

# **Fraud and Corporate Executives: Agency, Stewardship and Broken Trust**

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The purpose of this paper is to explore the relationship between theories of management and recent financial statement frauds. To accomplish this, we address three areas: First, we examine prevailing theories of management that seek to explain the complex relationship between various stakeholders in an organization, with particular attention to the role of the CEO and other executive managers. While varying in degree, and in the steps that may be taken to obviate conflicts, all of the theories considered share the common element of the transference of *some measure* of trust from shareholders to executive level managers. Next, we analyze recent frauds and the conditions and elements that led to these frauds. Why, in so many cases, have executives been willing to break the trust, betray shareholders, and commit fraud? Lastly, we examine various dimensions of corporate organization and propose a model to identify fraud risk factors that may predict fraudulent behavior. We conclude that there is an optimal combination of organizational dimensions to reduce the likelihood of fraud; and suggest that, to a meaningful degree, executives self-identify with behavior either more consistent with the agency theory or stewardship theory of management, and that those whose behavior is, in fact, more consistent with stewardship theory are more trustworthy and generally less likely to commit fraud.

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## **INTRODUCTION**

In 1602, the Dutch East India Company was established in the Netherlands as a trading company. It is widely believed to be the first organization to issue shares of stock and become a public company (Tschöpe, 2003). While uninvolved owners certainly had financial interest in companies before this time, the Dutch East India Company likely marked the first time the modern conception of stock, shareholders, and public ownership existed in a company.

The existence of many uninvolved, part-owners who are separate from management provided new challenges. How could the shareholders ensure that management acted in the collective interest of all stakeholders? What checks and balances needed to be in place to

ensure wise management and integrity? Over time, public companies were granted legal status – they could sue and be sued, own property, and pay taxes. While shareholders collectively owned a company, the entity existed in its own right – giving shareholders limited liability when things went wrong.

Public ownership and limited liability increased the importance of checks and balances. Since, in many circumstances, CEOs are not directly liable for their actions (the entity is), there is concern that executives may feel empowered or motivated to take actions that under other circumstances they would not normally take (Bagley & Page, 1999). The interaction between shareholders, top management, and the board of directors is an intricate balance of power, agency, stewardship, and responsibility. Recently – over four centuries after the Dutch East India Company introduced the concept of public ownership – we have seen significant abuse in companies leading to large-scale fraud, the bankruptcy of major companies, and the evaporation of wealth.<sup>1</sup>

These frauds have raised new questions about the responsibilities of Boards of Directors, CEOs, and other officers in public companies. In this paper, we address three areas: First, we examine the prevailing theories of management that try to explain the complex relationship between various stakeholders in an organization, with particular attention to the role of the CEO and other executive managers. While varying in degree, and in the steps that may be taken to obviate conflicts, all of the theories considered share the common element of the

<sup>1</sup> Six of the ten largest bankruptcies in U.S. history occurred in 2002 and four of these were associated with major financial statement and/or CEO fraud, including the two largest, WorldCom and Enron. The ten largest bankruptcies, including the six that occurred in 2002, are:

Company	Assets (Billions)	When Filed
1. WorldCom*	\$101.9	July, 2002
2. Enron*	\$63.4	Dec., 2001
3. Texaco	\$35.9	April, 1987
4. Financial Corp of America	\$33.9	Sept., 1988
5. Global Crossing*	\$25.5	Jan., 2002
6. Adelphia*	\$24.4	June, 2002
7. United Airlines	\$22.7	Dec. 2002
8. PG&E	\$21.5	June, 2002
9. MCorp.	\$20.2	March, 1989
10. Kmart	\$17.0	Jan., 2002
*Involved alleged financial statement and/or CEO fraud		

transference of *some measure* of trust from shareholders to executive level managers. Next, we analyze recent frauds and the conditions and elements that led to these frauds. Why, in so many cases, have executives been willing to break the trust, betray shareholders, and commit fraud? Lastly, we examine various dimensions of corporate organization and propose a model to identify fraud risk factors that may predict fraudulent behavior. We conclude that there is an optimal combination of organizational dimensions to reduce the likelihood of fraud; and suggest that, to a meaningful degree, executives self-identify with behavior either more consistent with the agency theory or stewardship theory of management, and that those whose behavior is, in fact, more consistent with stewardship theory are more trustworthy and generally less likely to commit fraud.

## THEORIES OF MANAGEMENT

Certainly, the Chief Executive Officer (CEO) and other members of upper management play significant roles in the success or failure of a company. This significance is reflected in the large salaries paid to CEOs, especially in the U.S.<sup>2</sup> Several theories have been proposed to explain the relationship between management, shareholders, and the board of directors in a company. This section presents an overview of these theories.

### Agency Theory

Agency theory, first proposed by Jensen and Meckling (1976), has become a classic theory of management. Agency theory has been taught in business schools for several decades. As a result, many students have entered the business world having been taught agency theory as a way to understand control and management of a company. This theory is likely shared by managers, board members, and shareholders (Ghosal, 2003; Sundaramurthy and Lewis, 2003).

Agency theory describes a principal-agent relationship between shareholders and management, with top managers acting as *agents* whose personal interests do not naturally align with company and shareholder interest (Jensen & Meckling, 1976). This line of reasoning stems from economic models that argue that all people are only motivated by self-interest

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<sup>2</sup> The average CEO salary, including cash, options and stock, during the period 1999-2002 was \$36.5 million (Klinger). Abdowd and Kaplan (1999) found that CEOs in the U.S. receive salaries that are out of line with salaries in a comparison group of CEOs in 11 other, comparable countries. In contrast, for example, the salaries of U.S. Human Resource directors (used as a control group in their study) were in line with the comparison group. According to Klinger, the salaries of CEOs of the 23 largest accounting firms during the period 1999-2002 was 70% higher than average CEO salaries, or an average of \$62.2 million compared to \$36.5 million.

and self-preservation. The theory holds that a person is a rational actor when he or she seeks to maximize his or her own utility in each situation. Given two options, the rational person will choose the option that most increases his or her own individual utility.

Since shareholder owners of public companies are not normally involved in the daily operations, Directors are selected to oversee, and CEOs and other professional managers are contracted to run, the companies. The principal-agent relationship involves a transfer of trust and duty to the agent while also assuming that the agent is opportunistic and will pursue interests which are in conflict with those of the principal. This potential conflict of interests is often referred to as "the agency problem." For example, a manager may target short-term gains rather than long-term solvency. (Davis, Shoorman, Donaldson, 1997).

According to agency theory, an important component of the solution to the agency problem is to artificially bring management goals in line with shareholder goals. This is typically accomplished by structuring management incentives in such ways that they *align* management behavior with shareholder goals. For example, the shareholders could give the CEO shares or options of stock that vest over time, thus inducing long-term behavior and deterring short-run actions that harm future company value. When the interests of top management are brought in line with the interests of shareholders, agency theory argues that management will fulfill its duty to shareholders, not so much because of any moral sense of duty to shareholders, but because doing what shareholders have provided incentives for maximizes their own utility (Donaldson & Davis, 1991).

Agency theory literature often uses the word *control*, meaning that the board of directors (a proxy representation for the shareholders) must control top management. This is the second component of the solution to the agency problem: monitoring and oversight of management by the board to further counter the agent's propensity to engage in opportunistic behavior. Because of the need for control, this theory argues that the CEO of a company should be a different person than the chairman of the board of directors. When CEO duality occurs (a CEO also chairs the board of directors), control is diminished and shareholders may lose some ability to monitor management behavior, hence sacrificing their ownership power.<sup>3</sup>

<sup>3</sup> It is interesting that of ten prominent companies that had recent significant scandals, eight of them had board chairs who were also the CEOs. The companies, their board chairs and their CEOs were as follows:

Company	CEO	Chairman
1. Enron	Kenneth Lay	Kenneth Lay
2. WorldCom	Bernie Ebbers	Bert Roberts
3. Tyco	Dennis Kozlowski	Dennis Kozlowski
4. Adelphia	John Rigas	John Rigas

Certainly, CEOs must be given enough freedom to effectively manage the companies they are entrusted with, and agency theory recognizes this need. However, one of the primary functions of the board is to curtail "opportunistic behavior" that can occur in upper management, such as shirking responsibility and indulging in excessive perquisites at the expense of shareholder interests (Donaldson & Davis, 1991). The board provides monitoring of CEO actions as well as input into decisions at the top management level. Agency theory proposes that this impartial review occurs best when the chairperson of the board is independent of top management of the company.

Agency theory has been widely discussed in the literature and has been used to understand the way principals and agents act. It has been used in many research studies as the base theory that is either built upon or argued against. Some argue that a primary reason for its acceptance is its simplicity. Its grounding in economic models enables the use of economic theories and experiments to understand human behavior. Several recent studies have questioned the simplicity of the model and have argued for a more comprehensive approach for understanding human actions (see, for example, Davis, Shoorman, Donaldson, 1997). People are extremely complex organisms, they argue, and not all management actions can be explained by simple economic theory, no matter how parsimonious.

### Stewardship Theory

An alternative to agency theory that has been proposed in recent years is stewardship theory. This theory has been put forth as a more comprehensive and realistic lens from which to view management actions and motivations. While agency theory is based in economic models, stewardship theory is based in psychology and sociology literature. In this theory, managers are viewed as stewards of their companies, predominately desirous of acting in the best interests of the shareholders. The theory holds that as stewards, managers will choose the interests of the shareholders, perhaps psychologically identified as the best interests of "the company," over the interests of self, regardless of personal motivations or incentives. (Sundaramurthy and Lewis, 2003).

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#### *Footnote 3 cont.*

5. <b>HealthSouth</b>	<b>Richard Scrushy</b>	<b>Richard Scrushy</b>
6. Global Crossing	Joun Legere	Gary Winnick
7. <b>Waste Management</b>	<b>Dean Buntrock</b>	<b>Dean Buntrock</b>
8. <b>Quest</b>	<b>Joseph Nacchio</b>	<b>Joseph Nacchio</b>
9. <b>Homestore</b>	<b>Stuart Wolff</b>	<b>Stuart Wolff</b>
10. <b>Sunbeam</b>	<b>Al Dunlap</b>	<b>Al Dunlap</b>

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Under this theory, rather than being exclusively motivated by self-interest, motivations of stewards are varied and complex. Generally, stewards have self-incentive, are motivated by a need to achieve and excel in their work, and are able to distinguish between their work and the compensation for it. Stewards also generally gain intrinsic satisfaction through successfully performing inherently challenging tasks. Stewards also often have a need to exercise responsibility and authority in order to gain recognition from peers and board members (Donaldson & Davis, 1991), or to obtain sufficient empowerment to "get the job done properly." An important aspect of stewardship theory is in the mind of the individual: stewards are owners of the company in proxy, and they fulfill their responsibility even when that responsibility is in conflict with their personal interests.

The literature on stewardship focuses on enabling managers rather than controlling them. Since the steward can be trusted to place shareholder interest first, he or she can be given significant control of the company. With this theory, the board of directors is a sounding board and resource for a steward CEO rather than a controlling body. The steward is not merely an agent of the shareholders – he or she is, in their own mind, an embodiment of all shareholders. A steward instinctively recognizes the trust with which he or she has been entrusted. This theory may also involve a high level of principal trust (Davis, Shoorman, Donaldson, 1997).

Since stewardship theory holds that there is no inherent problem with steward motivation, performance variations may arise from empowerment variations, and thus stewardship theory proposes that the steward-CEO can best act when he or she is also the chairperson of the board (Donaldson & Davis, 1991). Under this theory, CEO duality is an enabling force rather than a control violation. As both CEO and Chairperson, the steward can best utilize all resources of the company for the best possible purposes.

For example, Donaldson & Davis found that dual CEO structures outperformed independent chair structures in a 1991 study. The study controlled for industry effects and showed a statistical difference in performance between dual CEOs and independent CEOs.

Table 1 on the next page compares various aspects of agency theory and stewardship theory.

**Table 1**  
Comparison of Agency and Stewardship Theory (Davis, Shoorman, Donaldson, 1997)

	<b>Agency Theory</b>	<b>Stewardship Theory</b>
<b>Model of Man</b>	Economic Man	Self-Actualizing Man
<b>Behavior</b>	Self-serving	Collective serving
<b>Motivation</b>	Extrinsic: Lower order/economic needs (physiological, security, economic)	Intrinsic: Higher order needs (growth, achievement, self-actualization)
<b>Social Comparison</b>	Other managers	Principals
<b>Identification</b>	Low value commitment	High value commitment
<b>Power</b>	Institutional (legitimate, coercive, reward)	Personal (expert, referent)
<b>Management Philosophy</b>	Control oriented	Involvement oriented
<b>Risk</b>	Control mechanism	Trust
<b>Time frame</b>	Short-term	Long-term
<b>Objective</b>	Cost control	Performance Enhancement
<b>Cultural</b>	Individualism High power distance	Collectivism Low power distance

### Other Theories of Management

While agency theory has been the dominant theory of leadership in the literature, and stewardship theory has recently been a common reaction to it, other theories of management, although not as widely accepted or discussed, have been proposed.

The *power perspective theory* addresses the conflict between top managers, board members, and shareholders. Legally, the board of directors represents the most powerful body in a public company. However, this theory holds that, in practice, this power does not always rest with boards. Several factors can operate to give the CEO de facto power in a company (Daily, Dalton, Canella, 2003; Sundaramurthy and Lewis, 2003). The following are some examples:

- Strong CEOs can exercise influence over board members because he or she is more in tune with daily operations of the company.
- CEOs can exercise influence over the succession of board members to ensure board members that agree with him or her are appointed.
- CEOs can “train” new board members to trust and allow significant control to be given to them.

A fourth theory, that of *resource dependency*, argues that board members are boundary spanners of the organization and its environment. Rather than a controlling body, board members exist to provide the CEO access to resources to which he or she would not normally have access. For example, a lawyer might be appointed to the board of directors to provide legal advice to the CEO. This relationship automatically starts as a resource relationship (Daily, Dalton, Canella, 2003).

Because these theories are not widely discussed in the literature, we do not reference them further in this paper. We believe these theories are largely complementary to agency and stewardship theories. They primarily serve as mediating factors in these other theories rather than independent theories on their own.

## RECENT FRAUDS

In the context of recent frauds, which theory provides the best lens for explaining what happened and why the problems occurred? Are managers agents, stewards, power grabbers or something else? It should be noted that these different theories underlie many of the debates about the roles of CEOs and board members occurring today. In 2003, Sundaramurthy and Lewis state that, “Tensions between proponents of control versus collaborative approaches to governance are rising. Debates persist over whether detached outsiders or knowledgeable insiders should dominate boards, whether directors should monitor or empower executives, and whether the board should allow market forces to discipline managerial excess or should protect managers from market abuses.”

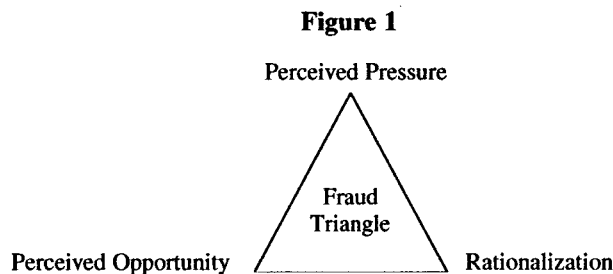
Whatever the answer to these questions, the complexities of human behavior and the many different available theories suggest that researchers face considerable challenges in determining what causes dysfunctional behavior in companies. Further, the vast majority of management research has addressed behavior in stable or growing firms, not companies that



have experienced problems such as management fraud. Relatively little research has been devoted to effective management in firms that are in crisis, financial or otherwise. (Daily, Dalton, Canella, 2003).

### Why People Commit Fraud

To answer the question as to which theory of stewardship of management best explains recent frauds, it's important to understand why fraud occurs. Fraud researchers have found that there are three elements common to all frauds: (1) a perceived pressure, (2) a perceived opportunity, and (3) some way to rationalize the fraud as acceptable and consistent with one's personal code of ethics (Albrecht, 2003). Whether the dishonest act involves fraud against a company, such as employee embezzlement, or fraud on behalf of a company, such as management fraud, these three elements are always present. Figure 1 illustrates the fraud triangle which is comprised of these three elements.

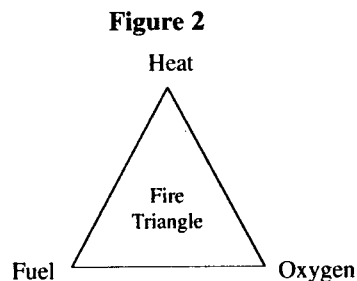


Every fraud perpetrator faces some kind of perceived pressure. Most pressures involve a financial need, although non-financial pressures, such as the need to report results better than actual performance, frustration with work, or even a challenge to beat the system, can also motivate fraud. Examples of perceived financial pressures that can motivate financial statement fraud are financial losses, failure to meet Wall Street's earnings expectations, or the inability to compete with other companies.

Fraud perpetrators must also have a perceived opportunity or they will not commit fraud. Even with intense perceived pressures, executives who believe they will be caught and punished rarely commit fraud. On the other hand, executives who believe they have an opportunity (to commit and/or conceal fraud) often give in to their perceived pressures. Perceived opportunities to commit management fraud include such factors as a weak board of directors or inadequate internal controls and the ability to obfuscate the fraud behind complex transactions or related-party structures.

Finally, fraud perpetrators must have some way to rationalize their actions as acceptable. For corporate executives, rationalizations to commit fraud might include thoughts such as “we need to keep the stock price high,” “all companies use aggressive accounting practices,” “it is for the good of the company” or “the problem is temporary and will be offset by future positive results.”

In many ways, fraud is like fire. In order for a fire to occur, three elements are necessary: (1) oxygen, (2) fuel, and (3) heat. These three elements comprise the “fire triangle,” as shown in Figure 2 below. When all three elements come together, there is fire.



Firefighters know that a fire can be extinguished by eliminating any one of the three elements. Oxygen is often eliminated by smothering, by using chemicals, or by causing explosions, as is the case with oil well fires, for example. Heat is most commonly eliminated by pouring water on fires. Fuel is removed by building fire lines or fire breaks or by shutting off the source of the fuel. Fire fighters also know that the more pure the oxygen, the less fuel or heat it takes for combustion; the more flammable the fuel, the less oxygen or heat it takes for combustion or the higher the heat, the less flammable the fuel and less pure the oxygen need to be. In other words, the three factors of the fire triangle work like an interactive scale. The more of one you have, the less of the other two it takes. And, if you can completely eliminate any one of the three, you eliminate fire.

As with the elements in the fire triangle, the three elements in the fraud triangle are interactive. With fraud, the greater the perceived opportunity or the more intense the pressure, the less rationalization it takes for someone to commit fraud. Likewise, the more dishonest a perpetrator is and the easier it is for him or her to rationalize deviant behavior, the less opportunity and/or pressure it takes to motivate fraud. One unfortunate caveat for those concerned with fraud is that rationalizations are usually unobservable.

The fraud triangle provides insight into why recent financial statement frauds occurred. Combined with the theories of management discussed earlier in the paper, we believe nine factors came together to create what we call the perfect fraud storm. In explaining this perfect storm, we will use examples from recent frauds.<sup>4</sup>

1. The first element of the perfect storm was the masking of many existing problems and unethical actions by the good economy of the 1990s and early 2000s. During this time, most businesses appeared to be highly profitable, including many new “dot-com” companies that were testing new (and many times unprofitable) business models. The economy was booming, and investment was high. In this period of perceived success, people made nonsensical investment and other decisions.<sup>5</sup> The advent of “investing over the Internet” for a few dollars per trade brought many new, inexperienced people to the stock market. History has now shown that several of the frauds that have been revealed since 2002 were actually being committed during the boom years but that the apparent booming economy hid the fraudulent behavior.<sup>6</sup>

The booming economy also caused executives to believe that their companies were more successful than they were and that their companies’ success was primarily a result of good management actions. Sundaramurthy and Lewis (2003), for example, found that extended periods of prosperity can reduce a firm’s motivation to comprehend the causes of success, raising the likelihood of faulty attributions. In other words, during boom periods, many firms do not correctly ascribe the reasons behind their successes. Management usually takes credit for good company performance. When company performance degrades, boards often expect results similar to those in the past without new management styles or actions. Since management did not correctly understand past reasons for success, they incorrectly think past methods will continue to work. Once methods that may have worked in the past only because of external factors fail, some CEO’s may feel increased pressure. In some cases, this pressure contributed to fraudulent financial reporting and other dishonest acts.

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<sup>4</sup> We realize that generalizing from examples is dangerous and that many of the elements we discuss are subject to empirical validation. However, this paper is exploratory and is written to stimulate further research and to suggest possible reasons for recent frauds.

<sup>5</sup> A common joke among academics during this period was that the way to value a dot-com company was to multiply its loss by a “-1” to get a positive number (since they were all losing money.) You then multiplied that number by 100. If the stock price was lower than that number, you bought the stock. If the stock price was higher than that number, you bought the stock anyway.

<sup>6</sup> One apparent fraud was already ongoing in 1997 when a senior financial manager at the firm suggested that the financial statement manipulation be discontinued. His suggestion was ignored and the fraud was discovered in 2003.

2. The second element of the perfect storm was the moral decay that has been occurring in the U.S. and the world in recent years. Whatever measure of integrity one uses, dishonesty appears to be increasing. For example, when comparing 2002 results to 2001 results, the Josephson Institute found that the percentage of high school students who admitted to cheating on exams had increased from 71 to 74 percent; that the percent of high school students who admitted lying to their parents had increased from 92 to 93 percent; that the percentage of high school students who said they would lie to get a job had increased from 27 to 37 percent, and that the percentage of high school students who admitted to taking something from a store increased from 35% in 2002 to 38% in 2003. (<http://www.josephsoninstitute.org/Survey2002/survey2002-pressrelease.htm>) Similarly, a study by the University of California at Berkely found that there had been a 115% increase in reported cases of academic dishonesty between 1995 and 2000<sup>7</sup> ([http://www.executiveforum.net/pdfs/jennings\\_summary.pdf](http://www.executiveforum.net/pdfs/jennings_summary.pdf)). While the population age of these studies does not directly address the likely age of corporate executives of US-based public companies, the studies may help partially explain why so many lower-level employees who became aware of various fraudulent activities at their firms remained silent.

3. The third element of the perfect storm was misplaced executive incentives. For example, agency theory's solution of aligning executive pay with company performance was practiced to the extreme in many cases. Executives of several fraudulent companies were endowed with hundreds of millions of dollars in stock options and/or restricted stock that made it far more important to keep the stock price rising than to report financial results accurately. In many cases, this stock-based compensation far exceeded executives' salary-based compensation. For example, in 1997, Bernie Ebbers, the CEO of WorldCom, had a cash-based salary of \$935,000. Yet, during that same period, he was able to exercise hundreds of thousands of stock options, making millions in profits and received corporate loans totaling \$409

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<sup>7</sup> A major reason for this increasing dishonesty may be the decline in the amount of positive modeling and labeling occurring in society. Moral development researchers argue that for someone to develop honesty as a personal trait, that person must be exposed to both positive modeling (example) and positive labeling (teaching and training) and that the less exposure to these factors a person has, the less honest their behavior will be. Unfortunately, what makes the news today is mostly examples of bad modeling and that news is more widely available and explicit than ever before. Similarly, it is widely believed that there is not as much explicit honesty training (labeling) occurring today as is the past. For example, whereas families used to experience sit-down dinners with opportunities for positive labeling, USA Today ([http://www.usatoday.com/money/industries/food/2003-04-23-grazing\\_x.htm](http://www.usatoday.com/money/industries/food/2003-04-23-grazing_x.htm)) recently referred to today's Americans as "grazers" who eat an average of 6 meals per day, mostly on the run and often consisting of a candy bar and a diet cola. The result of less positive modeling and labeling is increasing numbers of individuals entering the business world with situational ethics; that is, they do what's right if it pays to do what's right and often do otherwise if there are rewards for doing so. This moral decay makes it easier for individuals to rationalize dishonest behavior, especially when faced with perceived pressures and opportunities.

million for purchase of stock and other purposes ([http://www.usatoday.com/money/companies/management/2002-12-23-ceo-loans\\_x.htm](http://www.usatoday.com/money/companies/management/2002-12-23-ceo-loans_x.htm)). The attention of many CEO's shifted from managing the firm to managing the stock price. At the cost of countless billions of dollars, managing the stock price all too often turned into fraudulently managing the financials.

4. The fourth element of the perfect storm, and one closely related to the last, was the often unachievable expectations of Wall Street analysts that targeted only short-term behavior. Company boards and management, generally lacking alternative performance metrics, used comparisons with the stock price of "similar" firms and attainment of analyst expectations as important defacto performance measures. These stock-based incentives compounded the pressure induced by the analyst expectations. Each quarter, the analysts, often coached by companies themselves, forecasted what each company's earnings per share (EPS) would be. The forecasts alone drove price movements of the shares, imbedding the expectations in the price of a company's stock. Executives knew that the penalty for missing the "street's" estimate was severe—even falling short of expectations by a small amount would drop the company's stock price by a considerable amount. Consider the following example of one of the frauds that occurred recently. In this company, the "street" made the following EPS estimates for three consecutive quarters:<sup>8</sup>

<b>Firm</b>	<b>1st Qtr</b>	<b>2nd Qtr</b>	<b>3rd Qtr</b>
Morgan Stanley	\$0.17	\$0.23	
Smith Barney	0.17	0.21	0.23
Robertson Stephens	0.17	0.25	0.24
Cowen & Co.	0.18	0.21	
Alex Brown	0.18	0.25	
Paine Webber	0.21	0.28	
Goldman Sachs	0.17		
Furman Selz	0.17	0.21	0.23
Hambrecht & Quist	0.17	0.21	0.23

Based on these estimates, the consensus estimate was that the company would have EPS of \$0.17 in the first quarter, \$0.22 in the second quarter and \$0.23 in the third quarter. As has now been shown, the company's actual earnings during the three quarters were \$0.08, \$0.13

<sup>8</sup> The data relating to this case are real but proprietary. Because litigation is still ongoing, the source and name of the company have not been revealed.

and \$0.16 respectively. In order to not miss the "street's" estimates, management committed a fraud of \$62 million or \$.09 per share in the first quarter, a fraud of \$.09 in the second quarter and a fraud of \$0.07 in the third quarter.

The complaint in this case read as follows:

"The goal of this scheme was to ensure that [the company] always met Wall Street's growing earnings expectations for the company. [The company's] management knew that meeting or exceeding these estimates was a key factor for the stock price of all publicly traded companies and therefore set out to ensure that the company met Wall Street's targets every quarter regardless of the company's actual earnings. During the period 1998 to 1999 alone, management improperly inflated the company's operating income by more than \$500 million before taxes, which represents more than one-third of the total operating income reported by [the company]."

5. The fifth element in the perfect storm was the large amounts of debt and leverage each of these fraudulent companies had. This debt placed tremendous financial pressure on executives to not only have high earnings to offset high interest costs but also to report high earnings to meet debt and other covenants. For example, during 2000, Enron's derivatives-related liabilities increased from \$1.8 billion to \$10.5 billion. Similarly, WorldCom had over \$100 billion in debt when it filed history's largest bankruptcy. During 2002 alone, 186 public companies, including WorldCom, Enron, Adelphia and Global Crossing, with \$368 billion in debt filed for bankruptcy. (<http://www.bizjournals.com/portland/stories/2002/12/30/daily17.html>)

6. The sixth element of the perfect storm was the nature of U.S. accounting rules. In contrast to accounting practices in other countries such as the U.K and Australia, U.S. generally accepted accounting principles (GAAP) are much more rule-based than principles based.<sup>9</sup> One perspective on having rules-based standards is that if a client chooses a particular questionable method of accounting that is not specifically prohibited by GAAP, it is hard for auditors or others to argue that the client can't use that method of accounting. The existing general principles already contained within GAAP notwithstanding, when auditors and other advisors sought to create competitive advantages by identifying and exploiting possible loopholes, it became harder to make a convincing case that a particular accounting treatment is prohibited when it "isn't against the rules." Professional judgment lapsed as the

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<sup>9</sup> In 2003, the SEC acknowledged that US GAAP may be too "rule-based" and wrote a position paper arguing for more "principles-" or "objectives-based" accounting standards.

general principles already contained within GAAP and SEC regulations were ignored or minimized. The result was that rather than deferring to existing, more general rules, specific rules (or the lack of specific rules) were exploited for new, often complex financial arrangements, as justification to decide what was or was not an acceptable accounting practice.

As an example, consider the case of Enron. Even if Andersen had argued that Enron's Special Purpose Entities (SPEs) weren't appropriate, it would have been impossible for them to make the case that the SPEs alone were clearly against any *specific* rules. Some have suggested that one of the reasons it took so long to obtain indictments or plea bargains in the Enron case was because it wasn't immediately clear whether GAAP or any laws had actually been broken.

7. A seventh element of the perfect fraud storm was the opportunistic behavior of some CPA firms. In some cases, accounting firms used audits as loss leaders to establish relationships with companies so they could sell more lucrative consulting services. The rapid growth of the consulting practices of the "Big 5" accounting firms, which was much higher than the growth of other consulting firms, attested to the fact that it is much easier to sell consulting services to existing audit clients than to new clients. In many cases, audit fees were much smaller than consulting fees for the same clients, and accounting firms felt little conflict between independence and opportunities for increased profits. In particular, these alternative services allowed some auditors to lose their focus and become business advisors rather than auditors. This is especially true of Arthur Andersen, who had spent considerable energy building its consulting practice, only to see that practice split off into a separate firm. Privately, several Andersen partners have admitted that the surviving Andersen firm and some of its partners had vowed to "out consult" the firm that separated from them.

8. The eighth element of the perfect storm was greed by executives, investment banks, commercial banks, and investors. Each of these groups benefited from the strong economy, the high level of lucrative transactions, and the apparently high profits of companies. None of them wanted to accept bad news. As a result, they sometimes ignored negative news and entered into bad transactions.<sup>10</sup> For example, in the Enron case, various commercial and investment banks made hundreds of millions from Enron's lucrative investment banking transactions, on top of the tens of millions in loan interest and fees. None of these firms

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<sup>10</sup> A March 5, 2001 *Fortune* article included the following warning about Enron: "To skeptics, the lack of clarity raises a red flag about Enron's pricey stock...the inability to get behind the numbers combined with ever higher expectations for the company may increase the chance of a nasty surprise. Enron is an earnings-at-risk story..." (<http://www.fortune.com/fortune/print/0,15935,369278,00.html>)

alerted investors about derivative or other underwriting problems at Enron. Similarly, in October 2001, after several executives had abandoned Enron and negative news about Enron was reaching the public, 16 of 17 security analysts covering Enron still rated the company a "strong buy" or "buy" (<http://fitzgerald.senate.gov/legislation/stkanalyst/analystmain.htm>). Enron's outside law firms were also making large profits from Enron's transactions. These firms also failed to correct or disclose any problems related to the derivatives and special purpose entities, but in fact helped draft the requisite associated legal documentation. Finally, the three major credit rating agencies, Moody's, Standard & Poor's and Fitch/IBC – who all received substantial fees from Enron – also did nothing to alert investors of pending problems. Amazingly, just weeks prior to Enron's bankruptcy filing – after most of the negative news was out and Enron's stock was trading for \$3 per share – all three agencies still gave investment grade ratings to Enron's debt (<http://www.cdfa.net/cdfa/press.nsf/pages/275>).

9. Finally, the ninth element of the perfect storm was three types of educator failures. First, educators had not provided sufficient ethics training to students. By not forcing students to face realistic ethical dilemmas in the classroom, graduates were ill-equipped to deal with the real ethical dilemmas they faced in the business world. In one allegedly fraudulent scheme, for example, participants included virtually the entire senior management of the company, including but not limited to its former chairman and chief executive officer, its former president, two former chief financial officers and various other senior accounting and business personnel. In total, it is likely that there were over 20 individuals involved in the earnings overstatement schemes. Such a large number of participants points to a generally failed ethical compass for this group. Consider another case of a chief accountant. A CFO instructed the chief accountant to increase earnings by an amount somewhat over \$100 million. The chief accountant was skeptical about the purpose of these instructions but did not challenge them. Instead, the chief accountant followed directions and allegedly created a spreadsheet containing seven pages of improper journal entries – 105 in total – that he determined were necessary to carry out the CFO's instructions. Such fraud was not unusual. In many of the cases, the individuals involved had no prior records of dishonesty – and yet when they were asked to participate in fraudulent accounting, they did so quietly and of their free will.

A second educator failure was not teaching students about fraud. One author of this paper has taught a fraud course to business students for several years. It is his experience that most business school graduates would not recognize a fraud if it hit them between the eyes. The large majority of business students don't understand the elements of fraud, perceived pressures and opportunities, the process of rationalization, or red flags that indicate the possible presence of dishonest behavior. And, when they see something that doesn't look right, their first reaction is to deny a colleague could be committing dishonest acts.



The third educator failure has been to neglect exploration of possible relationships between various theories of management behavior and fraudulent activity.

Table 2 shows how these nine “perfect storm” elements fit into the fraud model.

**Table 2**

<b>Element of the Fraud Triangle</b>	<b>Element of the Perfect Fraud Storm</b>
Perceived Pressures	3. Misplaced executive incentives 4. Unrealistic Wall Street expectations 5. Large amounts of debt 8. Greed
Perceived Opportunities	1. Good economy was masking many problems 6. Selective interpretation of rules-based accounting standards 7. Opportunistic behavior of CPA firms
Rationalization	2. Moral decay in society 9. Educator failures

### ***THEORIES OF MANAGEMENT APPLIED TO RECENT FRAUDS***

The fraud model discussed in this paper is instructive in facilitating an understanding of some recent corporate frauds. With the prerequisites of perceived pressures, perceived opportunities, and executive rationalization in mind, we now consider the three important organizational dimensions of structure and controls, rewards and incentives, and executive behavior.

#### **Structure and Controls**

Every company has a corporate structure that is either primarily agency theory based or stewardship theory based. Corporate structures that support agency theory include controls that limit the opportunities of executives to maximize their own utility at the expense of shareholder interests. Corporate structures that support stewardship theory include high levels of trust and enabling and empowering mechanisms. We would argue that agency-based corporate structures provide low opportunities for fraud to be committed while stewardship-based corporate structures provide high opportunities for fraud to be committed.

## Rewards and Incentives

Every company has executive rewards and incentives that are either primarily agency theory based or stewardship theory based. Executive rewards and incentives that are stewardship-based provide low pressures to commit fraud while agency-based rewards and incentives provide high pressures to commit fraud. Stewardship theory holds that executives are not primarily motivated by pay, but rather by the intrinsic satisfaction of successful performance. On the other hand, despite intentions, agency-based rewards and incentives that attempt to align CEO interests with those of shareholders (e.g. stock options, restricted stock, etc.) create pressures which are often in conflict with shareholder interests.<sup>11</sup>

## Executive Behavior

Every executive has behavioral attitudes that are either primarily consistent with stewardship theory or agency theory. Executives whose behavior is primarily stewardship based would have a difficult time rationalizing fraud against an organization and would be less likely to participate in any short-term behavior (e.g. manipulating reported income) that maximized their self interest to the detriment of shareholders. Executives whose behavior is stewardship-based would only commit financial statement fraud if they thought it was in the best long-term interest of all the shareholders, something that would be extremely rare. Executives whose behavior is primarily agency based would more easily rationalize fraud against organizations or manipulate reported earnings if they felt it was in their personal, short-term interest, regardless of the long-term impact on the company

The behavioral attitude of executives likely manifests itself within a personal code of ethics (an aspect of the rationalization element of the fraud triangle), with the management control philosophy,<sup>12</sup> and in other ways.

Combining these dimensions in a matrix shows that it is the combination of stewardship-based structure, agency-based rewards, and agency-based behavior that provide the greatest likelihood of financial statement fraud. See Table 3 on the following page.

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<sup>11</sup> Agency theory proposes that principals can control executives by aligning incentives with the interests of the shareholders. Unfortunately, stock-based compensation requires a high degree of control that is not always possible. Output signals, such as stock price, are noisy in practice - affected by many things - only one of which is executive performance (Buck, et. al. 2003).

<sup>12</sup> Recent research suggests that management *attitude* and actions toward control structures – management control philosophy – often negates the effectiveness of formal control structures (Dunn 2003).

Table 3

	Executives whose behavior is primarily consistent with <i>stewardship</i> theory	Executives whose behavior is primarily consistent with <i>agency</i> theory
Corporations with stewardship-based structures and stewardship-based rewards and incentives	<p>Pressure to Commit Fraud: <i>Low</i>            Opportunity to Commit Fraud: <i>High</i>            Inclination to Rationalize: <i>Low</i></p> <p><i>These executives receive rewards and incentives and work in a corporate structure that is consistent with their personal behavior. These executives are highly satisfied and are not likely to commit fraud, regardless of the high opportunities.</i></p>	<p>Pressure to Commit Fraud: <i>Low</i>            Opportunity to Commit Fraud: <i>High</i>            Inclination to Rationalize: <i>High</i></p> <p><i>These executives don't have rewards and incentives that provide pressure to commit fraud but operate in environments that provide high opportunities to commit fraud. They also have a higher tendency to rationalize fraud than other executives. These executives could commit fraud but are not as likely to do so as those in the next cell.</i></p>
Corporations with stewardship-based structures and agency-based rewards and incentives	<p>Pressure to Commit Fraud: <i>High</i>            Opportunity to Commit Fraud: <i>High</i>            Inclination to Rationalize: <i>Low</i></p> <p><i>These executives have pressures to commit fraud because of rewards and incentives and work in environments that enable fraud to be committed. However, because they have a low inclination to rationalize fraud, they would not be likely to commit fraud.</i></p>	<p>Pressure to Commit Fraud: <i>High</i>            Opportunity to Commit Fraud: <i>High</i>            Inclination to Rationalize: <i>High</i></p> <p><i>These executives are the most likely of all executives to commit fraud: they have all the elements of the fraud triangle—high perceived pressures, high perceived opportunities and a high level ability to rationalize dishonest acts.</i></p>
Corporations with agency-based structures and stewardship-based rewards and incentives	<p>Pressure to Commit Fraud: <i>Low</i>            Opportunity to Commit Fraud: <i>Low</i>            Inclination to Rationalize: <i>Low</i></p> <p><i>These executives receive rewards and incentives that are consistent with their behavioral attitudes but are frustrated by the high level of controls in their organizations. They would have a hard time committing fraud even if they wanted to but would rarely be inclined to do so. These executives are the least likely to commit fraud.</i></p>	<p>Pressure to Commit Fraud: <i>Low</i>            Opportunity to Commit Fraud: <i>Low</i>            Inclination to Rationalize: <i>High</i></p> <p><i>These executives have low pressures and opportunities to commit fraud but a high ability to rationalize fraud. The likelihood that these executives will commit fraud is contingent upon the adequacy of the control environment.</i></p>
Corporations with agency based structures and agency-based rewards and incentives	<p>Pressure to Commit Fraud: <i>High</i>            Opportunity to Commit Fraud: <i>Low</i>            Inclination to Rationalize: <i>Low</i></p> <p><i>These executives have rewards and incentives that motivate fraud but limited opportunities to commit fraud. In addition, they would be unlikely to rationalize committing fraud even though they work in environments that are frustrating to them.</i></p>	<p>Pressure to Commit Fraud: <i>High</i>            Opportunity to Commit Fraud: <i>Low</i>            Inclination to Rationalize: <i>High</i></p> <p><i>These executives have high pressures to commit fraud and a high ability to rationalize dishonest acts. However, because they work in environments that make it difficult to commit fraud, they would be less likely to do so. The likelihood that these executives will commit fraud is highly contingent upon the adequacy of the control environment.</i></p>

This paper is not suggesting that all management fraud can be completely explained by a combination of stewardship-based corporate structure, agency-based rewards and incentives, and behavioral attitudes that are consistent with agency theory. This combination, which provides high perceived pressures, high perceived opportunities, and a higher likelihood of rationalization seems to provide a dangerous combination, however. Certainly, these three dimensions are not dichotomous. A corporate structure, a rewards and incentives system, and an executive's behavioral attitude are not completely agency-based or stewardship based. Each of these dimensions represents a continuum, meaning that all executives do not face the same degree of perceived pressures and opportunities,<sup>13</sup> nor do they have the same tendency to rationalize dishonest acts. These categorizations are helpful, however, in providing a possible model to consider fraud risk in the context of the combination of executive behavioral tendency and corporate organization. Moreover, we do suggest that the more stewardship-based behavior an executive has, the more stewardship-based a company's rewards and incentives are, and the more agency-based the corporate structure is, the less the likelihood of corporate fraud.

## CONCLUSION

The purpose of this paper is to explore the relationship between theories of management and recent financial statement frauds. Table 3 summarizes the relationship between corporate structure, rewards and incentives, and executive behavior. We believe the next research step in understanding the relationship between agency theory, stewardship theory and financial statement fraud is to use empirical data to test proxies for the elements in these models. The perfect storm analogy, in combination with Table 3, provides a useful lens for identifying the types of research that need to be conducted.

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<sup>13</sup> Whenever management fraud has been studied, it has always been found that it is the CEOs and CFOs who are most involved. For example, the COSO-sponsored study by Beasley, Carcello, and Hermanson found that the CEOs were involved in 72% of the financial statement fraud cases. The next most frequent perpetrators (in descending order of frequency) were the controller, COO, vice presidents, members of the board, lower lever personnel, and others.

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