

THE ROLE OF THE EXPERT WITNESS IN ACCOUNTING FRAUD CASES

Maria H. Sanchez, Rider University
Shirley Wei Zhang, Rider University

ABSTRACT

We provide information regarding expert testimony in financial fraud cases. Financial fraud, including tax fraud, is on the rise, and so is the demand for expert witness testimony for both the prosecutors and the defense team when these frauds are prosecuted. We detail the role and qualifications of the accounting expert witness and we provide examples of two high profile fraud cases in which expert testimony of accountants was used. This article should be of interest to attorneys, accountants, academics and students.

JEL: M40

KEYWORDS: financial frauds, expert witness

INTRODUCTION

Financials frauds have been making headlines for years. From Enron and WorldCom to Fannie Mae and Freddie Mac, it seems like there is a new high-profile scandal every week. Less publicized financial frauds are also on the rise (Emshwiller, 2010). This paper examines the role of the expert witness in accounting fraud cases. This is an important topic to examine because of the sheer magnitude of cases involving accounting fraud. In 2009, approximately 10% of all federal criminal cases were related to fraud (United States Sentencing Commission, 2010). In a recent poll by Deloitte, more than half of the 2,100 business professionals thought more financial fraud would be uncovered in 2010 and 2011 than in the prior three years (Deloitte, 2010). Due to the recent financial crisis in the United States, businesses, individuals, and large corporations have been facing huge financial pressures.

They have suffered or may still be suffering from financial losses, which could, to some extent, increase number of incidents of financial fraud. Pressures, opportunities, and rationalization form the fraud triangle for financial fraud perpetrators. Accountants play an increasingly important role in providing litigation services for financial fraud cases. Many attorneys need assistance from accountants during the preparation of their cases and then later need accountants to testify as expert witnesses. Currently, there is a lack of academic literature that addresses the role of the accountant as expert witness.

This article adds to the current literature by providing an overview of the role of the accountant as an expert witness in financial fraud cases, with a specific focus on two high profile cases: Enron and HealthSouth. In this paper, we examine those two high profile cases in detail, with actual quotes from the expert witnesses at trial. This paper should give both students and practitioners good insight into the role of the expert witness, from preparation to actual testimony. The remainder of the case is organized as follows. First, we review the prior research. Next, we look at tax fraud in general. Then we examine the role and the qualifications of an expert witness. Then the role of the expert witness in the Enron case is examined in detail, followed by an examination of the role of the expert witness in the HealthSouth case. Finally, a conclusion section summarizes the paper and provides suggestions for accountants in an expert witness role.

Prior Research

There is little academic research that examines in detail the role of the expert witness in specific accounting fraud cases. Many case studies examine accounting frauds in detail (e.g., Moriceau, 2005). The frauds at Enron and HealthSouth have been studied extensively. The frauds were widely covered by the popular press, especially the Wall Street Journal. There are cases on them in numerous textbooks (e.g., Knapp, 2011; Beasley et al., 2009). Most business students study at least one of these cases during their time at the University.

Enron is such an important part of accounting history that some faculty use the Enron case during the first day of all of their accounting classes to capture student interest and let them see that accounting is anything but boring (Stice and Stice, 2006). Enron is one of the most widely cited accounting fraud cases in recent history and is used to teach a variety of business topics, such as special purpose entities (e.g., Chasteen, 2005), ethics (e.g., Mintz, 2006; Earley and Kelly, 2004), auditor independence (e.g., Roybark, 2008), corporate governance (Cunningham and Harris, 2006) and other topics.

The HealthSouth case can also be used to teach ethics (e.g., Jennings, 2003; Johnson and Johnson, 2005), corporate governance (e.g., Veasey, 2003) as well as other topics. Part of the popularity of this case in academia may stem from the fact that the CEO of HealthSouth was the first to be tried under the Sarbanes-Oxley Act of 2002. Both Enron and HealthSouth have been studied extensively in the academic literature as well as the popular press. However, we are unaware of any study that examines the role of the expert witness in these cases. This paper contributes to the literature by examining in detail the role of the expert witness in these two important cases.

Tax Fraud

Among the kinds of financial fraud, tax fraud is one of the most common, resulting in billions of dollars lost every year. According to the IRS website, there were between 2,000-3,000 tax fraud investigations initiated each year from 2007 to 2010 (IRS, 2011). Such a large number of fraud cases indicate the increased demand for relevant services offered by accountants. Most often they serve as consultants before trial or as expert witnesses in court. The major phases of litigation are: pleadings, discovery, trial, and possible appeals. During the pleadings phase, the lawsuit is filed and then the defendant files their response. Next, during the discovery phase, written questions and requests for documents are exchanged. After the documents are exchanged, depositions may be taken. Finally, if the case is not settled, it will go to trial. Many cases then go on to appeal. The accountant as expert witness can be invaluable during both the discovery and trial phases.

In most tax fraud cases, although the defense counsel knows what evidence will be presented at the trial, he or she cannot predict every point that the prosecutor will make. Hence, to prepare for the trial, the defense counsel should know every detail about the client's financial records. The defense attorney needs to try to anticipate what will happen in court and mount an affirmative defense for the case. This usually cannot be accomplished by the attorney alone, because defense attorneys are not often experts in financial matters. This is where an accountant comes in during the preparation of the case or as an expert witness in court, which would be crucial to the defense. Therefore, when someone is charged with financial fraud either civilly or criminally, it is very important for an attorney to work with an accountant who can provide expert suggestions. The strategy of a defense counsel for a fraud case can depend largely on an accountant's evaluation of the case.

In the defense of a fraud case, attorneys need to know specifics, because the offense level, which would determine how many years the client could be sentenced, depends largely on the amount of losses. For example, in tax fraud cases, according to the Sentencing Guideline Excerpts for Tax Fraud Examination

by University of Houston (2003), the defendant should be sentenced based on their offense level, and the offense level would be determined by the largest tax loss for tax evasion, the filing of fraudulent tax returns, and the failure to file returns. In the case of tax evasion or fraudulent returns, the tax loss is considered to be the amount of loss that would have resulted if the offense had been successfully completed. In the case of failure to file a tax return, the tax loss is considered to be the amount of tax that was owed but not paid.

When dealing with a fraud case, because of sentencing requirements, an accountant would be needed to examine the financial records in detail. After examining the details, an accountant should be able to make a judgment as to whether the defendant understated or overstated revenues, or if there are any fictitious items, and what is the accurate amount of the fraud. An accountant should also consider the tax perspective on both the federal and state level to see if there is any tax evasion or if any fraudulent tax returns have been filed, because these acts could raise tax issues after the main prosecution and generate multiple counts. Since most fraud perpetrators do not pay taxes on the money they steal, there would probably be a multiple counts issue. In addition, attorneys should be aware that it may be easier for prosecutors to file a case on tax crimes when they cannot find sufficient evidence for the main prosecution. By comparing the accountant's conclusion and the prosecutor's indictment, the attorney can make a decision as to whether or not the prosecution is reasonable, and if he or she should try to settle the case out of court instead of going to trial. In fact, the majority of tax fraud cases are settled out of court, whether the charges are civil or criminal. On the civil side, attorneys may advise a client to make a settlement in order to avoid the large expense that would be caused by going to trial. On the criminal side, avoiding the trial expenses is also a concern. However, avoiding a criminal record is the most important reason for out-of-court settlements in criminal cases.

Role and Qualifications of the Expert Witness

For the cases that are not settled, accountants can play another important role in the trial, the role of expert witness. Accountants can testify in court regarding the client's financial matters and give an expert opinion based on their findings. An accountant testifying in federal court must follow the Federal Rules of Civil Procedure and the Federal Rules of Evidence as well as other federal and state laws. An accountant testifying in state court must follow the rules in place in that state, some states have their own standards. CPAs also must comply with the AICPA Code of Professional Conduct. Federal Rule of Evidence 702 (enacted in 1975 and later updated) deals with the admissibility of expert testimony. Before Rule 702, under the Frye standard, courts generally did not accept expert testimony from accountants (The Frye standard is no longer used in federal courts, however, it is still used in some state courts.) The Frye standard requires the judge to consider the opinion of the "expert's" peers when deciding whether or not the expert should be allowed to testify. With the enactment of Rule 702, someone with "scientific, technical or otherwise specialized knowledge" could qualify as an expert witness, but it was left to individual courts to decide if accountants would qualify.

However the case of *Daubert v. Merrell Dow Pharmaceuticals* (509 US 579, 113 SCt 2786, 1993) is currently applied by most states. This case gave a checklist of factors for courts to use when assessing the reliability of scientific expert testimony. With this case, the Supreme Court ruled that the testimony of expert witnesses must be related closely enough to the issues under trial to aid in their resolution. Under *Daubert*, the judge must decide if the expert testimony is both relevant and reliable. It places the court as a "gatekeeper" in evaluating the admissibility of testimony.

The *Daubert* case focused on the admissibility of scientific evidence, and a later case, *Kumho Tire Co. v. Carmichael* (526 US 137, 119 SCt 1167, 1999.) extended this admissibility to include technical and other specialized knowledge (i.e., nonscientific). Rule 702 was modified in 2000 to include the standards set by the *Daubert* and *Kumho* cases. Educational, professional and litigation experience are all important for an

expert witness (Cendrowski et al. 2007). An expert witness in a fraud case is required by the courts to have specialized knowledge in the area in which he or she will testify. Testimony should be based on reliable facts and data. The accountant must convince the judge that they are an expert and that their testimony is both relevant and reliable. Below are two examples of high profile fraud cases in which expert witnesses testified in court.

The Enron Case

The Enron case is probably the most famous fraud case of all time. The Enron scandal resulted in a \$1.2 billion reduction of owners equity in 2001. A complex business model had allowed dubious accounting practices to go unquestioned. Enron used hundreds of special purpose entities to keep debt off of its books. The corporate culture was one where executives were focused on short term profits and an increasing stock price. Enron's founder and Chairman Kenneth Lay and CEO Jeffrey Skilling were accused of misleading investors about Enron's financial health, including artificially inflating earnings, overvaluing assets, hiding losses, and tapping reserves to meet or beat earnings forecasts. Several expert witnesses testified in the Enron trial.

One expert witness, an accounting professor named Jerry Arnold, testified on behalf of Kenneth Lay. Arnold testified that Enron had followed generally accepted accounting principles on disclosing earnings and losses (Platt a, 2006). When government witnesses testified that Lay and Skilling were "cooking the books," Arnold said that there are different interpretations of accounting rules and "reasonable minds could differ" and that "there is a lot of judgment involved in reaching a conclusion (Platt, May 2, 2006). He testified that Enron used the "most appropriate way" of disclosing the financial information (Platt, May 2, 2006). Arnold testified that Kenneth Lay's description of a \$1.2 billion reduction in shareholder equity was not misleading because it is immaterial (McWilliams, 2006).

Witnesses for the prosecution testified that Enron had overvalued many of their underperforming assets. For example, witnesses contended that an Enron power plant in India which was shut down due to political and legal battles with Indian authorities was overvalued by \$1 billion. Arnold testified that Enron was trying to recover the \$1 billion through legal action which was still occurring in 2001, so a write-off was not necessary at that point (Platt, May 2, 2006). Arnold testified that his company was being paid more than \$1 million by Lay for expert witness services, of which Arnold had personally been paid over \$600,000 (Dow Jones International News, May 3, 2006). Arnold testified that he reviewed more than a million pages of documents, but he said he never talked to former Enron employees or anyone from Arthur Andersen, and that he had only met with Lay for less than one day, and took no notes during that meeting (Dow Jones International News, May 3, 2006). When the prosecutor implied that Arnold would not have been paid that much "if you have opinions not favorable to Mr. Lay and his lawyers," Arnold said he found that "in a sense insulting. I don't get paid to be a puppet. I get paid to use my expertise to form opinions and judgments" (Dow Jones International News, May 3, 2006).

Another expert witness, Walter Rush was hired by Skilling to testify in his criminal trial (Roper, 2006). Rush is a former PricewaterhouseCoopers partner and has also worked at the Securities and Exchange Commission. Rush testified that last minute changes to accounting records are not unusual or improper and that the accounting reserves created by Enron were proper (McWilliams, 2006). He also testified that, "I went back to take a look and see if anything unusual was going on to manipulate the numbers, and the answer is no" (Graczyk, 2006). During questioning about whether Enron was hiding \$700 million in losses from its retail energy business by moving the loss to the wholesale division through a reorganization, Rush said the accounting was acceptable as long as it was disclosed. When the prosecutor asked Rush whether he grasped the intent of what Enron was doing with that accounting maneuver, Rush answered, "Intent is not part of the rule" (Roper, 2006). Rush's testimony also included references to materiality, noting that many of the disputed amounts were immaterial, in other words, they were too

small to affect Enron's overall financial picture. He said, "...for us to be talking about \$40 million or \$14 million? is truly immaterial" (Platt b, 2006).

Rush was questioned on the stand about the charge that Enron used its reserves like a "cookie jar" to artificially inflate earnings. Rush testified that the reserves had been set up legitimately in 2000 and 2001 to protect Enron from volatile energy prices (Roper, 2006). During cross-examination, the prosecutor found fault with Rush's methods, noting that Rush had not interviewed Enron's former accountants and auditors, but had rather only reviewed documents in order to come to his conclusions (Roper, 2006). Skilling was also accused of directing employees to bump earnings per share from 30 cents to 31 cents in 2000. Employees from the Investor Relations department at Enron testified early in the trial that Enron executives made or knew of overnight changes to earnings estimates that were made to meet or beat analyst expectations. Rush testified that he had reviewed documents and found nothing wrong, and that during financial reporting, "there are changes going on up to the very last second. It is universal. Every company goes through this" (Graczyk, 2006).

Rush testified that he was being paid \$600 per hour by the defendants for his services, totaling \$570,000. He testified that he is objective and had also been retained by the U.S. Department of Justice and other federal agencies for about a dozen investigations and financial reviews (Platt a, 2006). In the end, the testimony of the expert witnesses was not enough. Lay was convicted of 10 counts in 2006, and could have faced 20-30 years in prison. However, Lay passed away before his sentencing and a judge then vacated his conviction. Skilling was convicted in 2006 of multiple charges and is serving his sentence. In 2010, on appeal, the Supreme Court vacated part of Skilling's conviction and sent part of the case back to the lower court. Numerous Enron executives pleaded guilty or were convicted for their roles in the scandal. A federal jury convicted Enron's auditing firm Arthur Andersen of obstruction of justice, which effectively caused Arthur Andersen to go out of business. The conviction was later overturned. In the wake of the Enron scandal, congress passed the Sarbanes-Oxley Act of 2002 to help deter financial statement fraud and prosecute those who engage in it. Below, the HealthSouth case is discussed. The CEO of HealthSouth was the first to be tried under the Sarbanes-Oxley Act.

The Healthsouth Case

The HealthSouth case is interesting because of the enormity of the fraud and the use of accounting expert witnesses by both the prosecution and the defense. In the \$2.7 billion HealthSouth scandal of 2003, CEO Richard Scrushy was charged with fraud, money laundering, false corporate reporting, obstruction of justice, racketeering, bribery and other charges. Scrushy was the first CEO to face trial under the Sarbanes-Oxley Act of 2002. After the fraud was discovered, HealthSouth's Board of Directors hired a forensic accounting team from PricewaterhouseCoopers to uncover the extent of the fraud. During the trial, one of the investigators, Harvey Kelly, testified that during the 23,000 hour fraud investigation, he and the other investigators had sorted through millions of documents (Shmukler, February 1, 2005). He testified that he and others interviewed more than 200 people and visited HealthSouth facilities throughout the country, but they found few emails to work with because HealthSouth's system deleted old emails every 60 days (Morse and Shmukler, 2005). The witness testified as to how the finance department employees "cooked the books," noting that 80% of the fraudulent income entries related to fake numbers being dumped into "contractual adjustments" (Morse and Shmukler, 2005). Kelly used flat screen video monitors in the courtroom to help show how the fraud was orchestrated. HealthSouth's field units would send their correct figures to corporate headquarters, then finance department employees would change the numbers to increase net income. Kelly said, "that's where they cooked the books... they just made up the numbers" (Morse and Shmukler, 2005). Kelly testified that he was paid \$700 per hour by the government for his expert testimony (Shmukler, February 1, 2005).

Later in the trial, the prosecution used another expert witness, William Bavis, a money laundering expert, to testify against Scrusby. The prosecution argued that Scrusby laundered the profits from the fraud by buying very expensive luxury items. Bavis testified that Scrusby received millions of dollars in bonuses for meeting financial targets in HealthSouth's business plan and under bonus plans for management (Associated Press, LA Times April 13, 2005). The expert witness and his team of accountants analyzed more than 34,000 transactions while reviewing Scrusby's accounts (Associated Press Chicago Tribune April 16, 2005). Bavis testified that Scrusby would not have been eligible for the bonuses without the fraud and that Scrusby made \$163 million in profits from stock options (Associated Press, LA Times April 13, 2005). The expert detailed, along with photographs, some of Scrusby's lavish purchases including a nearly \$329,000 Rolls Royce, a \$428,000 ring for his wife, and paintings by Picasso, Chagall, Renior and Miro. Scrusby's defense team argued that Scrusby's subordinates at the company had conducted an elaborate accounting fraud which they kept secret from Scrusby.

A forensic accountant used as an expert witness by the defense team, Tim Renjilian, testified that HealthSouth was so big and complex that Scrusby was not able to detect the fraud. Renjilian testified that the company had more than 2,500 bank accounts and \$378 million in fake cash on its books and that the 15 people who pleaded guilty to participating in the fraud had years of experience in banking and working with the external auditors. He argued that the fraud was concealed from Scrusby, saying "You've got a group of folks involved in the fraud... who I think could have overcome the world's greatest internal controls" (Reeves, May 6, 2005). Renjilian also testified that the government's expert witness used "accounting fictions" when trying to show that Scrusby used money from the fraud to make lavish purchases (Reeves, May 6, 2005). This accounting expert testified that Scrusby's stock options had value before the fraud, implying that Scrusby would have a lot to lose by participating in the fraud (Reeves, May 9, 2005). Renjilian testified that his firm was paid \$1.2 million by the defense (Reeves, May 6, 2005).

Another expert witness for the defense, Wayne Guay, testified that Scrusby's compensation was in line with CEOs of other companies. Guay also testified that Scrusby was entitled to the multimillion dollar compensation packages and that there was nothing wrong with Scrusby selling stock and exercising his stock options (Reeves, May 12, 2005). Scrusby was acquitted in 2005 on criminal charges of directing an accounting fraud. In 2009, Scrusby was convicted on civil charges and ordered to pay \$2.8 billion in damages.

CONCLUSION

The goal of this paper was to examine the role of the expert witness in accounting fraud cases. This paper looked at two accounting frauds in detail, Enron and HealthSouth. This is an important topic because in these weak economic times, financial frauds may continue to rise. Considering the definite accounting and financial matters involved in financial fraud cases, and in order to have a better performance in defending clients who were accused by committing fraud, the demand for accountants, especially CPAs, who can assist attorneys and/or act as expert witnesses, will likely be strong. This paper explored tax fraud, the role and qualifications of an expert witness, and then the two cases in detail.

Recommendations for expert witnesses include, in addition to appropriate technical knowledge, someone who testifies well and is credible and likeable to juries (Coenen, 2007). Accountants should also keep themselves in a continuing learning process, for example, being more familiar with the relevant code and sentencing guidelines, in order to give attorneys analytical suggestions based on their expert knowledge. This paper looked in detail at two high profile cases, Enron and HealthSouth. The role of the expert witness was very important in these newsworthy cases and expert witnesses were used by both the prosecution and the defense. Expert witnesses were used to testify about accounting treatments as well as compensation issues. A limitation of this paper is that we only examined two cases in detail. Expert

witnesses are used in a large amount of cases. Future research in can examine other accounting fraud cases in detail.

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ACKNOWLEDGEMENTS

The authors gratefully acknowledge the support of Rider University's Accounting Advisory Council.

BIOGRAPHY

Shirley Wei Zhang is a graduate student at Rider University pursuing her Masters of Accountancy with a concentration in Fraud and Forensic Accounting. She has a degree in International Business from Sanda University in Shanghai, China. She is the recipient of the Rider University Accounting Advisory Council Student Research Award. Email: shirley.wz@hotmail.com

Maria H. Sanchez is an Associate Professor of Accounting at Rider University. She received her Ph.D. in Accounting and her MBA from Drexel University and her Bachelor of Science in Accountancy from Villanova University. Her research primarily focuses on decision making and decision maker behavior in accounting and auditing contexts. She can be contacted at Rider University, 2083 Lawrenceville Rd., Lawrenceville, NJ 08648, US. Email: msanchez@rider.edu