a 15,000-mile fiber optic network, and had a stake in several electricity-generating operations around the world. In 2000, the company reported gross revenues of $101 billion” (Beasley Auditing 46). In addition, Enron offered its customers an array of financial hedges and contracts. In 2000, EnronOnline produced $1 billion in transactions daily.

Accordingly, Enron received tremendous praise as an innovative company. It had grown to become the seventh largest company in the US. Lay became active in the national political arena. Skilling, who became CEO when Lay solely became chairman in early 2001, was dubbed one of America’s top CEOs. CFO Andrew Fastow was recognized for his achievements, seemingly bringing order to the complex financial structure that the transactions created. The company maintained such political clout that they influenced Vice President Cheney’s national energy plan.

In 2001, Enron’s stock began to tumble, falling from $80 a share in October 2000 into the mid-$30s a year later. Also in 2001, after just six months, Jeff Skilling resigned as CEO for “personal reasons” and Ken Lay was forced to return to his CEO position. In October 2001, the company’s third-quarter earnings revealed a huge loss and an unexplained $1.2 billion reduction in owners’ equity and assets. The markdown came as a result of the swap of Enron stock for notes receivable. “Enron had acquired the notes
receivables from related third parties who had invested in limited partnerships organized and sponsored by the company” (Knapp 5th Ed. 9). The company and its auditors determined that the earlier entries were wrong and that the markdown was necessary to correct the earlier entries.

Despite the troubles, Lay continued to tell shareholders that the stock was undervalued and encouraged further investment. However, just three weeks after the first restatement, earnings were restated for the entire preceding five years. Consequently, with diminishing liquidity and a loss of trust by investors and creditors, Enron filed for bankruptcy on December 2, 2001. More than $60 billion in losses fell to the shareholders, marking this as the largest bankruptcy to date (it was exceeded by WorldCom the following year).

**Fraud Logistics**

The use of Special Purpose Entities (SPEs) was central to the Enron fraud. The SPEs, dubbed by Enron as Braveheart, Rawhide, Raptor, Condor, Talon, LJM2, Chewco, and Whitewing, among countless others, were used to move the company’s debt off the balance sheet. Furthermore, some of the deals were structured so that Enron could receive borrowed funds and record them as revenues while ignoring the associated liability.

SPEs “can take several legal forms, but are commonly organized as limited partnerships. During the 1990s, hundreds of large companies began establishing SPEs. In most cases, SPEs were used to finance the acquisition of an asset…fund a construction
project” (10) or to meet a similar specific company objective. SPEs are also often used to help a company sell off particular assets. For instance,

after identifying which assets to sell to the SPE, the selling company secures an outside investment of at least 3 percent of the value of the assets to be sold to the SPE. The company then transfers the identified assets to the SPE. The SPE pays for the contributed assets through a new debt or equity issuance. The selling company can then recognize the sale of the assets to the SPE and thereby remove the assets and any related debts from its balance sheet (Beasley Auditing 49).

Both the SEC and the FASB fumbled the rules governing SPEs in the early 1990s. Their mandates called for a three percent rule, allowing companies to omit a SPE’s assets and liabilities from their own balance sheet if three percent of the capital came from outside the company. Of course, in many cases, exactly three percent would come from outside the company to meet the minimum of the rule. Critics alleged that this rule violated the reasoning behind consolidated financial statements and undercut the importance of such statements.

While many companies used SPEs for legitimate purposes and to move debt off the balance sheet, Enron certainly did so the most frequently and most aggressively, creating “an intricate network of SPEs, along with complicated speculations and hedges” (49). Likewise, while most companies restricted their use of SPEs to financing activities, Enron did not, and continually used the SPEs freely to unload under performing assets. Enron would have a third party, often Enron executives such as Lay, Skilling, and Fastow, or their friends, contribute the needed three percent, then sell Enron’s assets to the SPE. In fact, in a blatant conflict of interest, Fastow himself would realize a $30 million profit from the SPEs while also serving as CFO.
“The SPE would finance the purchase of those assets by loans collateralized by Enron common stock. In some cases, undisclosed side agreements made by Enron with an SPE’s nominal owners insulated those individuals from any losses on their investments and, in fact, guaranteed them a windfall profit” (Knapp 5th Ed. 12). In controlling the SPE’s activities, Enron was able to sell their assets to the SPE at a price they determined, creating huge gains that carried over to the income statement.

LJM and Chewco were just two of the SPEs that spearheaded the fraud. In 1999, Enron invested in an Internet start-up called Rhythm NetConnections (Rhythm). Its share of the company was very valuable, yet Enron was not able to sell it until later that year. To recognize the profit before selling the stock, Enron created the LJM partnership with a Cayman Islands company. LJM then established a subsidiary, funded partly with Enron stock, that agreed to buy the Rhythm stock at a preset price. The partnership was especially risky because of the possibility that both Rhythm and Enron’s stock could fall simultaneously. Yet, partnerships like LJM allowed Enron to keep debts and liability off their financial statements, and so they continued.

Enron executives formed Chewco in 1997. Fastow directed one of his employees, Michael Kopper, to control Chewco. To hide the connection, Kopper’s investment in the partnership was made in his spouse’s name. When Enron decided to buy out Chewco, Fastow drove up the price, making huge profits for Kopper and his partner. Kopper was also given $1.5 million in management fees and other payments, which reports claim were of dubious legality. He shared these with Fastow. Similar instances are present in many of Enron’s other SPEs.
Enron’s disclosure of the SPEs was inadequate, failing to clearly state the purpose and activities of the ventures. The related-party transactions that the SPEs created were also completely ignored. After the earnings restatements and the ensuing public outcry over the SPEs, the Enron board reacted by appointing an investigative committee, which labeled the SPEs as “byzantine” and found that in many instances Enron was able to recognize an increase in the value of its own capital stock on the income statement.

In using the SPEs and shielding the debt from the balance sheet, Enron was able to maintain a high credit rating, needed to continue to secure loans to grow the company and expand its many new ventures. In addition, many of the SPE loans contained provisions that would force additional contributions if the Enron stock price fell. Indeed, when the stock did fall in 2001, these provisions in the SPE contracts exacerbated the earnings restatements. Prior to 2001, in continually using the SPEs to an even greater degree, Enron was able to appear increasingly profitable and avoid making these additional contributions.

In addition to the SPE abuse, Enron aggressively employed mark-to-market accounting techniques for their long-term contracts. These long-term contracts often stretched for 20 years or longer. Although not even a fraction of the revenue had been earned, energy companies were able to book the profits from the contract in the quarter that the deal was made. Doing so, companies were forced to estimate the costs of providing the contract over the long-term period. Enron frequently made unrealistic forecasts, underestimating expenses and overestimating profits. The accounting rules
governing such transactions were greatly supported and influenced by US Senator Phil Gramm, whose wife Wendy sat on the Enron board.

Many observers would later state that the company’s culture made a tremendous contribution to the fraud. As Enron was reeling, Dynegy, a rival firm, considered acquiring Enron. The deal fell through and Dynegy’s CEO later concluded that the lack of internal controls at Enron was mind-boggling. Furthermore, affairs were rampant within the company, particularly among the senior-level executives. Employee concerns, including those of whistleblower Sherron Watkins, were largely ignored.

WHERE WERE THE AUDITORS?

Arthur Andersen became an orphan early in life and was forced to take night classes to graduate from high school. Through the adversity, he learned to maintain a strong work ethic, coupled with discipline and honesty. These traits carried Andersen to the University of Illinois. Following his graduation, he joined Price Waterhouse in 1908 and became the state of Illinois’s youngest CPA at age 23.

Just a few years later, Andersen and a friend left Price Waterhouse and established an accounting firm of their own, Andersen, Delany & Company. Delany soon departed and Andersen renamed the venture Arthur Andersen & Company. He earned a reputation as a stern practitioner, carefully adhering to accounting guidelines. In one well-known example, in 1915, he pressed a client to disclose a subsequent event, insisting that the freight company’s financial statement users needed to know that a ship had sank after the fiscal year-end. Years later, Andersen and DuPont, one of the firm’s largest clients, quarreled over the definition of operating income. Refusing to back down,
Andersen was terminated as DuPont’s auditors. Such instances of unyielding ethics and honesty added to the firm’s image and character.

By the 1940s, “Arthur Andersen and Co. had offices scattered across the eastern one-half of the United States and employed more than 1,000 accountants” (Knapp 5th Ed. 5). Arthur Andersen died in 1947 and Leonard Spacek rose to the firm’s lead position, while maintaining the same values that Andersen had built the firm on. Spacek retired in 1973 after growing the business into one of the nation’s largest and most respected accounting firms. By 2001, Arthur Andersen and Co. had adopted the one-word name Andersen and divested their Accenture consulting arm, formerly Andersen Consulting.

With the Enron bankruptcy gripping the nation, investors and retirees collectively losing billions, and Enron executives staying mum, criticism fell to the auditors. Several months prior to the bankruptcy, Andersen auditors became aware of Enron’s deteriorating financial condition and worked with Enron executives to weather the storm. The auditors even assisted in restructuring the SPEs to keep them from being consolidated. Meanwhile, others in the firm, frustrated with the overly aggressive accounting treatment, proposed dropping Enron as a client as early as February 2001.

In their defense, Andersen executives stated that they ordered Enron to correct an SPE error as soon as they discovered it, leading to the first earnings restatement. In another 2001 example, the Andersen executives also asserted that while half of the needed three percent of another highly material SPE was contributed directly by Enron, Enron had failed to present this information. When Andersen did make the discovery, they again reported the error. Although they had served as Enron auditors for fifteen
years, Andersen claimed to have been only minimally involved in the transactions that led to the earnings restatements.

Andersen was also chastised for their extensive consulting relationship with Enron. In providing both consulting and auditing services and receiving revenues from both, Andersen auditors had a conflict of interest. In fact, while Andersen earned some $52 million from Enron in 2000, just $25 million came from the financial statement audit. Despite the firm’s claims, many alleged that Andersen had reviewed and analyzed the SPEs frequently over the past several years, essentially helping Enron to mask its debt. In fact, Andersen collected $1 million in total for their work on the Raptor SPE. Likewise, the auditors had approved the limited disclosures of the SPEs, continually delivering an unqualified audit report.

Testimony later concluded that Andersen failed to bring the many issues to the attention of the Enron board, notably failing to mention the lack of internal controls and high number of related-party transactions. The auditors failed to maintain any objectivity in performing their work. Adding to their woes and ushering in the firm’s dissolution, Andersen’s Houston office, who performed the Enron audit, shredded a large amount of documents relating to their work at Enron even after the SEC began their investigation into the fraud. Many Andersen critics alleged that the firm no longer emphasized quality work, integrity, or independence and instead, focused on keeping the clients happy and “billing their brains out” to maximize revenue.
CONCLUSION

Both Enron and Andersen were forced to file for bankruptcy. With the investigations likely to continue for years, many Enron executives have already been sentenced on criminal charges and many continue to face such action. Michael Kopper, who worked closely with Fastow, was the first Enron employee to be convicted. Both CFO Andy Fastow and his wife received prison sentences after pleading guilty. The company’s treasurer also admitted guilt. CEO Jeff Skilling, who proclaimed ignorance, as he was “not an accountant,” is awaiting trial while still proclaiming his innocence. Likewise, the chief accounting officer has been indicted and entered an innocent plea. While not yet being charged, Chairman Kenneth Lay also denies any wrongdoing.

The Andersen CEO who staunchly defended his firm resigned after failing to negotiate a merger with Deloitte & Touche. By June 2002, more than 400 of Andersen’s largest clients had terminated them as auditors. The firm was immediately forced to lay off much of its work force. After the former audit partner in charge of the Enron engagement pleaded guilty to obstruction of justice and testified against his own firm, Andersen was also found guilty of such charges. Andersen was also investigated for their roles in the frauds at Waste Management, Global Crossing, Sunbeam, Qwest, and Worldcom. As Andersen collapsed, Ernst & Young would absorb many of the 88 year-old firm’s offices. JP Morgan Chase & Co. was also investigated for their business activities with Enron. Enron’s law firm was named in lawsuits as well.

More so than any other case, the Enron fraud critically damaged the accounting profession. “A slew of recommendations was made to strengthen the independent audit
function and to improve accounting and financial reporting practices” (Knapp 5th Ed. 22). While some argue that the accounting standards failed to provide proper guidance, others dispute that the rules are too specific and merely encourage companies to push the rules. Many of the proposals and arguments are now included in the Sarbanes-Oxley Act, which strongly increases the responsibility that a company’s executives take for their financial statements. Likewise, Sarbanes-Oxley also resolves many of the other highlighted problems, such as the issues surrounding the auditors’ independence. The fraud forced changes in SPE accounting. FASB Interpretation No. 46 was issued in January 2003 to restrict the use of SPEs, while raising the three percent threshold to 10 percent. In addition, the Enron fraud sparked tremendous interest in corporate culture, governance, and business ethics. For its prominence and the headlines it received, the Enron case has and will continue to alter the accounting and auditing arenas.
CONCLUSION

Professional financial analysis and appropriate decision making is based on a thorough understanding of the development of the historic accounting landscape. To understand the present and plan for the future requires an understanding of the past. Thus, there is a long lineage of companies throughout history that have offered inflated stock to the public. This study has discussed some of these cases with companies that have all “cooked the books” to impress investors. While the discussion involved colorful characters and interesting stories that make for excellent reading, meaningful conclusions can also be drawn. The most significant conclusion comes simply through demonstrating that fraud can occur in a number of companies and across a wide time frame. Likewise, while inventory and revenue recognition are frequently exploited, fraud can involve any of a number of accounts. Such findings demonstrate the ever-present potential for fraud and have a powerful influence on an auditor’s work and preconceptions going forward.

Competitiveness and aggressive business leadership continue to create pressures for fraud. While all of the frauds discussed were directed from the top levels of senior management, this certainly isn’t always the case. In fact, although executive-level frauds represent the financial bulk of activity, fraud actually occurs much more frequently at the employee level.

The current auditing environment has changed considerably in the past few years. Following the myriad of accounting frauds beginning with Enron, the profession vowed, through the AICPA, to change and approved new audit standards language, creating more audit procedures, tests of controls, and interpretations of accounting standards. The
Panel on Audit Effectiveness of the Public Oversight Board performed the most comprehensive study of the profession ever, calling for the use of forensic techniques in every audit and the incorporation of an element of surprise in audits. Their suggestions would emerge in SAS No. 99 in 2002, which modifies “the otherwise neutral concept of professional skepticism and presumes the possibility of dishonesty at various levels of management, including collusion, override of internal control, and falsification of documents.” SAS No. 99 also called for auditors to vary materiality levels, start thinking like a fraudster to uncover schemes, and ordered that auditors should not assume that management is honestly reporting results. Additionally, the auditors’ new role in detecting fraud was clearly stated when one of the most important paragraphs in the authoritative auditing literature was put into practice (AU Section 110, paragraph 2):

The auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.

“Capital markets are complex, global, operate 24 hours a day, and rely on accounting information” (Giroux). The role of accountants continues to expand as technology advances and modern capital markets depend on an abundance of reliable financial information. Thanks to decades of change, opportunity, and disasters, financial data in most forms is largely relevant, reliable, and regulated. Yet others, including Wall Street historian John Steele Gordon, contend “it's never going to change. As long as
there's a great deal of money to be made on Wall Street, there will always be people of
dubious morals coming up with new ways to fleece the sheep. Welcome to capitalism”
(Carlson). Considering past events and such forecasts for the future, auditors “must
defend their battered integrity – their very stock in trade” (Frieswick).

As a result, a proactive approach to increasing regulation and accounting
standards must be taken. Likewise, increased emphasis on professional skepticism and
auditor training will help to combat fraud. However, the ultimate fate of any profession
lies not in its rules, regulations, and controls. The fate lies in the will and dedication of
the majority of people who serve in that profession. Clearly, although the fight against
fraud has gained momentum, many opportunities for improvement still exist.
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