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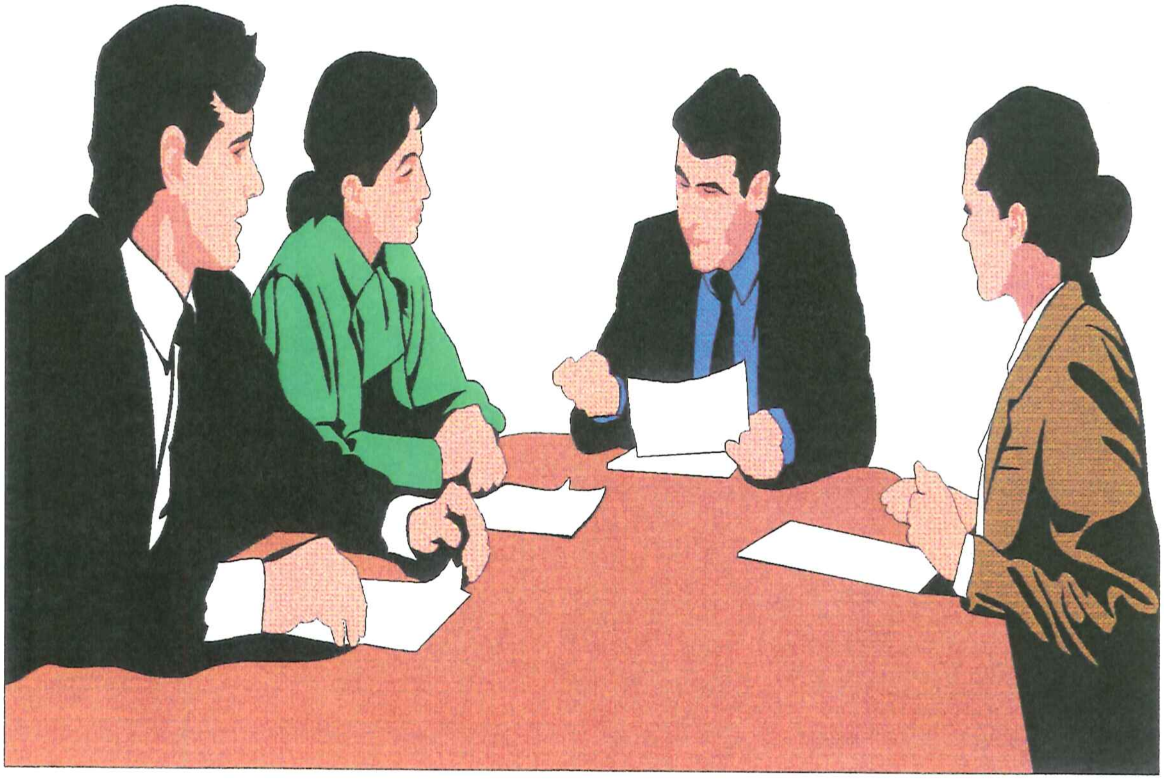
The Detection of Fraud in Financial Reporting: Did the Treadway Commission Make a Difference?

Michael Williamson



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Acknowledgments

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Michael Williamson
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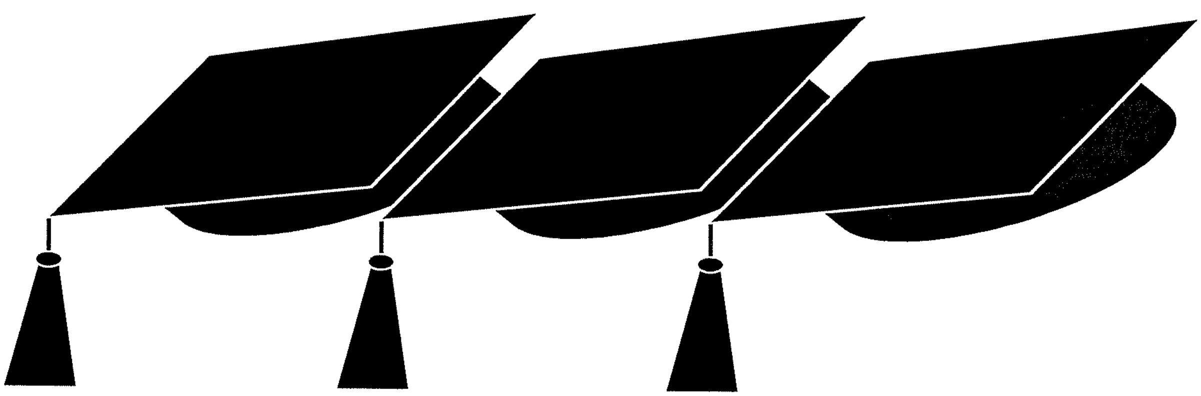

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Abstract

The reputation of the United States' financial reporting system greatly deteriorated in the late 1970s and early 1980s. Well-publicized fraudulent activity at seemingly well-respected institutions cast serious doubts upon the accounting profession's ability to report accurate financial information for the investing public. The Treadway Commission was established in 1984 to attempt to restore public confidence in the accuracy of published financial information. The work of the Commission produced 49 recommendations, many of which were embraced and implemented by the accounting profession. Despite the efforts of the accounting profession, incidents of fraudulent financial reporting continue to make headlines. Three accounting professionals surveyed for this report contend that incidents of fraud are isolated and unique situations that cannot be totally removed from the financial reporting system. The work of the Treadway Commission, however, has heightened awareness of the fraud problem.

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INTRODUCTION

During the early to mid-eighties, the public was bombarded with cases of fraudulent activity in corporations throughout the United States. Cases such as the EF Hutton check-kiting scandal, the United American Bank fraud, and the Home State Savings and Loan of Ohio fraud made even the most steadfast corporate stakeholder's knees shake. With each passing report of fraud in corporate America, the public's[1] faith in the credibility of the financial reporting system eroded more and more. The public's loss of faith in the financial reporting system threatened to make them wary to invest in corporate America, with devastating results for the United State's entire financial system. (King and Chironna 1989, 27). Then and now, business depends on the public for capital that would otherwise not be available.

Fraudulent financial reporting is "the intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements." (Treadway 1987, 2) As the number of incidents of fraudulent financial reporting continued to lessen the public's trust in the financial reporting system in the 1970s and 1980s, blame shifted to the independent public

[1] Public is used throughout the text to refer to the pool of investors in the United State's financial system.

accountant (hereafter, public accountant or external auditor). With each passing report of corporate fraud, the public was astonished that the external auditor did not unearth the crime. The public believed that because of an auditor's education and experience, he or she should be able to sniff out frauds wherever and whenever they exist in the financial statements.

A public accountant, however, cannot possibly live up to the high standards of fraud detection placed upon him or her by the public. The auditing standards in effect during this period of increased awareness of fraudulent activity required the auditor to detect fraud within the inherent limitations of the audit process. These limitations of the auditing process prevent external auditors from examining every transaction of a public company. Also, public accountants cannot possibly be held accountable for the failed detection of a cleverly concealed upper level management fraud. The collusion of management and its overriding of internal controls can sometimes hide fraudulent transactions.

An obvious gap existed between the public's expectation of the auditor's role and the public accountant's perception of the external auditor's responsibility to detect fraud that affects financial statements. This gap has been the source of extreme tension between the two sides and is widely known as the "Expectation Gap." Unfortunately for the public accountant, the public's tension materialized in the form of hundreds of lawsuits thrust upon the external auditor's doorstep.

These lawsuits have cost public accounting firms millions of dollars in litigation settlements (Bologna and Lindquist 1995, 88).

Despite the outcries and the lawsuits against the public accountant, external auditors contended that the responsibility to deter and detect fraudulent activity rests with a public company's management. Legislation such as the Foreign Corrupt Practices Act of 1977 (FCPA '77) forced management of public companies to develop a system of internal controls adequate enough to insure complete and accurate financial records (Arens and Loebbecke 1994, 188). This legislation, however, clearly has not been sufficient to thwart the hundreds of frauds making headlines across the United States.

To assist management in its fraud prevention efforts, internal audit departments grew in popularity during this time of increased public awareness of fraudulent financial activity. Many of these departments, however, were plagued with problems. First, many departments lacked the independence from management needed to perform their duties effectively (Corless 1978, 16). Second, many internal departments did not fully understand their functions within the organization (Sawyer 1974, 70).

The Treadway Commission and the Accounting Profession's Response

Eventually, the tension and the public outcries became worrisome enough in 1985 that five professional accounting organizations [the Institute of Internal Auditors, the Financial Executives Institute, the American Institute of Certified Public Accountants, the American Accounting Association, and the National

Association of Accountants (now the Institute of Management Accountants)] funded a study to examine the growing expectation gap (Treadway 1987, 1). Thus, the National Commission of Fraudulent Financial Reporting, or so-called Treadway Commission after its chair, was born. After two years of study, the Commission published 49 recommendations directed at the following key players in the financial reporting process: public companies, public accountants, regulatory agencies, and educators of future accounting professionals.

The recommendations directed at public companies urged top management to establish an ethical tone for the corporation and to communicate the company's responsibility for the integrity of the financial statements. Specifically, these recommendations advise public companies to:

- Develop and maintain effective internal controls
- Create and enforce a corporate code of conduct
- Maintain an objective and effective internal audit department
- Establish an informed, vigilant, and effective audit committee
- Include a management letter in the company's annual report that explains the responsibility of management for the maintenance of internal controls (Treadway 1987, 21-48).

The Treadway Commission's recommendations to the public accountant insisted that auditors accept more responsibility to detect fraud in the financial statements of public companies. Once more responsibility is assumed, the accounting profession needs to communicate effectively the responsibility of the

external auditor to detect and deter fraud. Specifically, the Treadway recommendations urge public accountants to:

- Take steps to assess the potential that fraud exists within the public company
- Design audit tests to detect fraud in the financial reporting system
- Perform more analytical procedures
- Communicate effectively the role the external auditor plays in the detection of fraud in the financial reporting system
- Improve audit quality by participating in peer review programs (Treadway 1987, 49-62).

The accounting profession responded immediately and positively to the Treadway Commission's Report, published in October of 1987. Over the course of the late eighties and even extending to the early nineties, both the public company and the public accountant raced to implement the recommendations contained in Treadway. This response resulted in major improvements to the financial reporting system, such as more effective external and internal auditing standards and more effective communications to the public.

Despite the response to the Treadway Report, much is left to be done to ward off fraudulent financial reporting. The public accountant still needs to communicate its role in the detection of fraud to the public more effectively. Until the public fully understands the external auditors fraud detection responsibility,

the litigation expenses plaguing the accounting profession will continue to mount (Liebtag 1984, 54).

Public companies also need to better educate the public. The public needs to understand the ultimate role top management plays in the reporting of accurate financial data. Unfortunately, proper communication to the public are the least of some companies' worries. Recent surveys reveal that some companies still refuse to implement the findings of the Treadway Report (Savage 1988, 56). These companies need to understand the consequences of a faulty control environment more fully before it is too late.

The Present State of the Financial Reporting System

The sections of this paper to follow will further analyze the expectation gap, the Treadway Commission's recommendations, and the response of the accounting profession. The paper will conclude, moreover, with a detailed assessment of the present state of the financial reporting system. To accomplish this assessment, the well-publicized Barings Bank fraud will be closely examined. This examination will examine the bank's faulty control environment that allowed a young securities trader to lose fraudulently about one billion dollars in 1994 (Talt 1995). Although the fraudulent activities spanned an entire year, the actions of the unscrupulous trader went undetected. The bank's top management is not completely to blame for this fiasco, for Barings Bank was also the victim of ineffective audit work.

Finally, the present state of the financial reporting environment will be examined by presenting the insights of a public company manager, an internal auditor, and a public accountant. These three representatives of the accounting profession were presented a questionnaire in October 1996 to assess their opinions of the Treadway Commission's work. Before the findings of the questionnaire are reported, however, the financial reporting environment before the Treadway Commission's report will be described.

THE FINANCIAL REPORTING ENVIRONMENT BEFORE TREADWAY

The Public's Expectation

The widely publicized financial frauds disturbed the public. The public was sickened by the now infamous redistribution of wealth in America from the hard-working, honest investor to the unscrupulous fraudster. Society needed a scapegoat and, unfortunately for the public accounting profession, the blame fell to the external auditors.

The public placed blame on the external auditor because of a misconstrued perception of the public accountant's role in the financial reporting process. The public accountant is envisioned as an omnipotent warrior protecting the public from the evils of corporate America. The vast experience and intensive training of public accountants only strengthen society's misperception of the external auditor's role as the public's watchdog.

News reports covering the fraudulent financial activity further tarnished the image of the public accountant. Despite the tremendous diversity of each fraudulent case presented, the news story, with the help of hindsight, intricately described the auditors' blunders. The auditor bashing of some news reports, however, was justified. The fraud at ESM Governments Securities, a Ft. Lauderdale concern, in 1985 was a case in point (Knapp 1996, 15). As can be seen from the case study below, the fraud devastated the accounting profession's reputation. The collusion of ESM's executives and its external

auditor cost the investing public millions and finally propelled the accounting profession to initiate reforms in the financial reporting system.

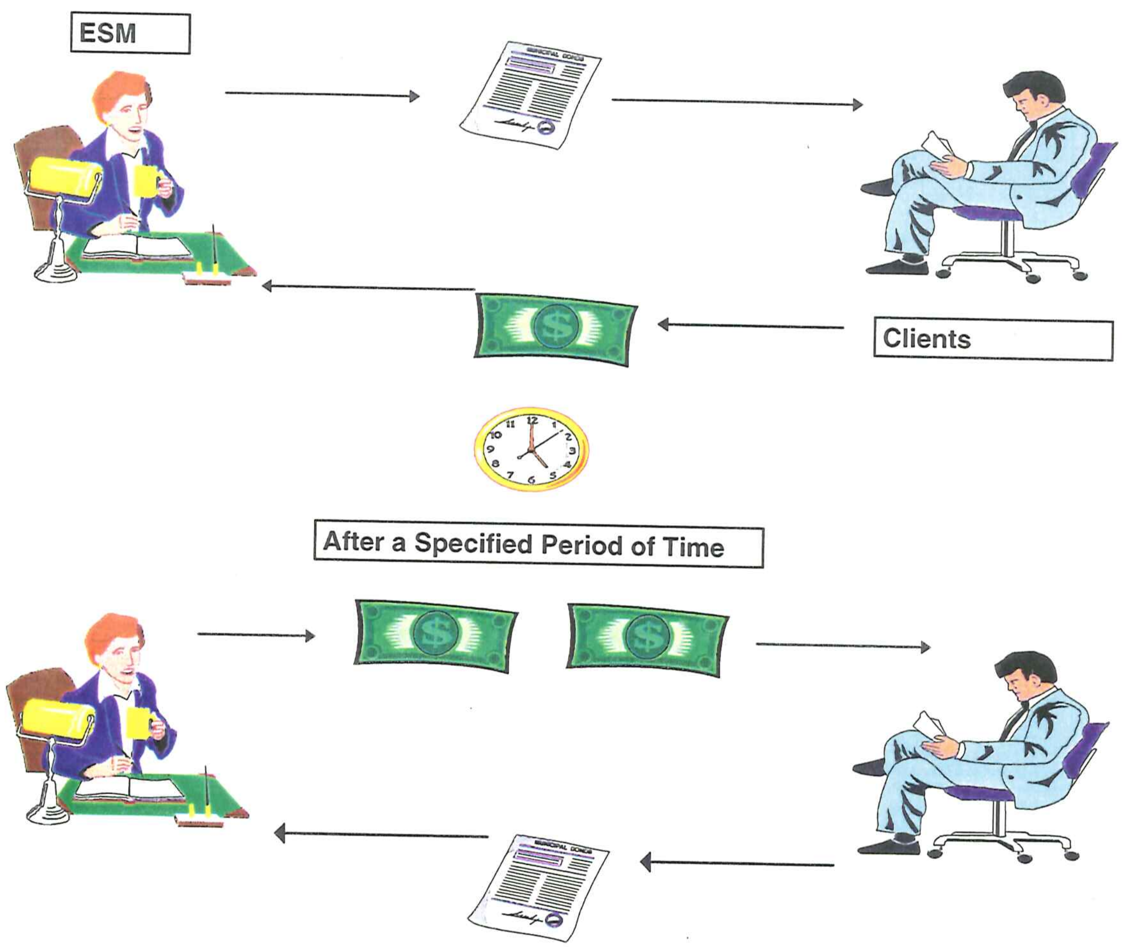
The ESM Government Securities Fraud

The explosion of the national debt during the Carter and Reagan Administrations buried the investing community in a sea of government-backed debt. Large brokerage houses were overwhelmed by the effort to market this debt. Capitalizing on this phenomenon, many small secondary government securities dealers became essential players in the marketplace (Knapp 1996, 17). Unfortunately, the wave of new brokerage houses introduced many undesirable characters into the industry. During the 1980s, the industry was susceptible to these evil-doers because it was subjected to very little regulation, despite being over 30 times larger than the New York Stock Exchange (Apostolou and Apostolou 1988, 22). A group of these unscrupulous traders formed ESM Government Securities in 1975.

At first, ESM enjoyed moderate success in its government securities trading. Many banks and municipalities, such as the Ohio Savings and Loan, shackled by government regulations allowing investments only in government-backed debt instruments raced into the clutches of ESM's list of growing clientele (Knapp 1995, 16). The repurchase agreement (repo) became the backbone of ESM's success. In ESM's typical transaction, one of its clients would buy a block of government securities with ESM's promise to buy the security back at a specified time and price (Apostolou and Apostolou 1988, 21). ESM profited on

the repurchase agreement when the price of the security appreciated in the hands of its client.

Illustration 1. The Repurchase Agreement



ESM, however, was not satisfied with its moderate success in the repo business. Salivating at the potential for lucrative profits, ESM began speculating

in government securities on its own behalf. The market, however, did not cooperate with ESM's vision of enormous profits. In three years of unsuccessful trading, ESM's entire equity of $80 million dollars vanished (Knapp 1995, 18). The company now lived in a house built on sand.

ESM steadfastly refused to admit to its insolvency. Instead, the Company began to trudge down the all too familiar path of deception. First, ESM elected to cover up the losses sustained in its speculative trading fiasco. The Company swept the losing accounts under the rug of a newly formed corporate shell formed by ESM executives. This transfer gave the illusion that ESM was not engaging in speculative trading at all. Instead, ESM was merely serving as a broker for an ill-advised client (Knapp 1995, 19).

Although the losses were now removed from ESM's books, its cash reserves were severely eroded. In response, ESM devised a scheme to exploit the trust of its unsuspecting clientele. Under normal circumstances, investors received debt certificates after purchasing government securities. ESM, however, usually maintained possession of the collateral in a repurchase agreement because the length to maturity was short. This action permitted ESM to sell the same instruments as repurchase agreements to many different clients, providing cash flow to cover losses (Knapp 1995, 18). The additional cash from the fraudulent sales allowed ESM to continue its speculative trading and to mount its already staggering losses.

For eight years, ESM's stakeholders slept soundly with their investment, for their public watch dog, the public accounting firm of Alexander Grant & Co., did not even whimper at the fraudulent going-ons at ESM. The simplistic fraud should have been no match for an auditor's test. A simple examination of the related party transactions would have raised glaring red flags. The public watch dog, however, did not unearth the deplorable crime. It was too busy enjoying the juicy morsels being tossed to it by ESM executives. Jose Gomez, CPA, the partner in charge of the ESM audit, overlooked ESM's transgressions for the paltry sum (i.e., bribe) of $175,000 (Knapp 16, 1995). Gomez proved well worth the money. Not only did he continue to issue unqualified audit opinions on eight years of fraudulent financial statements, but he also managed to keep his firm ignorant of the entire affair.

Because Alexander Grant & Co. did not inform the public of ESM's crimes, ESM continued down the road of deception undeterred by outside forces. When the primary scoundrel in the ESM atrocity suddenly died of a heart attack in 1984 (Knapp 1995, 22), the web of deceit unraveled. Unfortunately for the trusting stakeholders, the unraveling came $315 million dollars too late. (Apostolou and Apostolou 1988, 24)

ESM's clientele paled at the news of the fraudulent activity. The losses sustained by ESM made the investments purchased through it worthless. Because the Ohio Savings and Loan had entered into a substantial amount of now unrecoverable ESM repo agreements, thousands of Ohioans raced to

remove their deposits from uninsured banks. This bank run forced the Ohio governor to declare the first "bank holiday" since the Great Depression. Several Texas municipalities also held a substantial investment in ESM repo agreements. Because these investments were now worthless, Texas municipalities were forced to lay off workers just to remain solvent. The US dollar plunged 14% in value as foreigners worried that the United States' entire banking system was in jeopardy (Knapp 1995, 16).

Not only did the ESM Government Securities fraud injure the US banking system, but it also was a devastating blow to the accounting profession. The public's confidence in the financial reporting system, already withering from previous incidents of fraudulent financial reporting, had all but vanished. Without confidence in the independent verification of the public accountant, the public's confidence in investments waned.

The Auditor's Responsibility to Detect Fraud

The investing community's outrage at the external auditor baffled the public accounting profession. Prior to Treadway, external audit tests were not designed to sniff out fraudulent activity wherever it existed in business. Statement on Auditing Standard (SAS) 16 (AICPA 1977) spells out the external auditor's responsibility to the public. SAS 16 assigns the "independent auditor... the responsibility, within the inherent limitations of the audit process, to plan his or her examination to search for errors or irregularities that would have a material effect on financial statements". Because of the limitations of the audit process,

SAS 16 continues by stating "the subsequent discovery that errors or irregularities existed during the period covered by the independent auditor's examination does not, in itself, indicate inadequate performance on his or her part."

The Limitations of the Audit Process

The primary limitation of the auditing process is budgetary constraints. As stated by one Big Six audit partner, "If contract charges for an audit where fraud is not suspected are represented as X, I would start the quote to perform a fraud audit at 20X. Further, ultimate billings might be more than twice that figure when the review is completed" (Thornhill 29).

Because of these budgetary concerns, an auditor cannot possibly examine every transaction for the year. In fact, only a small sample of a client's total transactions are scrutinized in an audit. Unfortunately, even the examination of every transaction made by a client does not guarantee a fraud will be discovered (Levy 1985, 78). If carefully concealed, a fraud can be virtually undetectable to the auditor. Perhaps the most notorious carefully concealed fraud involved Wall Street's so-called Boy Wonder, Barry Minkow.

ZZZZ Best Fraud

Barry Minkow's ZZZZ Best Corporation began as a small carpet cleaning business run out of his mom's garage. Minkow, however, was not satisfied by the meager profit-making potential that his new business offered. With help from an insurance claims adjuster, Minkow was able to create a fictitious building

restoration division that racked up $50 million in phony revenues and bilked investors out of $100 million (Knapp 1995, 41).

Minkow retained the Big Eight Accounting firm of Ernst & Whinney to perform a review of the financial statements. Ernst & Whinney reportedly went to great lengths to verify the existence of the building restoration business. Confirmations were sent to the insurance company allegedly responsible for contracting the restoration projects to ZZZZ Best. Unfortunately, the insurance claims agent confirming the contracts had been bribed by Minkow and, as a result, he verified the fictitious claims. In addition, Minkow forged many of the invoices and canceled checks examined by Ernst & Whinney (Knapp 1995, 45).

Ernst & Whinney even visited one of the buildings ZZZZ Best had allegedly restored. Minkow convinced the owner of this building to allow him to have the keys to show the building to a prospective tenant on a weekend. Before the auditors arrived, Minkow planted signs around the building indicating that ZZZZ Best was restoring the building. This visit convinced Ernst & Whinney that the restoration division of ZZZZ Best existed (Knapp 1995, 47).

Can a standard audit possibly detect every management fraud? According to Daniel Akst, a Wall Street Journal reporter, "Changing the accounting rules and securities laws will help, but every now and then a Barry Minkow will come along, and ZZZZ Best will happen again. Such frauds are in the natural order of things, I suspect, as old and enduring as human needs" (Knapp 42).

The Expectation Gap

As can be seen from the aforementioned case histories, different expectations exist between the public and the external auditor with regard to the auditor's responsibility for fraud. The public expects the external auditor to prevent and detect fraud in the financial statements. In fact, one British writer claimed that if an auditor is not responsible for the detection of fraud, then corporations "are misdirecting [millions of dollars] a year by having their financial statements audited by public accounting firms" (De Marco 1978, 83). The auditor, on the other hand, cannot possibly unearth fraud wherever and whenever it exists.

According to Jerry Serlin, this expectation gap grew wider in the early 1970s and 1980s for two reasons. He states (Serlin 1984, 137):

> First, there have been numerous reports of massive management fraud in recent years that the auditors failed to detect. In many of these cases, with the help of hindsight, the auditor's work has been characterized as deficient. Secondly, the accounting profession has failed to adequately communicate its role in the detection of fraud to the public.

The expectation gap is expected to widen even further as many smaller investors continue to pour funds into the market (Maingot 1985, 119).

The effects of the expectation gap hit the accounting profession where it hurts the most-in the pocketbook. During this time of increased fraud awareness, Ralph Nader's consumerism movement was sweeping through the United States. During this movement, the actions of professionals from every business line came under increased scrutiny. (Maingot 1985, 120) Because the

public places such high expectations on the accounting profession to deter and detect fraud, class action lawsuits against auditing firms increased rapidly. In fact, at the end of 1993, pending suits against auditors totaled between $20 and $30 billion dollars in the United States alone (Bologna and Lindquist 1995, 88).

As the litigation amounts continued to soar, the external auditors continued to deny that their primary responsibility is to deter, detect, and prevent fraud in the financial statements. In fact, auditors proclaimed that the corporation's management, not the external auditors, bear the ultimate burden for the detection of fraud. Consideration of the responsibilities of this other player in the financial reporting process follows.

Management's Responsibility for Fraud Deterrence and Detection

According to Arens and Loebbecke (1994, 137), management bears the ultimate responsibility for the detection of fraud in a public company's financial statements. Despite management's role in the preparation of financial statements, few pieces of guidance and legislation existed in the early 1980s to aid management in its reporting endeavors. The enactment of the FCPA '77, however, did attempt to communicate management's ultimate role for the fair disclosure of financial information.

The Control Environment of the Public Company

To disclose accurate financial information, the FCPA '77 mandates public companies to establish and maintain a system of internal controls. Despite the FCPA '77, large financial frauds continued to make headlines across the United States. A majority of the large frauds occurred because top management easily could override the established controls (Bishop 1992, 53). To ensure the effectiveness of a public company's system of internal controls, however, many organizations maintain internal audit departments.

The Internal Audit Departments of Public Companies

Despite the reliance on the internal audit department, the role of the internal auditor in public companies during the 1970s and early 1980s was not well defined. Most viewed the internal audit function as maintainer of internal control. As stated by John Corless, "If there is any special expertise the internal auditor brings to the management team, it is in the area of internal control" (Corless 1978, 13).

Although the internal audit department assists in the public company's efforts to maintain a system of internal control, internal auditors do not hold themselves responsible for the detection and deterrence of fraud. As Jim Bailey, a Certified Internal Auditor, points out, "Internal auditors do not discover the majority of fraud... In fact, they discover very few" (Bailey 1978, 26). Bailey contends that the discovery of fraud in a corporation is attributed to "just plain luck" (Bailey 1978, 26).

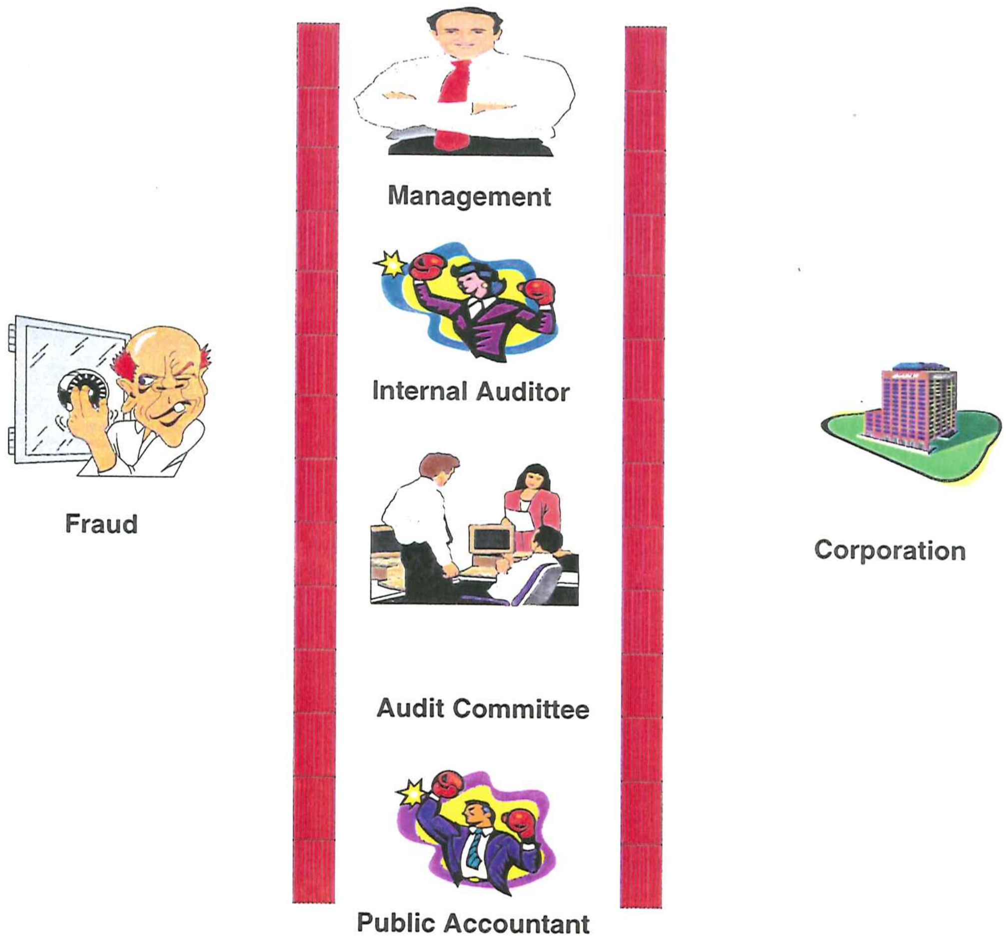
The primary obstacle faced by internal auditors is their loyalty to company management. Top management is responsible for providing resources to the internal audit department. Unfortunately, as John Corless points out, "If internal auditors decide their first loyalty is to the boss they can never be forceful advocates of doing what is right" (Corless 1978, 16).

THE TREADWAY COMMISSION

Despite the prevalence of fraud in corporate America in the early 1980s, no entity in the financial reporting process claimed responsibility for its deterrence or detection. The public refused to accept the defeatist and defensive attitude of many in the accounting profession that fraud could not be stopped. The Treadway Commission hoped to rescue the financial reporting environment from the clutches of fraud and instill a renewed public confidence in the integrity of the financial reporting process.

Two years of research by the Treadway Commission spawned 49 recommendations for the accounting profession. The recommendations highlighted the importance of each player in the reporting process to know its precise responsibility to detect fraud and to communicate its role to the public. The recommendations also created a hierarchical system of checks and balances. According to the Treadway Report, each financial reporting entity should ensure the effectiveness of the entities beneath it in the hierarchy.

Illustration 2: The Treadway Commission's Lines of Defense



Recommendations to Management

The first line of defense against fraud is corporate management. The Treadway Commission urged top management to set an ethical tone for the entire corporation. To accomplish this goal, top management must assess factors within the corporation that could contribute to fraudulent financial

reporting and establish controls that could mitigate the potential losses (Treadway 1987, 32).

Although rigid internal controls can prevent many incidents of fraud, the importance of ethics must resonate throughout the entire organization. The Treadway Commission recommends the implementation of a corporate code of conduct in every public company (Treadway 1987, 35). The corporate code of conduct must be more than just a symbolic jester. Top management must ingrain the code throughout the entire organization.

The Treadway Commission established management as the first line of defense in the battle to liberate the financial reporting system from incidence of fraud. As such, management must communicate its important role to the public. The Treadway Commission recommends that every annual report to a company's stakeholders include a management letter. This letter should state management's ultimate responsibility for the corporation's control environment. It should also include management's assessment of the control environment, perceived risks in the financial reporting system, and controls established to mitigate the list (Treadway 1987, 44). A management letter could have two positive effects on the war against fraudulent financial reporting. First, the company's stakeholders would more thoroughly understand management's responsibility to detect fraud. Second and more importantly, however, a management letter would force management to examine the company's controls more closely.

The Internal Audit Department

A company's second line of defense against fraud is an effective and objective internal audit department. According to the Treadway Commission's recommendations, the department's role in the corporation should be clearly defined. Once the role is defined, internal audit departments must be staffed with enough qualified personnel to add value to the financial reporting process. Finally, the internal audit department must remain independent of company management. To accomplish this goal, the internal audit department should report directly to the audit committee (Treadway 1987, 37).

The Audit Committee of the Board of Directors

Hovering above management and the internal audit department of a corporation should be the watchful eyes of a vigilant audit committee. The audit committee should be composed solely of independent directors. A written charter must detail the committee's role in the financial reporting process and a corporation must provide adequate resources to the committee for it to adequately discharge its responsibilities. (Treadway 1987, 39) These responsibilities should be adequately communicated to the public in an audit committee letter included in the annual report. The letter should also highlight the activities performed by the audit committee throughout the year (Treadway 1987, 46).

Recommendations to the Independent Public Accountant

The public accountant should be the final defense against fraud in financial statements. Despite its subordinated role in the detection process, the accounting profession needs to assume more responsibility in the detection of fraud. Specifically, professional auditing standards must force external auditors to take a more proactive role to insure financial statements are free of material fraud. Once the public accounting profession defines its role to detect fraud in financial statements, its responsibility needs to be more effectively communicated to the public (Treadway 1987, 50).

Two additional areas should be improved to strengthen the overall audit process. First, public accountants should use analytical procedures throughout the entire audit of a public company (Treadway 1987, 52). The Commission observed a number of cases where performing analytical procedures would have increased the likelihood of the auditor's detecting fraudulent financial reporting. Second, an independent public accountant should strengthen its review program to increase audit quality. A second partner should review an audit not only in the final review stage, but also in the planning stage. Standards should be adopted to assist public accounting firms in this endeavor. Also, the peer review program for all public accounting firms should also be strengthened (Treadway 1987, 54).

THE RESPONSE OF THE FINANCIAL REPORTING ENTITIES

The accounting profession embraced the Treadway Commission's findings resulting in a period of reformation that swept through the financial reporting community (Savage 1988, 56). In the months and years following the issuance of the Treadway Report, key players in the financial reporting community raced to implement its recommendations. In the following section, the response of the corporate management of public companies and the public accounting profession will be highlighted. Although these two players in the financial reporting system have diligently implemented many of Treadway's findings, much work is left to be done to install Treadway's grand vision. The additional response needed to successfully implement the Treadway Commission's recommendations will be discussed later in this section.

The Response of Public Companies

The Treadway Commission's recommendations presented public companies the opportunity to reevaluate their control environment. Many companies seized this opportunity and carefully crafted or improved internal controls, internal audit departments, and audit committees to defend against fraudulent financial reporting. Several success stories emerged from the pages of the Treadway Commission's report. BellSouth Corporation is just one of the many successes.

BellSouth's Control Environment

BellSouth's response to the Treadway Commission's report far exceeds the implementation of the literal recommendations contained in the report. BellSouth has instead embraced the spirit of Treadway to ward off fraudulent financial reporting in the turbulent environment of the telecommunications industry. This giant of the telecommunications industry has undertaken several initiatives not only to foster an ethical environment, but also to ensure that enough defense mechanisms exist to ward off fraudulent activity.

The cornerstone of BellSouth's control environment is its corporate code of conduct. Every employee not only receives a copy of this document, but also must sign a statement promising to adhere to the standards (Harrison 1995, 23). The corporate code of conduct is only a first line of defense against fraudulent activity. Management of BellSouth continually attend ethical awareness training sessions. Also, the company's employees are continuously surveyed to test their attitudes toward ethical behavior (Harrison 1995, 24). Finally, BellSouth has established a vice president of corporate responsibility to oversee the climate of the entire organization.

Despite the exhaustive work of BellSouth and other public companies to implement the recommendations of the Treadway Commission, no universally accepted guidelines existed to evaluate the effectiveness of internal control environments. For that matter, no standard definition of internal controls even

existed. The work of the five Committees of Sponsoring Organizations (COSO) that sponsored the Treadway Commission soon corrected this deficiency.

COSO

The most visible byproduct of the Treadway Commission's recommendations to public management has been the work of COSO. After years of research, COSO pronounced the first all encompassing definition of internal controls:

> Internal control is the process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; compliance with applicable laws and regulations (COSO 1992).

COSO also established objectives of internal control evaluations. First, the report states that management should continuously monitor the control procedures and information systems. The report also states that a yearly assessment of the following is also in order:

- Integrity, ethical values, competence
- Control Environment
- Communication
- Managing Change
- Risk Assessment
- Objectives (COSO 1992)

Despite the work of COSO and the well-documented cases of fraud destroying corporations, the management of many public companies still refuse

to implement the Treadway Commission's recommendations. A survey of 1,014 public companies was conducted in June of 1988 by COSO to examine the response to the Treadway Commission's recommendations. The results are highlighted in Figures 1-3 (Savage 1988, 56).

Figure 1. Does your company have a separate internal audit department?

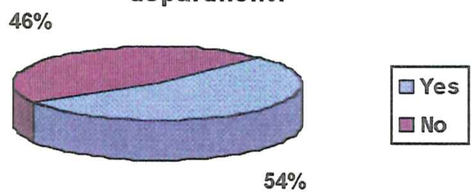


Figure 2. Does your company have a written code of corporate conduct?

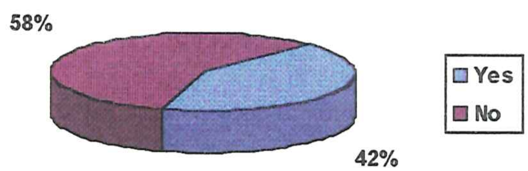
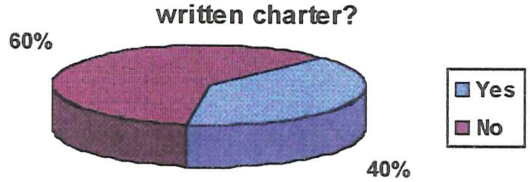


Figure 3. Does your company have an audit committee with a written charter?



The results of the COSO survey show that, as a whole, public companies have failed to implement the recommendations of the Treadway Commission. First, 46% of public companies refuse to install a much needed defense against fraud, an internal audit department. As indicated earlier, an effective internal audit department provides a much needed line of defense against fraudulent financial reporting. Second, 58% of American Corporations refuse to implement a written code of corporate conduct. COSO needs to continuously encourage effective control environments and monitor the response of corporations. The lackluster response, however, highlights the importance that the independent public accountant take more responsibility to detect fraud.

The Response by the Independent Public Accountants

The Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) was the first organization to heed the call of Treadway. (Savage 1995, 58) In fact, the Auditing Standards Board issued several auditing standards before the final report was even issued. The key standards are presented below and evaluated against Treadway's recommendations. First, Table 1 will provide a quick reference to the Standards.

Table 1
The Auditing Standards Board Response to Treadway

	Description
SAS 53	Auditors should assess the risk of material misstatement in financial statements and plan and perform the audit to detect fraud.
SAS 55	Auditors should assess the client's control and environment and determine the potential risk of the controls before completing the audit.
SAS 56	The auditor needs to use analytical procedures more effectively. Required use during planning and as overall review at end of audit.
SAS 58	Audit report wording changed to clearly articulate management's and auditor's responsibility for the financial statements.
SAS 60	The auditor needs to report significant internal control deficiencies to the audit committee.
SAS 61	The auditor is required to communicate significant audit issues with the audit committee.

The Standards to Improve an Auditor's Ability to Detect Fraud

The Treadway Report recommended that the public accounting profession clearly define its role in the detection of fraudulent financial reporting. The Auditing Standards Board answered with the Statement on Auditing Standard (SAS) 53 to supersede SAS 16 (AICPA 1987). SAS 53 calls for auditors to first assess the risk of fraudulent information in the financial statements. Once the risk is assessed, the auditor can more effectively design and perform tests to detect fraudulent financial information.

Although SAS 53 places more responsibility on the auditor to detect fraud in financial statements, it continues to stress that a carefully concealed fraud

may not be detected by the audit. The same inherent limitations in the audit process mentioned earlier continue to pertain. The standards mentioned in the following paragraphs, however, are aimed to increase the effectiveness of the audit process.

To increase the effectiveness of an audit, SAS 55 provided the guidelines for the auditor to perform the task (AICPA 1987). This statement requires the independent public accountant to assess the effectiveness of the client's internal control structure, consisting of the control environment, the accounting system, and the control procedures. Specifically, this standard requires the auditor to:

- Understand the internal control structure and determine whether related policies and procedures are in operation
- Document the understanding of the internal control structure
- Determine the planned assessed level of control risk
- Perform tests of controls to provide support for the planned assessed level of control risk
- Evaluate whether the planned assessed level of control risk is supported by the results of the tests of controls
- Document the assessed level of control risk and the basis if it is assessed at less than the maximum level
- Design substantive tests based on assessed level of control risk

SAS 56 requires that the auditor uses analytical procedures more extensively (AICPA 1987) This standard works under the basic assumption that

more frauds could be detected if a basic understanding of the relationships between accounts is understood. Analytical procedures are required not only in planning the audit, but also in the final review stage. SAS 56 also recommends the use of analytical procedures to obtain substantive audit evidence.

Finally, SAS 60 and 61 establish required communication channels for the auditor with the audit committee (AICPA 1987). SAS 60 states that all reportable conditions, which are defined as deficiencies in the design or the operation of the internal control structures, should be reported to the audit committee. Examples of reportable conditions include inadequate control design, absence of appropriate segregation of duties, and evidence of willful wrongdoing to the company's employees. SAS 61 states that "certain matters related to the audit should be communicated to those who have responsibility for oversight of the financial reporting process." This standard basically encourages an auditor to communicate significant audit findings to the audit committee.

Although the standards were established in 1987, frauds continue to be prevalent in the news. The audit process is understood to have certain limitations, but recent findings have been unacceptable to the public accounting profession. First, a recent Peat Marwick survey discovered that only 3% of the frauds in corporate America were unearthed by the public accountant (Peat Marwick 1994, 10). Also, the AICPA invited a number of educators and practitioners in 1992 to discuss the auditing standards that have been pronounced since 1988. This conference came to be known as the Expectation

Gap Roundtable. The key finding of this conference was that SAS 53 did not successfully narrow the expectation gap. Realizing that more needs to be done to improve the audit process, the Auditing Standards Board proposed a new standard to detect fraud.

The Newly Issued Standard

In response to the above-mentioned findings, the Auditing Standards Board pronounced the first standard directed solely at fraud in audits. When implemented, the Standard will supersede SAS 53 (AICPA 1996). This standard places more stringent requirements on the auditor to assess risk factors in the company and plan tests to mitigate the risks. According to the proposed standard, the integrity of management, the specific conditions of the industry, and the operating characteristics and financial stability need to be examined, when planning an audit.

The Standards to Aid in Public Communication

Now that the auditor's responsibility is more precisely defined and formal guidelines exist to better detect fraud in financial statements, the public accountant needs to take more responsibility for more effectively communicating his or her role to the public. To better communicate the auditor's role to the public, SAS 58 changed the auditor's standard report to better differentiate management's responsibility from the responsibility of the external auditor in the preparation of the financial statements.

The growing number of lawsuits against public accounting firms demonstrates that much more needs to be done to create realistic expectations by the public. The public accounting profession must make a more concerted effort to communicate its role to the public. Perhaps implementing the Treadway recommendation that requires the auditor to describe in the standard audit report the extent to which a company's internal controls were evaluated are in order.

Although the accounting profession has made great strides to improve the financial reporting environment, well-publicized frauds continue to undermine the tremendous progress made in the financial reporting environment. The discovery of the fraudulent activity at Barings Brothers in 1995 has further damaged the respect of the financial reporting community. The Barings Brothers debacle, however, could have been prevented. The case study presented below will demonstrate how Barings could have avoided the billion dollar sham by simply heeding the Treadway Commission's warnings.

THE BARINGS BANK FRAUD

Duc de Richelieu's 1818 quote (Rawnsley 1995, 5), "There are six great powers in Europe: England, France, Prussia, Austria, Russia, and Baring Brothers" captured the influence that Barings Bank enjoyed throughout its illustrious history. The Bank's world dominance, however, could never overshadow its proud but humble beginnings. The mighty bank began as the small dream for three brothers from the Netherlands. The three settled in London in 1763 and established a clothes manufacturing business. Captivated by the world of merchant banking, one brother escaped the encumbrances of the family business and began financing all aspects of international trade (Rawnsley 1995, 4).

His vision was lucrative, for it gave birth to one of the most powerful forces in the emerging world of business in the 19th century. Francis Barings' merchant bank truly financed all aspects of international trade, such as: the extraction of copper from the Congo, the trading of wool Australia, and even the construction of the Panama Canal. More significantly, Barings Brothers financed the United State's purchase of the Louisiana Territory. Barings based its calculations for the Louisiana Purchase on the future cash flow of the region on cotton prices and the impact of the abolition of slavery (Rawnsley 1995, 5). Along with its impressive achievements, Barings' reputation as the premier merchant captured an enviable list of famous clientele. Napoleon III, King Leopold of Belgium, and

the entire British royal family are just a few of the historical figures that banked at Barings (Rawnsley 1995, 6).

Despite its glorious history and renowned clientele, Barings' significance in the modern world of business plummeted in the early 1980s. Britain's large clearinghouse banks, such as National Westminister, stripped Barings of its clients and competitiveness. Barings' troubles, however, were just beginning. Looming on the horizon, the Big Bang deregulation of England's financial institutions, initiated by Margaret Thatcher in 1986, readied itself to punt Barings Bank into obscurity. According to Judith Rawnsey, "Barings was in short exactly the sort of family-run business which Big Bang... seemed set to sweep away" (Rawnsley 1995, 36).

The Big Bang deregulations attempted to wake up Britain's sleepy financial institutions and to regain the competitiveness that these institutions once enjoyed. Prior to the Big Bang, Britain's merchant banks could only issue securities. These hallmarks of conservativeness remained haughty and aloof from the trading floors. Because the deregulation allowed British banks to acquire brokerage houses, the snobbery was replaced with a frenzied race to establish partnerships. The frenzied scramble, however, created many undesirable partnerships and, many relationships between merchant banks and brokerage houses proved disastrous (Rawnsley 1995, 37). Barings, on the other hand, did not participate in the mad scramble. Instead, Barings patiently awaited

its opportunity to embrace the perfect ally. Barings found its comrade in Christopher Heath.

Despite Christopher Heath's association with a small brokerage firm, his reputation based on his success in the emerging Japanese marketplace carried immense weight. Japan's strong products, low inflation, soaring GNP, and educated workforce offered Barings the perfect opportunity to escape the dwindling profitability of the London market. Barings not only embraced the perfect partner, but also created a perfect environment for Christopher Heath to operate. Heath's small brokerage house, purchased for six million dollars, was made a completely autonomous subsidiary of Baring Brothers. The new subsidiary, Barings Securities, had a separate management and offices. It also retained 50% of its profits, before tax, to distribute among its staff.

Baring Securities' original office escaped the grandeur of its parent. Christopher Heath stationed his Japanese operations out of a pet food store. Clients waded through bags of cat and dog food for their investment advice. Business for the new subsidiary soon escalated from the mounds of kibble.

Barings Securities' pioneering efforts to position itself in the unheralded Japanese marketplace reaped enormous dividends. Five years after establishing itself in Japan, the country underwent a period of extraordinary economic growth. Between February 1985 and February 1988, the value of the Japanese yen more than doubled against the dollar. Although financial analysts envisioned a sudden recession, the economy expanded at a lightning rate for six

years. Not even Black Monday on October 1987 could derail Japan as its market fell less and recovered faster than in any other country (Rawnsley 1995, 56).

In the time leading up to this economic boom, Barings Securities was securing its position as the premier firm in Japan. First and foremost, Barings nurtured a very loyal client base. As Christopher Heath stated, "We had a good team of people who were dedicated to building up the business and who were very client-oriented in terms of servicing the institutional clients. We never believed that the world owed us a living; the client wanted to do business and it was up to us to go to him" (Rawnsley 1995, 44).

Barings Securities attempts to secure a loyal client base bordered on excessive. For example, Nick Faldo was once flown in to play golf with four Barings employees and four clients. Each player was photographed with Faldo, and a calendar was made of the shots (Rawnsley 1995, 58). The unusual antics to win client loyalty exemplified Barings Securities' insistence on being client driven.

Besides its loyal client base, Barings attributed much of its success in the emerging markets of the Far East to its superior researching capabilities. In fact, Barings touted itself as the premier researching institution for emerging markets. The investing community agreed, and Barings was awarded Euromoney's Award for Excellence for providing, "the most insightful and well-presented research

available on the Asian market...and having high caliber individuals who flourish in their markets" (Rawnsley 1995, 62).

Barings Securities' two core competencies and its early presence in the Far East catapulted the subsidiary to enormous success. In 1986, when the Japanese markets were at their busiest time ever, Barings Securities' profits proliferated. In 1986, Barings Securities accounted for over two-thirds of the total bank's profits (Rawnsley 1995, 66).

Despite Heath's successes at building Barings' securities division, tensions between the banking parent and the securities subsidiary developed. Barings wanted to exploit the possible synergies that could develop by making the banking and securities divisions interdependent. Heath, however, relished the Firm's freedom and even begged to be spun off from the bank. Unfortunately for Barings, as long as Barings Securities posted huge profits, Heath was untouchable. The Japanese market, however, nose-dived in 1990, and Barings Securities posted a loss for the first time in its existence (Rawnsley 1995, 95). The losses exposed what years of profitability was able to mask. Barings Securities was an inefficient operation with an archaic system of controls.

Baring's Control Environment

Christopher Heath's tone at the top was not conducive to accurate financial reporting. The corporate code of conduct did not embrace ethical behavior; instead it pledged allegiance to Barings Securities' client base. An

excerpt from the corporate code reads: "The client is the most important person ever in this office...the client is the person who brings us the bonus and it is our job to give him anything and everything he wants" (Rawnsley 1995, 45).

Christopher Heath felt that by hiring interesting employees, his clients could best be served. His hiring practices lured some of the industry's most unusual candidates for employment. As one Barings employee stated, "If you included fortune telling among the talents listed on your curriculum vitae... or had fought with tigers, you were definitely in with the chance of an interview" (Rawnsley 1995, 46).

Employees both new and old quickly grew accustomed to Heath's hands-off management style. The relaxed management instilled a family atmosphere in the organization of Barings Securities and fostered an intense employee loyalty to the organization. Although the hands-off approach fostered creativity, it lacked the standard business practices to which Barings had grown accustomed. As Barings Securities swelled, the potential for employees to take advantage of the lenient management became greater.

The firm also outgrew its archaic system of controls. For example, an external auditor from Deloitte and Touch in 1990 stumbled upon £100 million of bearer bonds stashed in an Indonesian bank vault. The shoddy back office staff could not pass the bonds to the owners because the certificates were in such disarray. Because the bonds could not be turned over to its clients for cash, they represented a towering liability for Barings (Leeson 1995, 25). Ominously

enough, a young settlement clerk named Nick Leeson made quite a name for himself by leading a team that effectively settled the trades.

Christopher Heath attempted to mitigate the effects of his hands-off approach to management by establishing an internal audit department. The department, however, had a very limited role in the control environment. The department could only react to problems as they developed and could not take a proactive role in the organization. The presence of internal auditors, even with limited roles, angered the staff. The employees did not grasp the implications of its control environment. The employees lack of understanding highlighted the need to address the control environment culturally (Rawnsley 1995, 67).

The Change in Leadership of Barings Securities

By 1992, Barings could no longer stomach the liabilities of Christopher Heath's free-wheeling approach to business. Peter Norris, a vice-president of the parent corporation, conducted a five-month study of the subsidiary's operating environment. He "discovered the absence of controls; there was no business plan or strategy, no effective control system or budgets, no management, offices had been opened all over the place. Christopher made all the decisions, trying to micro-manage it...Barings Securities had outgrown itself. It was a classic case of the need for a new culture to be established from the previous freewheeling entrepreneurial entity" (Rawsley 1995, 95).

Barings Securities needed to implement a control-conscious culture into the organization. Christopher Heath, however, was not the man for the job. In

late 1992, Peter Norris assumed the helm as Chief Executive Officer of Barings Securities. Heath was subsequently dismissed from the organization.

Peter Norris wasted very little time before implementing his agenda for Barings Securities. One hundred of the subsidiary's employees were fired only one month into Norris' tenure (Rawsley 1995, 97). Although the removal of the employees was an attempt to control the ballooning costs of the securities operation, it immediately destroyed the family atmosphere fostered by Christopher Heath during his eight-year reign.

The rapid restructuring of Barings Securities also muddled communication lines within the organization. The befuddled organizational chart left many departments unsupervised. As one Tokyo trader says, "All you needed was one mutant cell. It was the perfect environment for cancer to grow rapidly" (Rawsley 1995, 121). Nick Leeson capitalized!

Nick Leeson and the Billion Dollar Scam

Nick Leeson was born in 1967 and grew up in a modest household in London. He was a bright child and enjoyed moderate success in high school. Instead of attending college, however, he chose to enter the world of finance (Rawsley 1995, 71).

Leeson bounced around several brokerage houses offering his services as a settlement clerk. Like many of his fellow settlement clerks, however, his eyes were fixated on the trading floor. Barings Securities' international reputation lured Nick Leeson into the Company's ranks in 1991. Leeson's talent

for settling trades was quickly noticed, and he rapidly ascended through the organization. Barings management summoned Leeson to correct the settlement problems in Indonesia. Leeson responded and brilliantly headed up the settlement team that not only settled the £100 million in trades, but also saved Barings thousands of pounds in the process.

Because of Leeson's success in Indonesia, Barings management hand-chose him to head the newly formed futures and options operations in Singapore. Barings bestowed tremendous freedoms on Leeson's operations. Despite his excellent reputation, the loose reigns afforded Leeson's operations worried Baring executives. An internal memo circulated by the head of operations in East Asia outlined his fears stating, "My concern is that we are once again in danger of setting up a structure that will subsequently prove disastrous...in my view it is critical that we should keep clear reporting lines...for the SIMEX operations" (Rawsley 1995, 81).

Barings management, however, disregarded the memo. Four separate management teams shared responsibility for Leeson's Singaporean operations. No management team, however, claimed ultimate control. The muddled chain of command allowed Leeson to conduct his operations virtually unsupervised.

Despite the lack of control over Leeson's operations, Barings quickly expanded the responsibilities of its Singapore operations. Barings Securities devised a risk free proprietary trading strategy that would allow it to take advantage of momentary price differentials between the exchanges in Japan and

Singapore. Barings permitted Leeson to obtain his trading license to conduct the trades conducted in Singapore. Barings did not remove Leeson, however, from his role as head of the back office. Leeson's dual role created a major control weakness. Leeson could now conceivably make unauthorized trades and hide his transactions in his books.

The breach of controls did not bother Barings' management. Leeson proved to be a very trustworthy and capable employee. A memo circulated by Barings top management stated, "We need ten more Nicks leading the current rescue effort" (Rawsley 1995, 108). Unfortunately, Barings disregarded the warnings signals that should have raised red flags in regard to Leeson's character.

Before applying for a trading license in Singapore, Leeson applied in London. London, however, turned down his application because it contained untruths. Leeson failed to mention judgments against him from creditors. It appeared Leeson lived above his means. Although the London exchange contacted Barings in response to the dishonest application, Barings ignored the infraction. In fact, Leeson made the same untrue claims on his application to the Singapore exchange.

Leeson's proprietary trading operations quickly raised eyebrows within Barings, for the risk-free trades showed enormous profits. In fact, by 1993 the Singaporean operations accounted for over 10% of Baring Brothers' entire

profits. Barings Securities sent an internal audit team to investigate the operations.

The internal auditors report praised the efficiency and effectiveness of Leeson's Singapore operations. The reported stated "...that [Barings Singapore operations] has an almost unique capacity to arbitrage effectively between SIMEX and Japanese markets" (Rawnsley 1995, 139). The report continued to express a fear that if Leeson is lost to a competitor, Barings profitability would be greatly reduced.

Despite the praise, the audit report concluded that Leeson should not manage both the front and back offices. Specifically, the report stated, "While the individual controls...are satisfactory, there is significant risk that the controls could be overridden by [Leeson]" (Rawnsley 1995, 139). Once again, the warning fell upon deaf ears.

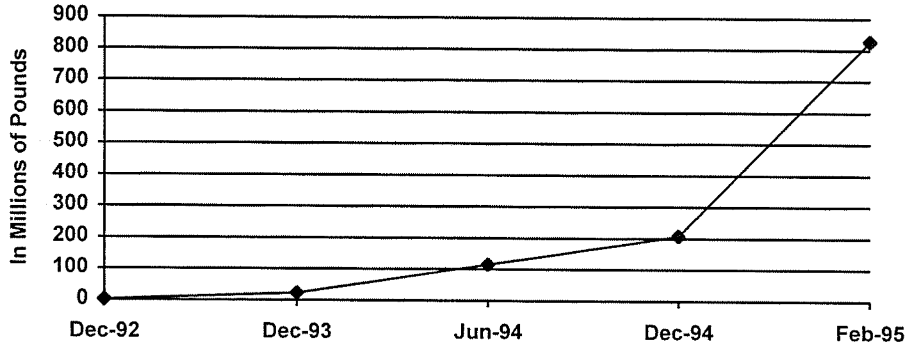
The audit report correctly warned against the risk of Leeson's dual role within the organization. Leeson exploited his role as manager of both the front and back office of the Singapore operations and capitalized on his lack of supervision. The internal audit, however, failed to discover that Leeson was already overriding the controls of the organization and was hiding a £50 million loss during the internal audit investigation.

The internal audit team did not unearth the loss because it was hidden in a secret account created by Leeson. Throughout his tenure as manager, Leeson conducted hundreds of unauthorized trades on behalf of Barings. All

profitable trades were reported on the income statement. Leeson buried the losses, however, in his secret account.

Outsiders contend that greed drove Leeson's motives. Leeson, on the other hand, stated his motive for years of deceit was pure. Leeson said that he hid the first transaction in the secret account to protect his friend and fellow trader who made an enormous blunder conducting a trade on behalf of Barings client (Leeson 1995, 42). Leeson worried that his best trader could lose his job, so Leeson stashed the mistake in a secret account. He then attempted to perform profitable trades that would offset the losses. Leeson's speculating prowess, however, was unspectacular and he continued to mount his losses. A mammoth earthquake in early 1995 accelerated Leeson's demise. Following the earthquake, the bottom fell out of the Japanese market. In a frenzied attempt to keep the market from bottoming out, Leeson went on a spending spree buying every contract he could. He tried to single handily hold up the value of the market. The market, however, was no match, and his losses swelled as demonstrated by the graph in Figure 4.

Figure 4.
Leeson's Accumulated Losses in His Hidden Account



As Leeson's losses mounted, the margin payments required to sustain his addiction grew substantially. Barings, however, funded the over £742 million of margin payments, over twice the entire reported capital for the firm, without hesitation. According to the Group Treasurer, "We just accepted his word that the figures required ran into millions. Yes, we just about accepted what he said" (Rawsley 1995, 136).

SIMEX officials became alarmed at the huge open positions in Barings' accounts and alerted Barings as to the size of its positions in the marketplace. In a letter to Barings' management dated January 27, 1995, SIMEX reminded Barings about its responsibility to ensure that it had sufficient funds to meet its obligations. Management, however, ignored the warning. In fact, Barings management requested Leeson to write the response to SIMEX officials.

Leeson's covert operation started to unravel before the end of 1994. After failing to cover up a loss of approximately £50 million, the external audit team of Coopers & Lybrand conducted an investigation. Leeson, however, convinced

the external audit team that the £50 million was a receivable. Leeson forged documents from the alleged debtor verifying the receivable's existence. Leeson, however, faxed the document from his home and failed to change the header. Therefore, the forged document read from Nick and Lisa Leeson. No one questioned the validity of the document.

The stress of Leeson's covert operation played havoc with his health. Ulcers plagued him starting in early 1994. In the week before the bank's crash, Leeson constantly dashed from the trading floor to vomit. Finally, the pressure became too much, and he escaped Barings leaving behind the following note: "My sincere apologies for the predicament that I have left you in..." Leeson had lost a total of £827 million and forced Barings into bankruptcy.

The Implications of the Treadway Report

Unfortunately, the Barings Bank disaster did not have to happen. Although Barings Securities understood the importance of maintaining a strong control environment, the implementation of internal controls was painstakingly slow. The implementation of the Treadway Commission's recommendations would have prevented the catastrophe.

First, the implementation of an ethical control environment would have been more effective had Peter Norris been forced to write a management letter assessing the controls. Peter Norris would have more fully understood his personal responsibility to ensure Barings Securities fostered a financial reporting environment conducive to accurate financial reporting. The serious breach of

controls provided by Leeson's dual role in the corporation might have been taken more seriously had Peter Norris claimed personal responsibility for the control environment to the company's stakeholders.

Finally, the public accountants use of analytical procedures would have unearthed Leeson's fraud immediately. A risk-free strategy should not be reaping huge rewards. Leeson's supposed risk-free investments were generating over 10% of the entire banks profits.

SURVEY RESULTS

The Barings Brothers debacle and other well-publicized corporate frauds of the 1990s continue to draw negative publicity to the accounting profession. Did the Treadway Commission have a positive effect on the present condition of the financial reporting system? Three representatives of the accounting profession were pulled from the trenches of corporate America to further assess the present state of the financial reporting community. Each person surveyed represents a key component of the financial reporting system. First, Marrianne Parrs represents public company management. She is the current chief financial officer of International Paper Company, Inc. Second, Tommy Hayden, a manager in Ernst & Young's Assurance Division, was chosen to represent the public accounting profession. Finally, Mark Godbold was chosen to represent internal auditors. Mr. Godbold has served as International Paper Company's corporate auditor for the past two years. A brief biography of each representative has been included in the appendix.

Each representative of the accounting profession was contacted by phone and then mailed a four-question survey. The four questions asked were as follows:

1. Do you think fraudulent financial reporting was a serious problem prior to the publication of the Treadway report?
2. Do you think the Treadway recommendations are effective at deterring and detecting fraud in financial statements?

3. What more can be done to deter and detect fraud in financial reporting?
4. How could the Barings Bank fraud have happened in view of Treadway's recommendations?

Although the complete thoughts of these accounting professionals are included in the appendix, a summary of their responses is presented below.

Ms. Parrs and Mr. Godbold both agreed that fraudulent financial reporting was not a problem prior to the Treadway Commission. According to Mr. Godbold, "Although you occasionally heard of a serious problem in a well-publicized case...these were unique, isolated instances." Because many of the frauds perpetrated in corporate America are unique, wiping out fraudulent financial reporting all together would be impossible. Ms. Parrs contends that, "Over the years there have been and will continue to be frauds perpetuated on the public for a variety of reasons, the most significant of which is greed."

Although fraud was not perceived as a significant problem, each representative agreed that the Treadway Commission's recommendations raised awareness of significant issues in financial reporting. Ms. Parrs believes that the "Commissions recommendations make sense and should be followed." Ms. Parrs strives to maintain an ethical tone for International Paper Company by properly segregating duties and maintaining effective internal audit and accounting functions. Mr. Hayden agrees that an ethical tone must permeate an organizations. He contends that effective internal controls could most effectively

ward off instances of fraudulent financial reporting. Although effective internal controls could ward off incidents of fraud, "an effective internal control structure can be diminished if management lacks integrity."

Each representative wants the accounting profession to strengthen its focus on ethical behavior and internal controls. Although Mr. Godbold and Ms. Parrs believe that this focus should permeate throughout the entire organization, Mr. Hayden was more direct. Mr. Hayden believes that "the audit committee of the board of directors should strengthen the focus on an effective internal control environment, specifically, management's control consciousness and operating style and management integrity and objectivity."

Finally, each accounting professional blames the Barings Brothers fraud on a lack of internal controls. Ms. Parrs believes that the simple segregation of duties among the employees could have prevented the entire episode. Despite the lack of controls, Mr. Hayden and Mr. Godbold believe that the other lines of defense in the Barings Brothers financial reporting system should have unearthed the deplorable fraud. The fact that every defense in Barings Brothers financial reporting system broke down proves, "You can't put in cost effective controls that prevent irresponsibility" (Godbold).

CONCLUSION

Despite the recommendations of the Treadway Commission, well-publicized incidents of fraudulent financial reporting continue to haunt the accounting profession. Was the work of the Treadway Commission and the ten years of reform that followed in vain? Unfortunately, some would say yes. Although the Treadway Commission's recommendations stressed that an ethical tone must permeate throughout public companies, a study published by Brief et al. (1996, 183) contends that corporate codes of conduct do not play a significant role in the reduction of fraudulent financial reporting.

In addition to Brief et al.'s (1996) findings, the three representatives of the accounting profession survey for this report believed the Treadway Commission simply raised awareness of fraudulent financial reporting. In fact, two of the respondents did not even perceive fraudulent financial reporting as a significant problem. According to these representatives, many of the large frauds perpetrated against the investing community are unique and, therefore, little can be done to stop them.

Although skeptics question the effectiveness of the literal recommendations of the Treadway Commission, the spirit of the Commission cannot be ignored. The Treadway Commission's recommendations not only prescribed a list of regimented rules, but it also challenged the major players of the financial reporting system to play a key role in fraud detection. Many accounting professionals responded to this challenge.

For the first time, internal controls have been universally defined, and authoritative guidelines exist for their implementation. Many internal audit departments and audit committees in corporate America are becoming increasingly independent of a public company's top management. Also, with each pronouncement of the AICPA's Auditing Standards Board, the public accounting profession is shouldering additional responsibility for the detection of fraud. Fraudulent financial reporting will never be completely removed from the financial reporting environment. Fully implementing the Treadway Commission's recommendations, however, would greatly enhance the financial reporting system's ability to weed out many incidents of frauds embarrassing it today.

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APPENDIX
THE COMPLETE SURVEY AND RESPONSES

The following letter, summary of the Treadway Commission's recommendations, and questionnaire were sent to three representatives of the accounting profession in October 1996. The complete response of the three representatives are presented at the end of this survey.

Tommy Hayden
Ernst & Young
1400 One Commerce Square
Memphis, TN 38103

Dear Tommy,

Thank you for helping me with my honors thesis, which examines the impact of the Treadway Commission's 1987 recommendations. I expect that it will take you 15 to 20 minutes to complete the survey.

As you may recall, the Treadway Commission investigated ways to deter and detect fraudulent financial reporting. I have included a summary of the Treadway Commission's recommendations to nudge your memory, since ten years have passed since its publication. After you reacquaint yourself with the spirit of Treadway, please answer the four questions on the survey form.

The Barings Bank fraud occurred in 1995, seven years after Treadway's report. I have enclosed an article on this fraud to assist you in completing the final survey question.

Please accept the LSU Accounting T-shirt as a token of my appreciation for your valuable assistance.

Sincerely,

Michael Williamson

The Treadway Commission (October 1987)

The recommendations of the Treadway Commission were presented to the public after two years of research by the National Commission on Fraudulent Financial Reporting. The purpose of the commission's research was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence.

Summary of Treadway Commission Recommendations

I. Recommendations for the Public Company
- Ethical Tone by Top Management
- Effective Internal Accounting and Auditing Functions
- Vigilant Oversight by Audit Committee
- Management Report Stating Responsibility for Internal Controls
- Additional Disclosure Following Change in External Auditor

II. Recommendations for the Independent Public Accountant
- Increase Fraud Detection Responsibility
- Strengthen Peer Review Programs
- Improve Communications to Users
- Reorganize Auditing Standards Board

III. Recommendations for the SEC and Other Regulatory Agencies
- Stronger SEC Sanctions and Criminal Prosecutions
- Mandatory Peer Review Programs
- Increase SEC's Funding
- Strengthen State Boards of Accountancy

IV. Recommendations for Educators
- Increase Student Understanding of Internal Controls
- Promote Ethical Behavior in Continuing Professional Education Programs

1. Do you think fraudulent financial reporting was a serious problem prior to the publication of the Treadway report? Please explain and cite personal experiences if possible.

2. Do you think the Treadway recommendations are effective at deterring and detecting fraud in financial statements?

3. In your opinion, what more can be done to deter and detect fraud in financial reporting?

4. Barings Bank lost $800 million in the fraud described in the enclosed article in 1995. How do you think this fraud could have happened in view of Treadway's recommendations? Please explain.

Please answer the following questions about yourself:

1. Educational Background

   University: ______________________

   Degree Earned: ______________________

   Major: ______________________

2. Work Experience

   Position: ______________________

   Years at Position: ______________________

   Certification? CPA CMA CIA

Survey Respondent #1

Mr. Mark Godbold is the corporate auditor for International Paper Company. Although he has only been at his present position for two years, Mr. Godbold has been with International Paper Company for 19 years. He holds an accounting degree from Mississippi State University.

1.

I do not think fraudulent financial reporting was a serious problem prior to the publication of the Treadway Report. Although you occasionally heard of a serious problem in a well-publicized case, in my opinion these were unique, isolated instances. I don't think there was widespread fraudulent financial reporting. Since graduating from college in 1978, I have only worked for one company, International Paper. Senior management at International Paper has placed a heavy emphasis on accurate and conservative financial reporting, as well as ethical business conduct in general. Operating and financial management at all levels share responsibility for ensuring cost effective internal controls are in place and working so that assets are properly safeguarded and used in the shareholders best interest, and that the financial reporting accurately represents the true financial condition of the Company.

Periodic internal and external audits and peer reviews ensure that company policies are adhered to, and that adequate controls are in place and working. Although I've seen some minor instances of fraud and fraudulent financial reporting, I've not seen any serious instances in my 19 year career. In my opinion, the tone set by senior management is key in establishing the financial reporting environment of a company.

2.

The Treadway recommendations have added some substance behind the role of the independent auditor, internal audit function, the audit committee, and educators. I would say it has raised the level of awareness and seriousness over fraudulent financial reporting and outlined responsibilities of audit committees, internal and external audit functions, as well as Company management.

3.

Overall, I don't think we need additional regulations. My experience has shown that fraudulent financial transactions or financial reporting are usually the result of a breakdown of established procedures and controls. Strong internal and external auditors, and effective peer review process, responsibility by all levels of operating and financial management for cost effective internal controls, and senior management support of ethical behavior are the best methods

available for preventing fraud of any type. However, the possibility of fraud or fraudulent financial reporting will always exist.

4.

Obviously, there were not effective controls in place at Barings to prevent unauthorized transactions. Normal segregation of duties were not in place. Effective internal controls should not only prevent unauthorized transactions, but also detect them. Neither prevention or detection controls were in place. Additionally, the internal and external auditors should have also picked up this internal control weakness and recommended controls to prevent his from happening.

Regardless of what internal controls or regulations are in place, there can always be a breakdown in internal controls. However, in most cases there are multiple preventative and detective controls in place over high exposure transactions. Established internal controls monitored by management, internal and external auditors, government regulations, and the audit committee are usually sufficient to prevent this sort of exposure to a company. In this case, there was failure by everyone involved. In my opinion, you can't put in cost effective controls that prevent irresponsibility.

Survey Respondent #2

Ms. Marianne Parrs is the senior vice president and chief financial officer for International Paper Company. Although she has only been at her present position for a year, Ms. Parrs has been with International Paper Company for 22 years. She holds a history degree from Brown University and is a Chartered Financial Analyst.

1.

I do not believe fraudulent financial reporting was widespread prior to the Treadway report and, therefore, not a serious problem. Over the years there have been and will continue to be frauds perpetuated on the public for a variety of reasons, the most significant of which is "greed". There is a saying that "if it's too good to be true, it probably isn't true". Even so, it's amazing what presumably well educated, sophisticated investors will believe. The most compelling example to me recently involved the New Era Philanthropy charity, and I have attached several stories from The Wall Street Journal on this affair, in case you are not familiar with the way it unfolded. A clever individual or group of individuals can probably figure out some way to perpetrate a fraud if they are determined to do so, almost despite good internal controls.

2.

Focusing on the commissions recommendations for public companies, I believe the commissions recommendations make sense and should be followed. From my perspective, the first two recommendations are the most important, that is the ethical tone set by management and effective internal auditing and accounting functions. In the case of International Paper, we rely heavily on internal audits of out operations conducted both by out internal audit staff and by financial personnel from other facilities or businesses that we call peer reviews. Proper segregation of duties is a key objective and we strive to make certain this is in place, even in small operations with limited numbers of personnel. We also require both financial and operating management to sign a quarterly letter representing that the financial condition of the facility or business is properly stated.

3.

A strong management stance on ethical behavior is a very important deterrent to fraudulent behavior. International Paper issues a statement of ethical business standards to all salaried employees and requires that it be signed. This document, plus management behavior, are important in setting expectations. When fraud does occur, we take rapid, specific action. Employees are terminated and, if appropriate, legally prosecuted.

Detecting fraud is difficult and requires a diligent internal audit function as well as management commitment.

Sometimes fraud-or mistakes- occur because of management pressure. For example, in recent years pressure for profits has caused some organizations to treat their treasury functions as "profit centers". The Procter & Gamble derivatives fiasco was caused, in my opinion, by pressure for profits from management and lack of understanding on the part of some P&G employees of the risk involved in their transactions. Of course, Bankers Trust did not go out of their way to explain the risks in the investments they were selling.

4.

The major reason for the Barings failure appears to have been inadequate segregation of duties. This failure can allow the circumstances for fraud- in both large and small amounts. One recent experience at International Paper involved small amount of money where a clerk was charging bingo parlor expenses to a corporate card and then processing and baying the bills. The issue was uncovered by an internal audit. Apparently Barings did not follow all the Treadway recommendations, most specifically those for good internal controls.

Survey Respondent #3

Mr. Tommy Hayden is an audit manager in Ernst & Young's Assurance and Advisory Business Service division. He has worked in this division for over 5 years. Mr. Hayden holds an accounting degree from The University of Mississippi and is a certified public accountant.

1.

The Treadway Commission report was issued in October of 1987, prior to my employment at Ernst & Young. Therefore, I was not aware of any fraudulent financial reporting.

2.

The Treadway Commission's recommendations address a very important matter, that of internal controls. Effective internal controls at a company reduce the likelihood of errors of audit importance. Errors of audit importance are defined as those types of errors which would cause a material misstatement in the financial statement of a company. In assessing whether an effective internal control environment exists, the following areas of a company are typically addressed: management's control consciousness and operating style; management control methods; organizational structure and methods of assigning authority and responsibility; personnel policies and practices; and other influences on management such as the board of directors and/or audit committee and the internal audit function. Each of the above areas are addressed directly or indirectly in the Treadway Commission's recommendations.

I believe that an effective internal control structure is effective in deterring and detecting material misstatements caused by fraud and other errors. However, an effective internal control structure can be diminished if management lacks integrity and objectivity. Management override of internal controls is frequently a factor in litigation involving fraudulent financial reporting.

3.

I believe that the audit committee of the board of directors should strengthen the focus on an effective internal control environment, specifically, management's control consciousness and operating style and management integrity and objectivity. An active audit committee which is concerned about a company's internal control structure can significantly reduce the likelihood of fraudulent financial reporting.

4.

I believe that the loss of Barings could have been avoided if an effective internal control structure was in place. Apparently, Barings Bank did not have an

adequate investment policy relating to proprietary investment transactions. An investment policy which places exposure limits on dealers would have been especially beneficial in this case, if properly applied. AS noted in item 2 above, personnel policies and practices are a component of a typical control environment assessment.

Also, periodic review of Barings' investment portfolio by an investment committee of the board of directors would have helped in detecting the large exposure that bank had in derivatives. This is one example of an internal control the company could have had in place.