

MEGAFRAUDS: SHOULD THE AUDITORS HAVE KNOWN?

Lessons for the Auditing Classroom

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The integrity of the whole society is undermined if financial information is misrepresented, or if it isn't accurate or understandable. Because we live in a market society and increasingly – the world does – unless the markets can be trusted, then you have widespread corruption...and a market economy that doesn't function (2002).

– Jeffrey E. Garten
 Dean, Yale School of Management

The spectacular frauds of Enron, WorldCom, HealthSouth, Adelphia, Tyco and others, coupled with significant financial statement restatements by other SEC reporting companies, resulted in passage of the Sarbanes-Oxley Act (hereafter “SOX”) by congress. SOX established the Public Company Accounting Oversight Board (PCAOB) to regulate the previously self-regulated accounting profession. The frauds will forever change the face of American business and the resulting legislation will have far-reaching impacts on the nature of the auditing profession. This paper examines the conditions underlying the megafrauds and presents an exercise to facilitate efficient classroom coverage of the various frauds.

High-profile financial frauds, massive business failures and incomprehensible breakdowns in

corporate governance have dominated the business news over the last few years and severely shaken faith in the U.S. capital markets. The accounting profession, once highly esteemed in the business world, has been badly tarnished as reports of shoddy audit work and the implosion of Arthur Andersen have made for disconcerting reading.

COSTS OF FRAUD

The cost of fraud to the United States economy was substantial even before the string of megafraud cases that began with Enron. In 1996, the Association of Certified Fraud Examiners estimated that fraud-related costs to the economy were \$400 billion dollars, an average of \$3300 per employee. By early 2002, the costs had increased to \$600 billion dollars and an average of \$4500 per employee (ACFE 1996, 2002). These estimates did not include the undoubtedly staggering price tags associated with Enron, WorldCom, Adelphia, Tyco, Xerox, Qwest, HealthSouth, Global Crossing, and Kmart, etc.

In macro terms, the cost to the economy is not just the \$600 billion dollars of fraud itself, but also the ensuing loss of confidence in the markets, the expensive efforts to revamp regulatory mechanisms, and the tremendous costs associated with litigation of highly complex, white-collar

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