Corporate governance response to an indication of possible fraud within the organization

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ABSTRACT

What should officers or directors of a corporation or other organization do when they suspect fraud within the organization? Should they begin an internal investigation? Should they consult with the external auditors? Should they consult the Corporation's outside counsel? Each of these alternatives have advantages and drawbacks.

The primary subject matter of this case study is the development of a proper corporate governance response to the indicators of possible financial fraud within the organization. In particular, this case considers the reaction of Michael Preston, chief executive officer of Image Innovations Holdings, Inc., to his own suspicions that managers within the organization were providing false financial information to the company's external auditors. The case describes Mr. Preston's personal efforts to find out the truth about his company's financial statements, as well as his interactions with the company's outside auditing firm and, eventually, a separate forensic accounting firm. The details of the case are drawn from public records, including pleadings, motions, and court opinions.

Students are invited to evaluate the actions and behavior of Mr. Preston, other officers and directors within the organization, and the outside auditing firm. Students are also challenged to consider the differences between the investigatory roles and resources of the external auditors, as compared to a forensic accounting firm. This case can be employed in support of the study of corporate governance at the undergraduate level (such as within a business law or business ethics course), or as part of a graduate course covering such subjects as management, corporate governance, business ethics, auditing, or forensic accounting.

Keywords: corporate governance, fraud, forensic accounting, business ethics, whistleblower

INTRODUCTION

This case is drawn from a securities class action lawsuit brought by purchasers of the common stock of Image Innovations Holdings, Inc. ("Image") against the company's auditors and some of the company's officers and directors.[1] Image was engaged in the business of selling sports and entertainment celebrity artwork and collectibles. The plaintiffs alleged that the defendants disseminated false and misleading financial information about the company, resulting in a temporarily inflated market price of the company's common stock. Specifically, it was eventually determined that in 2004 Image reported revenues of approximately $6 million, $5.7 million of which were attributed to sales through Image's wholly owned subsidiary, Image Innovations Sports & Entertainment, Inc. ("ISE"). In reality, however, the ISE sales were mostly bogus, and the reported revenues were achieved almost entirely through the booking of fictitious sales.

Students are invited to evaluate the actions and behavior of Michael Preston, the CEO of Image, as well as other officers and directors within the organization, and the outside auditing firm. Students are also challenged to consider the differences between the investigatory roles and resources of the external auditors, as compared to a forensic accounting firm. This case can be employed in support of the study of corporate governance at the undergraduate level (such as within a business law or business ethics course), or as part of a graduate course covering such subjects as management, corporate governance, business ethics, auditing, or forensic accounting. In support of student efforts to understand the details of this case, the URL website addresses are provided for online access to most of the pleadings, proceedings and opinions that pertain to this case.

This case is appropriate for undergraduate or graduate courses in business law, business ethics, or the legal environment of business, in consideration of corporate governance or corporate social responsibility issues. It also can serve in the exploration of the legal and ethical duties of managers, directors and auditors, especially at the graduate level. Advanced and graduate courses in financial or internal auditing, and in forensic accounting, would also benefit from the intellectual explorations invited by this case.

CASE SYNOPSIS

Image Innovations Holdings, Inc.("Image") was incorporated in early 2003 by Clifford Wilkins ("Wilkins"), Chris Smith ("Smith"), and several other individuals and entities. Image had originally been set up to manufacture and sell low-value, high-volume mementos bearing sporting entity logos. After a corporate reorganization involving a merger with another company (Busanda Explorations, Inc.), Image had 18,170,000 shares of stock issued and outstanding.

In October 2003, Smith was introduced to Joseph Radcliffe ("Radcliffe") who, together with his two sons, ran a sports memorabilia business. Smith and Radcliffe agreed that Image would acquire their business in exchange for Image stock. The Radcliffe business operation was eventually housed within Image Innovations Sports & Entertainment, Inc. ("ISE"), a newly

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[1] *See Katz v. Image Innovations Holdings, Inc.,* 542 F. Supp. 2d 269 (S.D.N.Y. 2008), available online at http://content.lawyerlinks.com/library/sec/briefs/2006/image/image_innovations_opinion_032408_136.pdf (last retrieved August 30, 2010).

formed wholly owned subsidiary of Image. One of Radcliffe's sons, Michael, became the sole officer and director of ISE. The 2003 financial statements of Image were audited by Clyde B. Bailey, CPA, through his firm, Clyde Bailey, P.C. ("Bailey"). Bailey issued an unqualified opinion regarding the 2003 financial statements of Image.

In early 2005, Radcliffe and Wilkins met Michael Preston, a business consultant with strong accounting credentials. They recruited Preston as a consultant with a view toward offering him an employment contract. Preston's responsibilities included the development and implementation of a strategy for Image to enter the field of art auctions.

Preston became CEO of Image in April 2005. His appointment coincided with the finalization of the company's 2004 financial statements and related SEC filings. The financial statements were audited by Goldstein Golub Kessler LLP ("GGK"), a prominent regional accounting firm. The GGK audit team was led by Eric Altstadter ("Altstadter"). The income statement showed revenues of $6 million, and the balance sheet showed receivables of $3 million. GGK rendered an unqualified audit opinion, declaring that in its opinion the 2004 financial statements presented fairly, in all material respects, the financial condition of Image as of December 31, 2004, and the results of its operation and its cash flow for the year 2004 in conformity with United States generally accepted accounting principles.

Despite the GGK opinion, CEO Preston began to question Radcliffe regularly over the next few months regarding Image's receivables, by which then had been outstanding for some time. Repeatedly and suspiciously, however, Joseph Radcliffe thwarted Preston's attempts to intervene in receivables recovery efforts on grounds that the customers were all personal relationships of ISE management and that involvement of other company personnel would jeopardize the relationships and the prospects of further sales. Preston's growing suspicions eventually led him to conduct his own investigation into the recoverability of the Company's 2004 receivables; he recorded his findings and observations contemporaneously in file notes and emails. By November 2005, Preston's investigation led him to believe that possibly 75% of Image's reported sales for 2004 may have been totally fictitious, with settlement for many of the paid invoices coming not from customers but from third parties.

At a November 2005 meeting of the audit committee of Image's board of directors, at which concerns concerning the receivables were discussed, the audit committee directed Preston to undertake an examination of the prior year's transactions. When he did so, Preston discovered even more serious issues. Preston documented and relayed his concerns to the company's outside counsel and to the audit committee in a report dated December 1, 2005. In that report, Preston stated his review of the 2004 sales showed some strange patterns of invoicing, and in subsequent emails in which he cited additional information leading him to believe that Image's reported sales were fictitious.

In December 2005, after consideration of Preston's report, Image's audit committee hired the forensic accounting firm Marks Paneth & Shron ("MP&S") to conduct a forensic investigation. In its report, provided to the committee on March 16, 2006, MP&S confirmed most, if not all, of Preston's suspicions.[2] MP&S found, among other things, virtually no

[2] *See Katz v. Image Innovations Holdings, Inc.,* 2006 U.S. Dist. Ct. Motions 184224; 2007 U.S. Dist. Ct. Motions LEXIS 70618 (November 14, 2007), available online at http://content.lawyerlinks.com/library/sec/briefs/2006/image/image_innovations_brief_111407_115.pdf (last retrieved on August 30, 2010) ("Plaintiff's Opposition to Defendants' Goldstein Golub Kessler, LLP's Motion to Dismiss and Memorandum in Support" provides a narrative summary of the forensic accounting firm's March 2006 report to the audit committee, and

shipping documentation existed for most of ISE's purported 2004 sales; purported 2004 sales were made to customers who had no knowledge of the sales; and multiple instances in which payments received from private purchases of Image stock were credited to ISE accounts receivable in satisfaction of 2004 sales invoices of ISE for which no satisfactory evidence of shipment could be found.

Within two weeks of the MP&S forensic accounting report, GGK announced that it was withdrawing its auditor's report of Image's year ending 2004 financial statements and that it had resigned as the Company's independent auditor. And within two months of the report, a class action lawsuit was filed in against Image, Preston, Radcliffe, and several other officers.[3] The complaint was amended in January 2007 to include the auditors, GGK, as defendants.[4] After a series of motions, hearings, and other legal proceedings, the class of plaintiffs was certified in July 2010.[5]

INSTRUCTORS' NOTES

Corporate Duty of Accountability

Corporate governance requires that officers and, in particular, directors, adhere to such fiduciary principles as good faith, loyalty, and accountability.[6] These requirements, which emanate from the common law, have been codified in most states as part of their business corporation statutes. For example, one of the most common definitions of corporate directors' fiduciary duties is set in the Model Business Corporation Act ("MBCA"), which requires that

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includes a detailed and carefully documented list of red flags).

[3]The original 2006 complaint in *Katz v. Image Innovations Holdings, Inc.,* is available online at http://securities.stanford.edu/1036/IMGVPK_01/2006515_f01c_063707.pdf (last retrieved August 30, 2010).

[4]The January 2007 amended complaint is available online at http://securities.stanford.edu/1036/IMGVPK_01/200713_r01c_063707.pdf (last retrieved August 30, 2010).

[5]The July 2010 certification of the class of plaintiffs is available online at http://securities.stanford.edu/1036/IMGVPK_01/2010722_r01o_063707.pdf (last retrieved August 30, 2010). Other documents and procedural information about this case are available at the Stanford Law School Securities Class Action Clearinghouse, at http://securities.stanford.edu/1036/IMGVPK_01/ (last retrieved August 30, 2010), and also at http://classactionworld.com/Image+Innovations+Holdings,+Inc./filed/10474.html (last retrieved August 30, 2010).

[6]*See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance,* 97 Nw. U. L. Rev. 547, 573 (2003) (arguing that compliance with fiduciary principles on behalf of stockholders falls within the domain of corporate directors); Leo E. Strine, Lawrence A. Hamermesh, R. Franklin Balotti, and Jeffrey Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 Geo. L.J. 629 (2010).

directors discharge their duties in good faith, with the care an ordinary prudent person in a like position would exercise under similar circumstances, and in a manner that they reasonably believe to be in the best interests of the corporation.[7] Similarly, the MBCA requires that corporations deliver to their shareholder's annual financial statements that include a balance sheet as of the end of the fiscal year, an income statement for that year, and a statement of changes in shareholders' equity for the year unless that information appears elsewhere in the financial statements. If financial statements are prepared for the corporation on the basis of generally accepted accounting principles, the annual financial statements must also be prepared on that basis. If the annual financial statements are reported upon by a public accountant, the report must accompany them.[8]

The accountability of public corporations, that is, corporations whose stock is widely held and traded on securities markets, is expanded by federal securities laws. These companies are subject to mandatory disclosure requirements that include quarterly and annual financial reports, proxy statement disclosures of many details of management policies and practices, and other documents. These disclosure requirements are intended to enhance the welfare and viability of the public corporation, restrain fiduciary abuse, control promotional practices, and allow for greater stockholder and investor oversight.[9]

Disclosure is not only mandated by the common law, and by state and federal statutes and regulations, but its content must be full, honest and trustworthy. Sanctions for the negligent or wilful dissemination of erroneous financial information range from civil liability, to treble damages for securities violations, to criminal fines and penalties (and even prison) for fraud. Officers, directors, accountants, and others who are associated with such misrepresentations are subject to these penalties, and can be banned from any future involvement with public corporations or SEC-related entities. Loss of their state-issued public accounting license is an additional risk for certified public accountants.

Responding to Red Flags

Auditors are governed by generally accepted auditing standards, which establish the duty of care for the auditing process. Among these is *Statement of Auditing Standards No. 99* ("SAS 99"), which specifically addresses situations where auditors become aware (or ought to become aware, based on their due diligence) of "red flags" that indicate the possibility that the financial statements under audit may contain fraud.[10] SAS 99 requires that auditors be alert to such red

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[7]Revised Model Bus. Corp. Act § 8.30(a) (1984). The RMBCA was drafted by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association. See LEWIS D. SOLOMON *ET AL.*, CORPORATIONS LAW AND POLICY 35 (4th ed. 1998). It was adopted in 1984, and thirty-five states have enacted corporation statutes modeled on it, or its predecessor, the Model Business Corporation Act (MBCA). *See id.*

[8]*Id*, § 16.20.

[9]Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. Chi. L. Rev. 1047 (1995).

[10]*See* Am. Inst. of Certified Pub. Accountants, *Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit* (2002), available online at

flags, and that they follow up on them to ensure that the financial statements under audit are not fraudulent.

Red flags, or fraud indicators, may come to the attention of auditors a number of different ways. Ideally, they are uncovered and addressed by the auditors during the audit process. Often, however, they are inadvertently brought to the attention of the auditors by employees who express concern about the financial integrity of the organization, or are intentionally brought to the attention of the auditors by whistleblowers (in which case various sections of whistleblowers under state and federal laws come into play).

Occasionally, as in the case at hand, indicators of possible fraud are discovered by top executives at the organization, or by members of the audit committee of the board of directors. When this happens, there is no "rule book" governing the proper responsive procedures. In some cases, it may make sense to refer the matter to the financial auditors, who can follow up as required by SAS 99. In other cases, and especially in those cases where there appears to be a high probability of illegality, it may make more sense to refer the matter to outside counsel. In any event, the ultimate responsibility for the financial statements rests with the board of directors of the corporation, and so the board must make these kinds of decisions.

An important advantage of seeking the assistance of counsel is that the attorney-client privilege can serve to protect the confidentiality of any follow-up investigation in response to red flags. Conversations, notes, and other communications between the corporation and its counsel are protected to some extent by this privilege. Audit work papers, on the other hand, are not protected by an attorney client privilege.

In many cases, when an organization decides to hire a forensic accounting firm to conduct a forensic investigation of possible fraud, the forensic accounting firm is actually hired by the corporation's law firm. This can, in many cases, extended the attorney-client privilege to the fraud investigation process, since the forensic accountants are actually working for the corporation's law firm and not for the corporation itself. Financial auditors, by contrast, work directly for the corporation, and of their work papers are in most cases readily accessible by subpoena or otherwise.

Of course, the biggest drawback to any decision to refer a potential fraud investigation to outside counsel (who, in turn, hires a forensic accounting firm), is cost. A forensic investigation can be very expensive, in part because the purpose of a forensic investigation is different than the purpose of a financial audit. A financial audit requires that financial statements be examined by the auditors to an extent that is sufficient to allow the auditors to render an opinion that the financial statements constitute a fair representation of the economic activity of the organization. The data and other support required for this purpose is often accumulated and analyzed by the auditors in a very efficient and cost-effective manner.

A forensic investigation, on the other hand, has a different objective. All of the evidence gathered and analyzed by forensic accountants must be so clear and solid that it can withstand the unblinking and often blistering scrutiny of opposing counsel (supported in many cases by opposing counsel's own forensic accountants). For this reason, forensic accountants cannot be satisfied with statistical testing, audit sampling, or other techniques normally used by financial accountants. Instead, each transaction being investigated must be carefully confirmed and documented, and every possible item of evidence must be secured and carefully analyzed for its

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http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00316.pdf (last retrieved August 30, 2010).

reliability and authenticity. Forensic accountants must also be prepared to serve as effective witnesses under cross-examination by opposing counsel during trial, and their work product must meet the requirements of judicial evidentiary area rules. All of this translates into high costs.

SUGGESTED QUESTIONS FOR STUDENTS NEEDING STRUCTURED GUIDANCE

1. **What kind of fact-finding should Michael Preston have done before stepping into his role as CEO of Image?**

   Since Preston had an accounting background, it would have made sense for him to study the financial statements more than he apparently did, before accepting the position. Some of the receivables had been on the book for a long time, and a simple query about the aging of the accounts receivable would have revealed that those accounts were not viable. On the other hand, since Radcliffe appears to have been willing to mislead the auditors, he would have likely done the same to Preston. But this question allows the student to place herself or himself in Preston's shoes, and consider the risks that confronted him (as well as, likely, the dazzle of a high paying position of significant responsibility).

2. **Did Preston wait too long before consulting outside counsel or the company's audit committee? What should he have done, and whom should he have consulted, when, and in what order? Include in your step-by-step recommendations and time line, whether and when Preston should have discussed his suspicions with GGK (the outside auditors).**

   Preston has been named as a defendant in the class action lawsuit, and he might not be able to escape liability for having "participated" in the fraud by waiting too long to blow the whistle. This question elicits a step-by-step "decision tree" type of response plan for an executive faced by these types of circumstances, along with an accompanying time line. This is an opportunity to engage in "Monday morning quarterbacking" for the purpose of developing principles and procedures that would help to guide an executive through this type of crisis.

3. **What investigatory procedures did MP&S (the forensic accounting firm) appear to have conducted in its effort to secure evidence of fraud? Which of those procedures could or should have been part of GGK's audit plan, pursuant to SAS 99? Which of those procedures are clearly outside the parameters of SAS 99, even when red flags are present?**

   This question gives accounting students an opportunity to attempt to delineate the differences between the financial auditing directives and requirements of SAS 99, from forensic accounting techniques. The question is also relevant to non-accountants who need to be able to know what to expect from external auditors, as opposed to forensic accountants.

4. **Evaluate the actions of the board of directions, and in particular the audit committee of the board, in this case. As part of your evaluation, describe what they**

could or should have done sooner, and what they could or should have done more diligently.

At the end of the day this is a corporate governance case. This question gives students an opportunity to take a few steps back and consider the overall corporate governance in this case. From this perspective, students can develop not only procedures, but, with some guidance, principles.

5. **How likely do you think it would be that in cases like this the corporation and the CEO (or other "whistleblower" employee) would turn against each other, even to the point of suing each other? Similarly, how likely do you think it would be that the auditing firm (as in the case of GGK) would abandon and turn against its own audit partner by leaving the partner to his or her own defense (or perhaps even suing the partner)? What can be done to reduce the risks of individuals and firms abandoning their (former) loyalties in cases like this?**

As explained below, Preston did end up suing Image and its directors, and GGK did end up claiming that it was not responsible for Altstadter's audit failures. This question anticipates these types of "betrayals" of workplace relationships, and invites students to consider how, or even whether, persons with these types of responsibilities can avoid these types of turns of events.

EPILOGUE

After investors filed their shareholder class-action against defendants (that is, against Image, its directors, Preston, Radcliffe and other officers, GGK, and Altstadter). Then, Preston was sued by all of his co-defendants, who claimed that he was really at fault. In response, Preston counterclaimed against his co-defendants, claiming that they actually defrauded him.[11] This "side lawsuit" by Preston against his co-defendants was eventually dismissed.[12]

In the meantime, Radcliffe's attorney, who also represented Radcliffe's son Michael (as well as Michael's mother-in-law), withdrew from the case because his law firm had been paid only $25,000 of the $ 412,996.47 in attorney's fees and disbursements.[13] And Bailey was sanctioned by the PCAOB for his lack of diligence in conducting the 2003 audit of Image.[14]

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[11]In legal jargon, Preston was a third-party defendant and also a fourth-party plaintiff.

[12]*Katz v. Image Innovations Holdings, Inc.*, 2008 U.S. Dist. LEXIS 91449 (S.D.N.Y. Nov. 3, 2008), available online at http://securities.stanford.edu/1036/IMGVPK_01/2008324_f02o_06CV3707.pdf (last retrieved August 30, 2010).

[13]*Katz v. Image Innovations Holdings, Inc.*, 2009 U.S. Dist. LEXIS 44799 (S.D.N.Y. May 27, 2009).

[14]PCAOB Release No. 2005-021, available online at http://pcaobus.org/Enforcement/Decisions/Documents/11-22_Clyde_Bailey.pdf (last retrieved on August 30, 2010).

Image has filed a petition in bankruptcy,[15] and has been banned from the public sale of its stock by the SEC.[16]

[15]*See In re Image Innovations Holdings, Inc.,* 391 B.R. 255, 2008 Bankr. LEXIS 2048, 50 Bankr. Ct. Dec. (LRP) 74 (Bankr. S.D.N.Y. 2008), available online at http://www.nysb.uscourts.gov/opinions/alg/149998_235_opinion.pdf (last retrieved August 30, 2010).

[16]*In the Matter of Image Innovations Holdings, Inc., Respondent,* SEC Administrative Proceeding File No. 3-13969 (Rel. 34-62535), 2010 SEC LEXIS 2377 (July 21, 2010), available online at http://www.sec.gov/litigation/admin/2010/34-62535.pdf (last retrieved August 30, 2010).