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Called to Account: Financial Frauds that Shaped the Accounting Profession

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Introduction

Double-entry bookkeeping is one of the most beautiful discoveries of the human spirit ...
—Johann Wolfgang von Goethe¹

Accountants and auditors are the offensive linemen of the business world—underappreciated and rarely even noticed unless they give up a sack or get called for holding. While superstar CEOs collect huge salaries for quarterbacking their companies to victory and Wall Street analysts earn accolades for forecasting winners and losers, accountants and auditors rarely get the credit they deserve for gathering and verifying the financial information essential to a modern economy.

The accountant's role is to provide useful information to economic decision makers. Accountants summarize millions of transactions into a few pages of financial statements, enabling managers, stockbrokers, portfolio managers, bank lending officers, bond traders, private investors, and government regulators to evaluate each company's performance.

Auditors protect decision makers from erroneous or fraudulent information. By examining samples of recorded transactions and verifying the existence of assets, auditors provide reasonable (but not absolute) assurance that the financial statements have been prepared fairly in accordance with generally accepted accounting principles.

Every day in financial markets around the globe, investors trade millions of shares based on companies' reported earnings, and creditors extend billion-dollar loans based on borrowers' balance sheets. Capital markets could not function efficiently without accurate financial statements prepared by accountants and verified by auditors.

Public accountants and fraud

The public accounting profession was born in Great Britain during the mid-1800s. The English Companies Act of 1845 required corporations to submit to an annual audit by a committee of shareholders and permitted the shareholders to hire, at company expense, outside accountants to help perform the audit. English and Scottish accountants established firms of "public accountants" to provide audit services. Notable among them were S.H. Price and Edwin Waterhouse, who established their famous partnership in London in 1860.

Throughout history, a handful of accountants and auditors distinguished themselves by uncovering financial crime. William W. Deloitte, whose firm still bears his name, helped unravel accounting frauds at the Great Northern Railway and the Great Eastern Steamship Company in England during the 1850s. Elmer Irey, head of the IRS Special Investigation Unit during the 1920s, played a key role in sending mobster Al Capone to Alcatraz. The *Wall Street Journal* (May 19, 1995) praised accounting professor Albert J. Meyer for

2 Introduction

exposing a \$200 million investment scam at the Foundation for New Era Philanthropy. Auditor Cynthia Cooper was named one of *Time* magazine's 2002 "Persons of the Year" for her role in uncovering the \$11 billion accounting fraud at WorldCom.

But on too many occasions during the last 100 years, public accountants failed to detect audacious frauds perpetrated by their clients. Accounting problems at companies such as McKesson & Robbins, National Student Marketing, Lincoln Savings & Loan, ZZZZ Best, MiniScribe, Sunbeam, Phar-Mor, HealthSouth, Lernout & Hauspie, Parmalat, and Toshiba cost investors tens of billions of dollars. Each scandal was followed closely by angry cries of "Where were the accountants?"

Although auditors often responded with denials and excuses, many of these scandals eventually led to significant improvements in auditing procedures and financial reporting practices. This book describes 16 accounting scandals that shaped the worldwide public accounting profession. Many of the scandals occurred because accountants and auditors violated existing professional standards. Other scandals revealed deficiencies in the standards of the time. Each of the book's eight sections describes the most important reforms that followed each pair of related scandals. Some changes were adopted voluntarily by accountants and auditors. Other reforms were imposed through government legislation.

Frauds are certainly not the sole source of progress within the public accounting profession. Thousands of men and women worked diligently during the last 150 years to improve corporate disclosures, establish meaningful accounting principles, and develop effective auditing procedures. But change is often painful, especially for "conservative" accountants. A well-publicized accounting scandal has often been necessary for the profession to admit its shortcomings and adopt improvements. Few politicians pay much attention to accounting until angry constituents demand reform. It is impossible to understand the modern public accounting profession without understanding the scandals and failures that influenced so many current practices. Many of today's accounting and auditing standards were adopted in response to past scandals. And many of today's problems come from failing to resolve controversies that have plagued accountants for decades.

Note

1 *Wilhelm Meister's Lehrjahre* (1796).