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# Causes, consequences, and deterence of financial statement fraud

Zabihollah Rezaee*

*Fogelman College of Business and Economics, 300 Fogelman College Admin. Building, The University of Memphis, Memphis, TN 38152-3120, USA*

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**Abstract**

Financial statement fraud (FSF) has cost market participants, including investors, creditors, pensioners, and employees, more than $500 billion during the past several years. Capital market participants expect vigilant and active corporate governance to ensure the integrity, transparency, and quality of financial information. Financial statement fraud is a serious threat to market participants' confidence in published audited financial statements. Financial statement fraud has recently received considerable attention from the business community, accounting profession, academicians, and regulators. This article (1) defines financial statement fraud; (2) presents a profile of financial statement fraud by reviewing a selective sample of alleged financial statement fraud cases; (3) demonstrates that "cooking the books" causes financial statement fraud and results in a crime; and (4) presents fraud prevention and detection strategies in reducing financial statement fraud incidents. Financial statement fraud continues to be a concern in the business community and the accounting profession as indicated by recent Securities and Exchange Commission (SEC) enforcement actions and the Corporate Fraud Task Force report. This paper sheds light on the factors that may increase the likelihood of financial statement fraud. This paper should increase corporate governance participants' (the board of directors, audit committees, top management team, internal auditors, external auditors, and governing bodies) attention toward financial statement fraud and their strategies for its prevention and detection. The Sarbanes-Oxley Act of 2002 was enacted to improve corporate governance, quality of financial reports, and credibility of audit functions. The Act establishes a new regulatory framework for public accountants who audit public companies, creates more accountability for public companies and their executives, and increases criminal penalties for violations of securities and other applicable laws and regulations. Given the difficulties and costs associated with deterring financial statement fraud, understanding the interactive factors described in this article (Cooks, Recipes, Incentives, Monitoring

* Tel.: +1-901-678-4652; fax: +1-901-678-0717.
*E-mail address:* zrezaee@memphis.edu (Z. Rezaee).


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and End-Results (CRIME)) that can influence fraud occurrence, detection and prevention is relevant to accounting and auditing research.


*Keywords:* Financial statement fraud; Corporate governance; Sarbanes-Oxley Act of 2002; Cooking the books; Fraud prevention and detection strategies

## 1. Introduction

Financial statement fraud (FSF) has received considerable attention from the public, press, investors, the financial community, and regulators because of high profile reported fraud at large companies such as Lucent, Xerox, Rite Aid, Cendant, Sunbeam, Waste Management, Enron Corporation, Global Crossing, WorldCom, Adelphia, and Tyco. The top executives of these and other corporations were accused of cooking the books and, in many cases, were indicted and subsequently convicted. The collapse of Enron has caused about $70 billion lost in market capitalization which is devastating for significant numbers of investors, employees and pensioners. The WorldCom collapse, caused by alleged financial statement fraud, is the biggest bankruptcy in the United States history. Loss of market capitalization resulting from the reported financial statement fraud committed by Enron, WorldCom, Qwest, Tyco, and Global Crossing is estimated about $460 billion (Cotton, 2002). These and other corporate scandals have raised three important questions of (1) how severe is corporate misconduct in the United States, (2) can corporate financial statements be trusted, and (3) where were the auditors? It is trusted that the majority of publicly traded companies in the United States have a responsible corporate governance, a reliable financial reporting process, effective audit functions, conduct their business in an ethical and legal manner, and through continuous improvements enhance their earnings quality and quantity. Nevertheless, the pervasiveness of reported financial statement frauds caused by "cooking the books" and related alleged audit failures have eroded the public confidence in corporate America.

The reliability, transparency, and uniformity of the financial reporting process allow investors to make intelligent decisions. Published audited financial statements that reflect a true and honest financial performance instead of a rosy picture and inflated and fraudulent earnings are useful to market participants, including investors and creditors. Enron, WorldCom, and other corporate scandals, earnings restatements, customized and managed pro forma earnings have undermined investors' confidence in the quality and reliability of the financial system. Capital markets participants (e.g. investors, creditors, analysts) make investment decisions based on financial information disseminated to the market by corporations. Thus, the quality, reliability, and transparency of published audited financial statements are essential to the efficient allocation of resources in the economy. Auditors lend creditability to the information disclosed in a firm's financial statements by reducing the risk that the information is materially misstated. The importance of financial information to the efficiency of securities markets is repeatedly noted in speeches given by Securities and Exchange Commission (SEC) commissioners. For example, "Audited financial statements provide the foundation for our securities markets. Audited financial statements allow investors to make decisions on whether to buy, hold, or sell a particular security" (SEC,