

COOK THE BOOKS AND YOU WILL GO DIRECTLY TO JAIL WITHOUT PASSING GO¹

D. Larry Crumbley* and Nick Apostolou

The Securities and Exchange Commission (SEC) is working closely with criminal prosecutors to attack financial statement fraud. Richard Walker, the SEC's director of enforcement, stated in a speech to the AICPA in Washington in December that the agency continues "to see an unacceptably higher number of busted audits." The SEC plans to increase its attacks on company's weak internal controls and individuals at companies "responsible for doctoring the books."

The 1995 securities-litigation reform gave accountants new defense mechanisms to fight allegations of audit malfeasance. Also, in October 1999, a federal jury exonerated BDO Seidman in an accounting irregularities lawsuit involving an audit of Health Management, Inc. Shareholders sued the Chicago-based accounting firm for \$25 million in compensatory damages for allegedly participating in and failing to uncover accounting abuses at Health Management in 1995.

Earlier in May 1999, a jury awarded a private investment company in Atlanta \$44 million because BDO Seidman allegedly botched an audit of an acquisition target's books by over-valuing the inventory. Mindis Acquisition Corp.

argued that Seidman's over-valuation caused it to overpay for the target company. In a 1993 audit, Seidman estimated the scrap-metal inventory to be worth \$85 million. After two other accounting firms (Grant Thornton LLP and Arthur Andersen LLP) arrived at a \$16 million valuation, the company sued Seidman for professional negligence.²

However, according to Richard Walker, the SEC plans to bring more enforcement cases against "weak-kneed auditors" and auditors who provide consulting services to corporate audit clients and have become soft on the companies books.³ Generally, the SEC starts an informal probe of a company if it believes there is information that should be investigated. An informal inquiry may be expanded to a formal investigation, which may lead to the filing of civil or criminal charges.

¹ Statement by Richard H. Walker, SEC's Director of Enforcement, December 7, 1999.

² Elizabeth MacDonald, "BDO Seidman Loses \$44 Mil. Verdict for Botching Audit of Buyout Candidate," *Wall Street Journal*, April 26, 1999, p. B-4

³ Elizabeth MacDonald, "SEC to Boost Accounting-Fraud Attack, Work More with Criminal Prosecutors," *Wall Street Journal*, December 8, 1999, p. A-4

The authors are, respectively, KPMG Endowed Professor, and LeGrange Endowed Professor at Louisiana State University.