The Comparisons of Country Terrorism and Corporate Fraud-Terrorism

By: Benjamin W. Bean and Sheldon R. Smith*

Abstract

In relatively recent times, the United States has experienced major terrorist activities and large-scale corporate financial reporting fraud. This paper analyzes comparisons of country terrorism and corporate fraud-terrorism by discussing various parallels and differences. In addition to discussing the comparisons between terrorism and financial reporting fraud, this research also discusses the significance of the fraud problem and some possible ways to deal with it. This discussion demonstrates and supports the importance of high ethical standards in accounting and shows how important accounting, financial reporting, auditing, and strong corporate governance are to our society.

Introduction

At 8:45 a.m. EDT on September 11, 2001, a commercial airliner crashed into the north tower of the World Trade Center in New York City. About 20 minutes later, another plane crashed into the south tower. Later that morning another plane crashed into the Pentagon. Yet another plane, apparently intended for another high-profile target, crashed into the ground in Pennsylvania shortly after the Pentagon crash ("Terror by the Minute," 2001). As a result of the plane crashes, both towers of the World Trade Center completely collapsed before the end of the morning. Viewers watched these events unfold on television, unable to imagine the cause for such events and unable to fathom the scope of the loss. Because of the large loss of life and the immense property damage caused by these specific events many people, not only in the United States, but around the world were personally affected by the direct events of this day. The rest of the world was indirectly affected by the events of that day: all of the world was affected by the economic, political, and military aftermath of this terrorism.

An act of terrorism took thousands of lives of those in the targeted buildings, including many rescue workers that rushed to the scene. Hundreds of additional lives were claimed with the three downed planes. The financial cost of the attacks in New York is estimated to be about $83 billion including 83,100 lost jobs. The Pentagon reconstruction cost $501 million ("Remembering September 11," 2002). The indirect loss to the economy may never be measured but is certainly immense. The entire world has experienced emotional trauma.

The collapse of the World Trade Center towers was followed later in 2001 by the collapse of Enron Corporation ("Enron," 2001; "The Fall of Enron," 2001), a result of fraud and misreporting of financial information to disguise liabilities owed by the company. While Enron collapsed over a longer period of time than did the towers of the World Trade Center and while the effects of the disasters differed, both collapses brought devastating results. While the Enron disaster did not result in direct loss of physical life, the economic and emotional effects of this disaster have brought uncertainty, terror, and trauma to many who were directly affected and to many times more who were indirectly affected.

The headlines this past year are filled by these two news stories, other terrorist acts such as the sniper killings in the Eastern United States ("Descent Into Evil," 2002), and other financial reporting frauds such as WorldCom ("How Three Unlikely Sleuths. . .," 2002). In addition, the resulting "war on terrorism" and the fight against corporate financial reporting fraud are covered by the news media daily. Besides sharing the front page of the news together, these terrorist acts and frauds have similarities. The comparisons of country terrorism and corporate fraud illuminate important lessons.

A recent article in *Time* ("Summer of Mistrust," 2002) makes comparisons between corporate criminals and international terrorists. "The corporate criminals among us, the swindlers and profiteers, are now described in language once saved for bin Laden's legions." In comparing how to deal with corporate fraud and terrorism, this same article recognizes that

> . . . a new reality takes hold, that our lives this year are being reshaped by enemies both foreign and domestic, and while the public did unite behind its leaders in the face of the terrorist threat, we have less faith that they can protect us against the villains we planted and watered in our own back yards ("Summer of Mistrust," 2002).

This paper analyzes comparisons of country and corporate terrorism by discussing similarities and differences in the causes and results of these two types of terrorism. The purpose of this paper is not to simply mention the comparisons. In addition, it discusses the fraud problem and possible solutions, demonstrates and supports the importance of high ethical standards in accounting, and reiterates the importance of accounting, financial reporting, auditing, and strong corporate governance to our society.

Similarities

Several similarities exist between terrorism and corporate financial reporting fraud. These similarities include the losses incurred, the regulation and control required, the reduction in confidence and trust, the lack of agreement on an appropriate response, and the triad of elements required for either terrorism or fraud.

Loss Incurred

Both country and corporate terrorism are extremely destructive, although in different ways. Terrorist acts often cause physical pain or death and destruction of property initially, followed by the resulting emotional distress and financial losses. Corporate terrorism is seldom designed to cause physical pain or specific destruction of property. However, corporate terrorism results in extreme direct financial loss and further indirect financial loss. Terrorism also results in emotional distress which can take a variety of forms and can be both short term and long term. While this paper does not try to equate loss of life and loss of financial assets in significance or importance, the research does point out the extreme destruction that can result from either terrorist acts or from fraud in financial reporting.

Regulation and Control Required

Both acts result in the need for increased regulation and controls. For example, the events of September 11, 2001, and the Enron fraud have led to legislative/executive regulations of unusually large magnitude. The September 11 terrorism has resulted in increased airport security procedures and homeland security measures. The cost of plane tickets has gone up to help pay for additional security measures. The time needed to check in at an airport has increased because of the extra security. In fact, the time to enter Disneyworld has increased because of security checks for those who enter. The Enron and other frauds have resulted in increased regulations (such as the Sarbanes-Oxley Act) and the need for increased internal financial reporting controls and stronger corporate governance. Increased controls on the accounting/auditing professions and on financial reporting will increase the costs of these items. The openness of society in the United States is threatened by terrorist acts, and the openness in financial markets and the self-regulation of the accounting profession is threatened as frauds are not prevented.

Confidence and Trust Reduced

Both types of terrorism reduce public confidence and trust, either the ability to be physically secure or for the financial markets to be secure. Speaking of the recent sniper shootings in the Eastern United States, a *Newsweek* article explains some of the fears that come from terrorism.

> With one rifle, an old car and a teenage disciple, authorities believe, he brought terror to the nation's capital. For almost three weeks, he kept schoolchildren in a state of 'lockdown,' a term normally associated with prisons. He forced high-school homecoming games to be played on undisclosed secure military bases. He made children run when they got off the schoolbus–not to the playground, but for cover. He caused thousands of sad conversations between parents and their children, who were painfully learning to adapt to an age in which everyone, old and young, feels less safe than before ("Descent into Evil," 2002).

In addition, it is quite obvious from the stock market and financial activity since September 11, 2001, and the publicity of several major corporate frauds and/or investigations, that investors are cautious at best and, in many cases, that they lack confidence in the financial reporting system. "The perception of deception is so widespread, the stakes so high and the costs so great that investors are choosing to forfeit a game they now think is rigged. Financial planners say many people won't open their 401(k) statements; they just can't look" ("Summer of Mistrust," 2002).

Appropriate Response Unclear

Additionally, it seems that there is an unsure "cure" for either type of terrorism. International terrorism has devastating results, but there are both "dove" and "hawk" perspectives on how to deal with terror. While many support President Bush's "war on terrorism" with or without traditional allies, others still think diplomatic channels must be used more than they have been. The question remains, do we deal with financial reporting fraud by exacting heavier penalties or by some type of positive moral suasion? "America's gilded ages have reliably ended in scandal, followed by soul-searching and reform. But investors are divided over what needs to be done" ("Summer of Mistrust," 2002).

Triad of Elements Required

A comparison of the three necessary elements for fire to the three necessary conditions for both corporate fraud-terrorism and country terrorism is revealing. Albrecht et al. (1995) remind us of the fraud triangle, comparing it to the fire triangle. Fire requires heat, fuel, and oxygen. Similarly, fraud has a triad of required elements: pressure, opportunity, and rationalization. Those caught committing fraud, when asked, can likely identify all three elements present in their situation. Even with financial pressure and opportunity, fraud needs rationalization to occur. Likewise, any other two elements of the triangle, without the third, are unlikely to result in fraud.

A close look at the activities surrounding the fall of the giant Enron Corporation reveals the presence of those three elements of the fraud triangle in a corporate fraud situation. In 2001 Enron was listed as fifth on the list of "Fortune 500" corporations. Early in 2002 Enron was in Chapter 11 bankruptcy, leaving thousands of employees without jobs and thousands of shareholders with worthless stock. The seeds for Enron's decline were sown during the period *Fortune Magazine* voted it Most Innovative among the magazine's Most Admired Companies for six consecutive years prior to 2001. The company's success created pressure to perform well for stock options, bonuses, and favorable ratings from Wall Street. Everyone was happy when Enron was riding high. Enron's Chief Executive Officer, Jeffrey Skilling, and its Chief Financial Officer, Andrew Fastow, rationalized the creation of precarious accounting manipulations such as "off-book" private partnerships called Special Purpose Entities (SPEs). These SPEs minimized the impact of Enron's large and growing debt by shifting it off the books of Enron. The opportunity was created because the financial chicanery was done at the highest level and was difficult to explain. Even Kenneth Lay, who was CEO prior to Mr. Skilling's appointment and again after his departure, was never able to explain how the partnerships worked (Bixby, 2003).

The rationalizations continued driven by the pressure to make more money. Wall Street firms were making millions of dollars selling Enron's stock and bonds. Goldman Sachs recommended the stock up until the day after the quarterly filing of a $618 million loss on October 17, 2001. "Enron executives were able to convince investors, bankers, analysts, accountants, debt-rating agencies and even Enron's own employees that its promise was real, and its growth never-ending" (Bixby, 2003).

Elements similar to these elements of fraud could likely be identified relative to terrorist acts. Although the "pressure" to commit terrorism is less likely a financial pressure (although it could be), some type of pressure, whether pressure from peers or self-induced pressure, is present before terrorism occurs. Opportunity must also be present. Often the opportunity for terrorism is created through careful planning, also facilitated by the openness of our society. Rationalization can take the form of hate, fanatical religious feelings, revenge, or national jealousy.

As a specific example, an analysis of reports about the alleged Washington D.C. sniper, John Williams, confirms the existence of these elements. After a troubled childhood and a subsequent failure in marriage, John became a Muslim and joined the U.S. Army to find order and meaning. Following a failed army experience, he tried to raise his children as strict Muslims. He was unable to support the children and wound up in a homeless shelter. Inspired by the September 11, 2001, tragedy he pretended to be a special forces commando and was said to express pride in the first two killings in a letter he wrote, "For you, Mr. Police, call me God." Certainly the above events demonstrate pressure to succeed and a possible rationalization for his activity. His opportunity was his modified killing car and his innocent, easy-prey victims ("Descent into Evil," 2002).

Differences

Although many similarities between corporate fraud and terrorism exist, there are also some differences. These differences include the level and type of planning involved, the specificity of the target chosen, the identity and fiduciary responsibility of the perpetrator, and the uniformity of the education and training available to corporate managers and accountants.

Planning Involved

One of the differences is the level and type of planning involved in the terrorism. With physical destruction of property and taking of life, the results, at least in general terms, are planned. With corporate fraud, although detailed planning may be involved in the fraud, the planning is generally how to perpetrate the fraud, not in the destruction that will result.

Targets Considered

International terrorism usually has a specific target whereas corporate fraud does not usually have a specific target, although there may be specific victims. Terrorism is designed to create mass hysteria, confusion, and fear, especially about the possibility of it happening again. Corporate financial reporting terrorism is not likely designed to create hysteria and fear, but it certainly can have that effect.

Trusted versus Unknown Perpetrator

One other difference between country and corporate terrorism is that corporate terrorism is carried out by someone trusted, someone with a fiduciary responsibility. Those who commit major corporate fraud are often top-level managers who have a responsibility to the shareholders of the company. However, sometimes managers lose sight of their fiduciary responsibility.

> As for the CEOs, they raid company coffers to pay off margin calls or build new mansions; awash in options, they manage the stock price instead of the company; as their business falls into bankruptcy and the layoffs pile up, they float away on golden parachutes–or yachts bought with company loans ("Summer of Mistrust," 2002).

The fact that the potential corporate terrorists will rise from the ranks of known employees presents another difference. Country terrorists may come from any corner of the world and are seldom known by their victims. The opportunity exists in the corporation to constantly cultivate its "known" employees by discussing ethics, focusing on the values of strong internal controls with frequent monitoring, and providing other measures to hopefully inspire their loyalty.

Education and Training Differences

Yet another difference is found in education and training of America's corporate recruits. The supply of corporate accountants have a uniform training in accounting principles from the nation's colleges and universities. Their training can be controlled and modified, whereas the endless supply of country terrorists have a myriad of complicated ideologies. One of the new "AICPA anti-fraud initiatives includes working to ensure college textbook authors incorporate anti-fraud education in programs and text materials" ("New Fraud Audit Standard. . .," 2002).

Discussion

The previous discussions of the similarities and differences between terrorism and corporate fraud illustrate that much can be learned by comparing the two. Although we cannot necessarily seek to eliminate or minimize them in the same ways, the comparisons are valuable. Focusing now on corporate fraud, this section discusses the significance of the fraud problem and some possible ways to deal with it, leading to the conclusion that accounting, financial reporting, auditing, and strong corporate governance are very important in our society.

Protection from Fraud

The public wants to feel safe and wants to feel protected from terrorist activities. People also want to have confidence in the financial information provided by companies so that investment and other financial decisions are made appropriately. Therefore, accounting and financial reporting functions are extremely important. Likewise, auditing, both internal and external, and careful corporate governance are important. Just as it is important to protect people from physical terrorism, it is important to protect them from corporate economic terrorism by mitigating the opportunity for financial reporting fraud.

Fight Against Fraud

There are many possible ways to fight fraud in corporate financial reporting. In a *Business Week* commentary, Don MacRae implies that we must attack more than one element of the fraud triangle.

> Significant changes must now be made to restore trust in public companies. Yes, we need longer jail sentences for corporate fraud and a stronger watchdog agency to catch accounting misdeeds and even oversee the profession, all now provided to some extent by new legislation. But ways must also be found to stamp out the greed and gluttony of the schemers (MacRae, 2002).

He then gives some specific suggestions relating to compensation rules, arms-length transactions, stock option compensation, and other areas.

In addition, the government has a vested interest in reliable financial reporting and in eliminating fraud. The Sarbanes-Oxley Act of 2002 was signed into law on July 30, 2002 by President Bush. The Act creates an accounting oversight board, new roles for audit committees and auditors, criminal penalties, protection for whistleblowers, and financial reporting and auditing process additions ("How the Sarbanes-Oxley Act. . .," 2002). This legislation is designed to reduce the possibility of financial reporting fraud.

U.S. versus International Accounting Standards

Some of the discussion of corporate reporting fraud has focused on the Generally Accepted Accounting Principles (GAAP) that are used in the United States. Some of the discussion blames the rules-based approach to accounting standards used in the United States (Barrier, 2002; Colvin, 2002). Just like the detailed U.S. tax code leads many to look for both intended and unintended loopholes, the rules-based accounting standards may lead corporate officers to find specific ways to work around those standards. Arguments exist for having the United States move toward the principles-based approach to accounting standards found in international accounting standards. The International Accounting Standards "have a strong concept of substance over form," and emphasize "the true nature of a transaction rather than conforming to narrowly drawn rules" (Barrier, 2002, 53, quoting Jan Dawson). "But [Joseph V.] Carcello raises a warning flag. In the past, when accounting rules were more principles-based, he says, auditors wanted more specific rules to strengthen their position in arguments with management" (Barrier, 2002, 53).

Colvin (2002, 44) examines accounting rules in terms of culture. He points out that the National Football League rules are extremely detailed and voluminous and compares these rules to U.S. GAAP. He also points out that international soccer rules are "more like a set of general principles" with less wording, fewer rules, and more judgment left to the referee. In comparing NFL and international soccer rules, he states

> That's because rules are more than just rules. They reflect cultures. Thus the U.S. approach to accounting is much like its approach to football, while the rest of the world crunches numbers sort of like they play soccer. The fundamental difference is that we Americans love rules. If they're really specific and complex, we love them more.

While disagreement exists whether rules-based accounting standards or principles-based accounting standards leave more room for fraud, the current environment of recent corporate frauds in the U.S. have made the discussion of accounting standards relevant and important. If change is needed, it may come because of a perceived failure of the existing standards.

Ethics and Social Responsibility

A discussion of reducing corporate fraud would not be complete without referring to ethics and social responsibility. Miller and Bahnson (2002) recognize the argument for more principles-based accounting standards. However, they also point out that both rules-based accounting standards and principles-based accounting standards leave room for fraud.

> No matter the system, bad guys will be bad. What's needed is a new concept that it's not OK if bad guys become managers and auditors. This will improve only when the management corps views capital markets like product markets–opportunities to establish mutually beneficial relationships that produce shareholder value. Following this strategy leads to reporting much more useful information, regardless of the standards (Miller and Bahnson, 2002, 16).

In addition, Miller and Bahnson conclude by stating that we should "pursue an entirely different vision that elevates truth-telling above all other strategies for achieving useful reporting."

MacRae (2002) addresses the need for corporate leadership with high moral principles. "Corporate leaders must embrace higher ethical and business standards–that's clear. And if they violate those, they should be precluded from ever again holding a position of such authority and influence." He feels that even though the recent problems with financial reporting fraud have been perpetrated by a significant number of managers, the problem is not systemic. In fact, MacRae states that he has known many CEOs and CFOs from both large and small companies who have "their moral compass set on serving the best interests of shareholders. These are not the corporate leaders that you are hearing about today. But they are the ones that you will be hearing about in the future" (MacRae, 2002).

An argument can be made that each person has a responsibility to society and to other human beings. While some types of rationalization are used against this premise and may lead to terrorist acts, most humans feel this responsibility exists, at least in their own "society," however that is defined for them. A more well-defined fiduciary responsibility exists for corporate officers in creating and maintaining shareholder value. This responsibility and trust is damaged or destroyed when fraudulent financial reporting occurs.

Importance of Accounting, Financial Reporting, Auditing, and Corporate Governance

The preceding discussion shows why the problem of corporate fraud is important. It also discusses some possible ways to address this problem. As discussed earlier, the possible losses, both direct and indirect, from corporate fraud are immense. Our society wants to have confidence in our financial reporting system so that investment and other financial decisions are made appropriately and so that financial resources are allocated efficiently. On a more specific level, individuals want to feel more secure about their personal investments for home purchases, college educations, retirement, and other financial goals.

This desire for confidence underlines the importance to society of the accounting and financial reporting functions. These functions are improved when auditing provides added value through independent assessments of the results reported on the financial statements. In addition, strong corporate governance by individuals with high ethical standards improves the accounting control system and provides additional protection to society that financial reports are reliable.

Conclusions

Terrorism has a major impact on our feeling of well being. When terrorism affects us, directly or indirectly, our safety and security are threatened. Our lifestyles are threatened. Fraudulent financial reporting has a major impact on our economy and its financial markets. Investor confidence is reduced or lost, and the results impact many people, directly or indirectly. Financial security is threatened and lifestyles are threatened. This paper has compared country terrorism and corporate fraud-terrorism by discussing various similarities and differences.

The similarities discussed include the extreme loss/destruction caused by both terrorism and corporate fraud. Both acts result in the need for increased regulation and controls. Both types of terrorism also reduce public confidence and trust, either in physical security or financial security. In addition, it seems that there is an unsure "cure" for either type of terrorism; the appropriate response to either country terrorism or corporate fraud is debatable. Finally, a comparison is made showing that just as a triad of elements–pressure, opportunity, and rationalization–is required for fraud, a similar triad of elements is required for country terrorism.

The differences discussed include the level and type of planning involved in the destruction that will result. The specificity of the target is another difference. Additionally, terrorists are often unknown to their victims, whereas those who commit corporate fraud are often trusted corporate officials with a specific fiduciary responsibility to those they harm. A final difference can be found in education and training. Terrorists have a myriad of complicated ideologies, and their training can be extremely varied. On the other hand, America's corporate accountants have a uniform training in accounting principles from the nation's colleges and universities. To some extent, this uniform training can include anti-fraud and ethics education.

Neither country terrorism nor corporate fraud-terrorism are easy to fight because of the great destruction one person can cause in either scenario. However, a better understanding of both may help analysts of each in better understanding appropriate efforts to combat these two problems.

In addition to discussing the similarities and differences between terrorism and fraud, this research also discussed the significance of the fraud problem and some possible ways to deal with it. Possible suggestions include increasing penalties for fraud, increasing the oversight of accounting and financial reporting functions, and finding ways to "stamp out the greed and gluttony of the schemers" (MacRae, 2002). Additionally, consideration ought be given to whether principles-based accounting standards should replace the current rules-based accounting standards used in the U.S. as a method to reduce fraud. Also, corporate managers must have high ethical standards and need to feel the importance of the societal and fiduciary responsibilities they have.

The possible financial devastation caused by corporate fraud leads to a strong desire for confidence in the financial reporting system. The need for reliability in this system reiterates the importance to society of accounting, financial reporting, auditing, and strong corporate governance.

* Benjamin W. Bean , M.S., is a CPA and Professor of Accounting at Utah Valley State College. Dr. Sheldon R. Smith is a CPA/CMA/CIA and a Professor in the Accounting Department at Utah Valley State College.

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