SOCIETY OF ACTUARIES

Article from:

Risks and Rewards Newsletter

October 2002 – Issue No. 40

‘Funny’ Accounting and White-Collar Ethics Highlights the Two Standards of Crime

by Nino J. Boezio

Thou shalt not steal; an empty feat,
When it’s so lucrative to cheat.
Arthur Hugh Clough, “The Latest Decalogue”

I have been hearing numerous complaints about the current market environment. Investors and portfolio managers generally understand that market declines are inevitable (even though hope that such declines are short-lived). However, they were not expecting that such market declines as the current one to become exaggerated because of gross dishonesty in financial reporting. Asset forecast models were not contemplating such events. In addition, many are adamant that such dishonesty will be rewarded, not punished. Consider the two standards of crime.

Let us say you are desperate for money and you therefore decide to rob a bank. The risk will be high (you will probably get caught) and the reward will be minimal (a small amount of “free” money if you make a successful getaway). So you manage to rip off $5,000 from a local bank branch, but unfortunately get caught by the police. You now face jail time and a criminal record, and have to give the money back. You also receive public humiliation.

Let us now say you are an office manager. You have some unexpected losses—say $50,000. You look around and decide to borrow money from one account to cover losses in another. Or you aggressively value the results of a recent project. The risks are low. You may not get caught, and if you do, you can claim that any fudging of accounts was simply an accounting error (and can blame subordinates), or that any aggressive projections were actually realistic—“such assessments are subjective” it is argued. This office manager also may not stick around with the company long enough to get caught, and probably no one outside of the firm will find out about what he did anyway.

Or let us say your future with the company and your career is tied to the performance of your company or unit. You realize that you may not make your revenue targets. Your bonus is also tied to the financial results, and you can benefit handsomely if you spin the results in a positive fashion. You also know that criminal litigation in such matters has often been low and unsuccessful. You also know that at worst you may face a fine and some restrictions on your ability to practice in your profession (an unlikely outcome), but at least you will not have to give any of the money you earned back.

As we have seen with the Enron/ Arthur Andersen cases and the other litigations now pending, there are shades of truth, shades of dishonesty and finger pointing in every direction. Supposedly concrete evidence gets tainted by claims that there were misunderstandings of what was happening, that information was not completely available, that others were actually the guilty parties and/or also knew what was going on, or that the business models were sound but others ruined them. Unlike the bank-robbing case where the facts are clear, supposedly concrete facts in a white-collar crime often become muddled at best. Ironically, if such unethical positions were taken by a set of teenagers, we would know they are lying—but for some reason credentialed adults wearing ties and holding high-level university degrees are held to a different standard, and are often given the benefit of the doubt.

The scariest and most troubling aspect from these fraudulent cases (and which is now spurring changes in regulation and punishments), is that many of those who were dishonestly engaging in the improper accounting activities will not only get away with it, but also have become rich in the process (and will keep the loot). Very few will be penalized. Even though we are now seeing a strong public backlash against such activity, it is difficult to say how severe the penalties will be for past abuses, and that only severe punishments for future abuses will be put in place.

A Simple Scenario On How It Works

Let us say a senior accountant (call him JJ) wants to cover a substantial write-off on an account. The write-off will be an embarrassment to him and could cause him to be removed from operating in certain practice lines. He decides to take money from a set of obscure and long-term trust funds which no one watches or monitors, and moves the money to cover the write-off.

To protect himself, accountant JJ also tries to get someone else to sign off on the transaction. The other person asked to sign off (call him BJ) understands that this is improper. He protests. JJ promises to protect BJ if anything goes wrong (“but how will anyone find out anyway,” JJ argues). Also, if BJ does not do what he is told, he may no longer work for the firm. Also arguments are presented such as “everyone does it” and

that "it is the duty of BJ to protect JJ—just as a bodyguard takes a bullet to protect the president." BJ is in a dilemma—he now knows about the impropriety, and if he does nothing about it, he could face professional ethics concerns down the road, even if he leaves the company. If BJ blows the whistle, any closed-door conversations will be denied and it will be BJ's word against JJ's, and BJ could even be charged that it was his idea all along (it is not as though BJ knew in advance that he was going to be pressured to do something illegal, so it is not likely he was recording the conversations).

BJ realizes that it is a no-win situation, but decides that blowing the whistle is more appropriate (wants nothing to do with any wrongdoing). He reports it to persons at a level above accountant JJ. JJ is questioned by upper management about what was going on. JJ claims that he did not realize what was happening and claims that it was all a misunderstanding or gaff, and argues that what occurred was actually okay, and tries to discredit BJ as simply a bad apple in the organization.

BJ now knows that there are several approaches that can be taken. Upper management needs to make a choice as to who is telling the truth. This may be easy based on whether what accountant JJ did is normal industry practice. However, upper management also wants to avoid embarrassment so it considers ways to shut-up BJ. This may involve firing BJ, since he may be collecting evidence on JJ. They can also order files to be discarded or revised so if any investigation does take place, it will not bring to light incriminating evidence. Human nature is such that it does not want to admit it did something wrong—the first inclination is to blame someone else and to institute a cover-up.

BJ decides to report the matter to the regulators and the accounting profession. The regulators and accounting profession become concerned, but also realize that it is just another battle they may not want to engage in, given its size relative to other litigations. Also there are just too many relationships existing between the firm, regulators and accounting bodies, that there may be a willingness to downplay the event, at least for this time. There may even be a suggestion of a trade-off among people on disciplinary committees—we'll protect your guy for a return of the favor down the road. Hence, the case is dismissed on a probationary basis.

The above situation may not be as unusual or as far-fetched as we want to believe. One side has tremendous power and influence. And David and Goliath battles are rarely won by the Davids. We see cries for regulation since there are very few alternative ways for such abuses to be corrected under the current system in which honesty plays a major role, and which is often dependent on a few people coming forward.

Why Two Standards?

White-collar crime has advantages since it can allow for subjective judgement in how transactions are reported. And for a set of reviewers, it is possible to throw a great deal of doubt on the facts of the case to make any strong conclusions difficult to reach. With the bank robber, what took place is clear based on the physical actions. But with actions such as accounting, numbers may not always tell the whole story, or so they say. Subjectivity, unclear professional standards and loose definitions can be exploited to the benefit of the guilty parties. As transactions can sometimes be complicated and involve a variety of factors, a dishonest deed when identified can sometimes be portrayed as a gaff, the result of bad communication, or unclear industry policy after the fact. Claims can be made that what took place was the result of a "misunderstanding," a "lapse of judgement," or an "accounting error." Subordinates could be blamed for what had happened, even if these subordinates knew nothing about it. Or claims can be made that others in the firm have done similar things so there is a precedent (safety in numbers). And, unfortunately, any viable witnesses are either unwilling or unable to come forward, due to fear and intimidation, and since their own future in the industry and the company can thereby be irreparably damaged if they speak out.

In cases where someone does squeal, say to a regulator or financial oversight body, one common ploy a company may use in response, is to claim that the investigation is still ongoing (even though it may have been completed already, and in only a few days). In the process, additional evidence from any complaining party can be brought to light (or hints of how they will attack), and thereby the defending firm can have better

(continued on page 14)

information on which to base a defense strategy. Also any prior conversations cited as being made by the guilty parties behind closed doors will be useless, for there will be denials that any such conversations took place (since they will prove incriminating), or such conversations will be "revised" by the guilty parties to claim that they were about different things than what was claimed. Lying becomes part of the game, and it is difficult for a neutral third party to assess who is telling the truth. It is not as though the honest people carry tape recorders to record such conversations, or that anyone really documents unethical conversations in memos.

If one is playing with the numbers, padding revenue through the diversion of trust funds from a obscure and an un-monitored account, or inflating invoices through such practices as premium billing, it should not be expected that one who steals is also not going to lie about it (in other words, one cannot expect the offending party to be honest in one area and a crook in another—there is no such thing as a honest thief). If one who is caught is truly open and honest about what took place, he or she is likely going to get into greater trouble if they truly portray the events surrounding the crime.

Deep Pockets and Industry Dominance

Unlike the bank robber who was down on his luck to begin with, white-collar criminals can be part of a large company with tremendous financial resources. The company can hire the best lawyers. It can afford to litigate for a number of years. The bank robber may only be able to use a lawyer provided at the mercy of the state. Anyone trying to fight a major corporation or industry needs a great deal of guts, money and stamina.

If the company is very dominant as we saw with Enron or Arthur Andersen, they may not only influence the direction of the industry, but also have influence among the regulators, professional associations and government. As we saw with Arthur Andersen, claims were made that everything done on the accounting side was legal, even though the legality of the accounting actions was determined based on policy heavily influenced and lobbied by the accounting industry (an industry which included Arthur Andersen). Very much a circular professional relationship.

Destruction of Documents Often Works

Destroying documents often eliminates incriminating evidence. Even though regulators and professional bodies may find this action to be further suggestion of wrongdoing, they find themselves up against the new dilemma of proof (valuable documents on what took place are now missing). The investigators may lack the teeth to impose significant charges related to document destruction.

Unless investigators can therefore get persons to come forward, they could be running out of options. And any potential persons to come forward may be reluctant to do so—they face issues of time, legal costs if counter-charges are laid against them, and being blackballed in the industry for future employment. Only in cases of a high-stakes and high-profile game such as Enron, is there the potential for persons to come forward in order to preserve their reputations and careers.

Documents need not always be destroyed—they sometimes can be modified and new memorandums added, thus tying up loose ends left over from the questionable activities. And unfortunately, perhaps as much as 80 percent of the discussions related to the conduct of unprofessional activity are not documented—hence it boils down to a "he says, she says" set of circumstances, which is difficult to substantiate. Therefore, when there is reasonable doubt, the crooks win.

What Happens To The Whistleblowers?

The potential whistleblowers always face a dilemma. If they see something wrong or illegal occurring, they

have a choice of blowing the whistle. Changes can then be made by the company internally, but it is likely that any "waves" made by the whistleblower will result in the whistleblower not only putting his or her job on the line, but also having his or her future with the company placed in jeopardy (they are now a prime candidate for termination). This can also affect their future in the industry. The offending company may also begin to build a file on the whistleblower, trying to find some dirt on his or her past actions, events that could somehow discredit them when the needs arise. If abuses become disclosed to any outside parties, there will also be attempts to label the whistleblower as simply a disgruntled and immature employee who is "out to get the firm," or is targeting another individual out of spite, and that the actions complained about are actually normal practices or are simply blown out of proportion. Even though this scenario does not make sense—it is not like the whistleblower planted such incriminating financial information, or had the power to influence others in order to get the company into trouble (it is the other way around), it still can create enough of a diversion from the main issue being reviewed.

The potential whistleblower could decide simply to keep quiet, but such an action could result in his or her own career being ruined if the improper actions someday become disclosed (one is not guilty simply by keeping silent about what they saw). The potential whistleblower could leave the company and not voice any concerns, but this is no guarantee that they will not be somehow blamed or used as a scapegoat down the road.

What Made Enron, Arthur Andersen And Other Cases Different?—Media Attention And Size Was A Key

When the scale of the misdeeds gets too large and public, as was the case with Enron and Arthur Andersen; then regulators, politicians and professional bodies are more inclined to come out condemning the activities and take proper action (they want to be perceived to be doing their job). If a case is not high profile and is not likely to go very far, then the pain of arguing over something for a number of years for uncertain results is not often worth the effort, or better left to someone else who is more passionate about the matter. Regulators will pick the battles they more likely can win, especially if they have limited resources.

What made the current cases of abuse different from what typically happens in the business environment is that they were big events and they made news headlines. For example, despite all the jockeying by the senior people in both organizations such as Arthur Andersen and Enron, it was difficult to put the genie back into the bottle—regulators, investigators, politicians, employee groups—were all on the trail and out for blood. Had this been a small case, the corporate maneuvrings to cover things up, the made up excuses and the "keep things quiet" approach could have worked.

Summary

Fortunately we in North America are governed by a system of laws that is intended to protect the innocent and punish the guilty; laws that are not available in all parts of the world. For example, we have even noticed a great deal of debate on the matter of rights and freedoms for those who were arrested or have committed acts related to the terrorist attacks of September 11, 2001. It is not necessarily a bad thing to have such debates. Unfortunately, however, our legal system also provides protection for those who are accused of crimes where the evidence is not concrete, or where reasonable doubts can be raised about the intents of the parties. In the areas in which we cannot read another's mind, then we do run into problems. Of course, we have noted that many of the improper financial reporting activities are outrageously out-of-sync with what a normal, thinking, competent, professional would do (and ironically, we have seen teams of professionals working on various reporting, and yet misstatements still occurred). Our laws may have to be primarily structured so that in certain instances a person or professional may have to be held to account based on the outcome, not on whether there was criminal intent clearly identified (hence if an honest person simply messed up, that's too bad. We often see this principle applied in accidents and fatalities—when such events arise, someone has to pay). However, we must always be mindful that any changes made to rules and regulations don't also undermine other important principles, such as those underlying limited liability—otherwise fewer new enterprises will start. Certification of financial results by CFOs and CEOs is one positive step in the direction of holding someone accountable and responsible, despite any arguments about prior malicious intent in financial reporting.

Nino J. Boezio, FSA, CFA, MAAA, is a consulting actuary at Matheis Associates in Toronto, ON. He is also co-editor of Risks and Rewards. *He can be reached at nboezio@sympatico.ca.*