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An Analysis of Fraud: Causes, Prevention, and Notable Cases

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I. Background

a. What is accounting and what role does financial reporting serve?

Accounting is often referred to as the language of business because it facilitates the communication of the financial position of a company in an easily comparable way that various users can understand. In simple terms, accounting involves setting up, maintaining, and reviewing the accounting records of a company in order to properly understand its financial position. There are many users, both internal and external, of the accounting records of an entity. Internal users typically refer to management, while external users refers to investors and lenders. Due to these various users, it is very important that the financial reporting provides a fair representation of the financial position of the company and that the company is disclosing all important financial information they are required to. Without strict oversight and regulations, stakeholders of public companies are susceptible to great risk.

As stated in Objective 2 of FASB Concept Statement No. 8: Conceptual Framework for Financial Reporting, "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit." Therefore, general financial reporting is primarily intended to assist external users in investing and lending decisions.

Objective 5 of Concept Statement No. 8 goes on to describe why external users are the intended beneficiary of general purpose financial reporting. "Many existing and potential investors, lenders, and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed." External users would not have any access to critical financial information if public companies were not required to produce financial statements. The availability of this information allows for more transparent and fair securities markets. Objective 9 explains that the management of the entity is not a primary user because they can obtain the necessary information internally. Objective 10 states that financial reporting of an entity may be useful to regulators or other non-investing members of the public, but these are also not intended to be primary users.

Simply stated, financial reporting is meant to protect the investing public and provide confidence in the securities markets. Investors and lenders have the right to fully disclosed, reliable financial information when making investing decisions about an entity. Any benefits received from financial reporting by anyone other than these investors and lenders is above and beyond the primary goal.

b. History of accounting standards

In American history, the 1920s is often referred to as the "Roaring Twenties". Social norms were challenged and the country experienced an intense economic boom. Prohibition led to the opening of speakeasies and other underground alcohol markets; the role of women changed vastly; tastes in fashion and music changed immensely; urbanization was at an all time high; and the widespread use of automobiles, telephones, and electricity led to increasing technological growth. The six years leading up to the stock market crash in 1929 represented unprecedented prosperity for most sectors of the American economy (pbs.org).

However, during this time of widespread economic gain, the use of fair value accounting and the lack of regulation in the securities markets left investors at great risk. The reported values of many stock prices had no information to justify the value. Banks were lending recklessly with no guarantees to customers and the gap between the wealthiest and poorest Americans was increasing steadily (pbs.org). Although many thought the prosperity of this time could go on indefinitely, the future proved to be much less glorious than anticipated. On October 29, 1929, which came to be known as Black Tuesday, the economic growth came to an abrupt halt as the country saw the stock market completely crash. Vast amounts of Americans had invested their life savings in the stock market without knowing the possible consequences of doing so. This left much of the country in financial devastation and led to a worldwide financial disaster known as the Great Depression, which lasted until 1933.

Following the Great Depression, there was a dire need for regulation and full disclosure of accounting records within the securities markets. "Some feel that insufficient and misleading financial statement information led to inflated stock prices and that this contributed to the stock market crash and the subsequent depression" (Spiceland 9). When investors did not have accurate financial information at their disposal, they were prone to making poor investing decisions. The Securities & Exchange Acts of 1933 and 1934 were the first pieces of legislature to require public companies to be audited quarterly and annually. These acts were designed to restore investor confidence in the markets. The 1934 act also created the Securities & Exchange Commission (SEC), which "Congress gave the authority to set accounting and reporting standards for companies whose securities are publicly traded." (Spiceland 9). A publicly traded company is any company that issues stock, bonds, or other securities to the general public through a stock exchange or other market. Considering the vast number of stakeholder's of a public company compared to a private company, the guidelines for reporting and auditing a public company are much stricter.

The SEC chose to delegate the standard setting process to the private sector; however, the SEC maintains the standard setting power if it does not agree with a specific standard that has been set. The first private body to assume the standard setting task was the Committee on Accounting Principles (CAP). The CAP maintained this position from 1938 until 1959, during which time 51 Accounting Research Bulletins (ARBs) were issued (Spiceland 10). These ARBs dealt with specific accounting issues that arose rather than general accounting framework, which led to significant criticism of the accounting profession. From 1959 through 1973, the Accounting Principles Board (APB) took over the role of public accounting standard setting. In this time, the APB issued 31 Accounting Principles Board Opinions (APBOs), various Interpretations, and four Statements (Spiceland 10). The APB was criticized for a perceived lack of independence because it was composed almost entirely of certified public accountants, meaning the members may have been influenced by their clients to make certain decisions.

It is this criticism of the APB that led to the creation of the current standard setting board in 1973, the Financial Accounting Standards Board (FASB). The FASB has a much different structure than the APB, as it has seven full-time members elected to five year terms, where the APB had only part-time members (fasb.org). Also, while all members of the APB belonged to the AICPA, members of the FASB are representatives from different backgrounds influenced by accounting standards. In the past, the FASB has had members from the accounting profession, profit-oriented companies, accounting educators, and government positions (Spiceland 10). The FASB has created the generally accepted accounting principles (U.S. GAAP) which are recognized in the United States by the SEC, PCAOB, and the AICPA. U.S. GAAP is a rule-based accounting system which is much more specific and than its principle-based international counterpart the International Financial Reporting Standards (IFRS) used by much of the world.

As stated on fasb.org, "the mission of the FASB is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports. That mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the Financial Accounting Foundation's Board of Trustees."

Along with the standard setting bodies, there are also regulating bodies to ensure that the various accounting laws and regulations are being followed. Following the collapse of Enron and its "Big Five" auditor Arthur Andersen, the Public Company Accounting Oversight Board (PCAOB), under the Securities and Exchange Commission (SEC), was created as part of the Sarbanes-Oxley Act of 2002. The PCAOB oversees the audits of public companies. As stated on their website, "The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports." (pcaob.org).

Other accounting regulatory bodies in the United States include the American Institute of Certified Public Accounting (AICPA) and the state regulatory boards. The AICPA currently sets the accounting standards for private companies, oversees theses companies, and writes the CPA exam. The state regulatory boards handle the CPA licensing in their respective states.

c. Role of auditing

The reason for an independent audit is to provide investors and creditors with confidence in the securities markets by protecting them from fraudulent financial reporting. The role of independent auditors is not only to find material misstatements and possibly fraud, but ultimately to provide a "reasonable assurance" that the financial statements are a fair representation of the company's financial position. Due to time and money constraints, it is impossible for every transaction and document of a company to be audited. Therefore, the auditors must take samples and assume that the audit evidence collected is representative of all of the company's financial data.

Auditors must be independent in order to minimize bias involved in the engagement. If an auditor has a financial stake in the client, they are more likely to make audit decisions that benefit themselves rather than the various stakeholders. There are also several independence rules involving family members working for audit clients, as this could also lead to bias during an audit. There are very strict rules about independence, and upon receiving certification as a Certified Public Accountant, all auditors are expected to adhere to the requirements of the profession. Without independent auditors, fraud could actually occur at the hands of the auditors in order to benefit them or close family members financially.

An integrated audit, which involves the auditing of both a company's financial statements and their internal controls, is now required for all public companies and is an effective method for decreasing fraud. Integrated audits are required by the Sarbanes-Oxley Act of 2002 and overseen by the PCAOB.

II. Fraud

a. Two types of fraud

When inaccuracy of accounting records occurs, there are two possible reasons for the discrepancy: error or fraud. An error is unintentional and often occurs due to computer malfunction or human error, such as carelessness or lack of knowledge. In contrast, fraud is intentionally committed in order to render some gain for the perpetrator. The two means through which fraud is committed include the misappropriation of assets and the misrepresentation of financial statements.

i. Misappropriation of Assets

Misappropriation of assets occurs when an employee steals company assets, whether those assets are of monetary or physical nature. Physical assets of the company include everything from office supplies and office furniture to expensive items in inventory, such as cars or large machinery. With lack of supervision or security, employees could take inventory right out of a facility. However, misappropriation of physical assets includes not only taking items, but also the unauthorized use of company assets. An employee driving a company car for personal use would be an example of this.

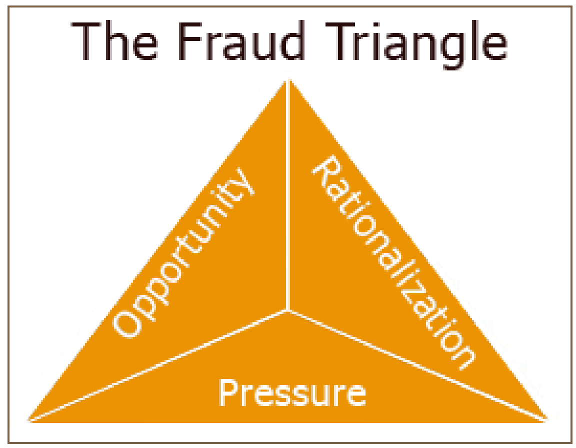
Monetary assets susceptible to fraud typically include cash or cash equivalents because these items are highly liquid and often easily accessible. With poor internal controls, a company employee could steal checks and cash them for themselves. Another example of fraud includes causing the company to pay for goods or services that were not actually received or utilized by the company (Messier 112).

i. Misrepresentation of Financial Statements

Misrepresentation of financial statements, often referred to as "cooking the books", occurs when the financial statements are intentionally misstated in order to make the financial position of the company look better than it actually is. This often involves increasing reported revenues and/or decreasing reported expenses. It could also involve misrepresenting balance sheet accounts in order to make ratios, such as the current or debt to equity ratios, look more favorable. Reporting amounts different from what would have been reported under GAAP is also considered a misrepresentation of financial statements (Messier 111).

Of the two fraud techniques, misrepresentation of financial statements is often much more detrimental to the company in the long run. With misappropriation of assets it is hard to fraudulently misappropriate huge amounts, whereas it is much easier to simply add large sums of money that never actually existed to various accounts. Once fraudulent financial reporting is uncovered, share prices often plummet and company's true value is often revealed to be much less than was being reported.

b. Fraud Triangle



In order for fraud to occur, three conditions must exist: rationalization by the person committing the fraud, incentives or pressures to commit fraud, and also the opportunity to do so (thecaq.org). These factors are commonly known as the Fraud Triangle, which was first created by Dr. Donald Cressey when he was studying criminology, specifically the behavior of fraudsters. Pressure is typically what causes a person to commit fraud. It is most often financial, such as the inability to pay medical or other bills; an addiction to drugs, alcohol, or gambling; or the desire for expensive luxury items (University of Michigan). However, some fraud is committed simply out of greed and with no pressure except the desire to gain wealth.

When preventing fraud, opportunity is the most important factor to consider. If you eliminate opportunities for fraud to be committed, then it can be greatly reduced. Preventing fraud is much cheaper for companies than detecting it later because there is little chance that losses will be recovered once the fraud has already occurred. Opportunity is therefore where internal controls come into play. The more internal controls a company has designed and implemented, the less opportunity there should be for employees to commit fraud. It is important that there internal controls be effective and efficient in order to gain the most benefits for the company. Internal controls include: segregation of duties, supervision, and information technology controls (passwords, hand scanners, etc.).

Finally, rationalization involves making excuses for why it is acceptable to commit fraud in certain circumstances. A rationalization may be strong, for example a ransom case where someone might die without the money or a medical emergency where money is needed for surgery. However, it can also be weak, with simple reasoning such as "I want the money" or "I will not get caught". Other examples of rationalization include: "everyone else is doing it", "I deserve it for my hard work", "I will pay it back later", or "it is for a good cause". Once these three fraud factors have been established, fraud will most likely be committed. As previously stated, it is most important to prevent opportunity from arising.

c. What to look for in a fraudster

When companies are proactively trying to prevent fraud within their organization, there are certain things to look for in employees. (It is important to note, however, that fraud is not always committed by employees of the organization. Customers, third party vendors, or other individuals can also commit fraud against a company.) There are several personality traits that are common in people who commit fraud. These include: controlling behavior, resistance to other people reviewing their work, a strong desire for personal gain, living beyond their means, an unusually close relationship with customers or vendors, inability to relax, and excessive overtime work (University of Michigan).

Individuals with a sudden change in behavior may also be showing signs that they have or may potentially committed fraud. Employees who go on a sudden spending spree, brag about new purchases, carry unusual amounts of cash, or becomes extremely upset when questioned may have already committed fraud. Employees who have creditors/bill collectors call or show up at work, borrow money from coworkers, or discusses family or financial problems may potentially commit fraud due to the financial pressures they are experiencing (University of Michigan).

When fraud is uncovered, auditors must use professional skepticism as they consider how to proceed. When investigating further, there are certain procedures that auditors should take. It is important to note that the auditor should not contact the person who committed the fraud directly because this may give them an opportunity to cover their tracks. The auditor should: 1) obtain an understanding of the situation, 2) talk to management at least one level above the fraudster (or go directly to the audit committee if upper management is the suspected perpetrator), 3) obtain more evidence, 4) consult with legal counsel, 5) communicate with the audit committee, and 6) resign from the engagement--depending on the extent of the fraud--as this is a last resort.

III. Past Cases of Fraud

In the past decade, there have been many large cases of accounting fraud, most notably the Enron and Bernie Madoff scandals. Along with these scandals are those of WorldCom, Tyco International Ltd., and Adelphia Communications Corporation. Each of these cases led to vast losses for many individuals involved in the companies. In order to help prevent future accounting fraud scandals, it is important to understand how past fraud was perpetrated and how it went undetected for so long. In serious cases, fraud can result in the bankruptcy of the company, loss of pensions for employees, staggering lawsuits, and legal prosecution of the highest perpetrators. Many of these consequences occurred in the case of WorldCom, which involved fraudulent financial reporting.

a. WorldCom

WorldCom, now known as MCI Inc., was founded in 1983 as LDDS (Long Distance Discount Service). The telecommunications company experienced rapid growth in the 1990s primarily due to several large acquisitions. The company became WorldCom Inc. in 1995 following the purchase of Williams Telecommunications Group Inc. for $2.5 billion (foxnews.com). In 1998, WorldCom completed its largest corporate merger to date, purchasing MCI Communications Inc. for $40 billion. Also in 1998 were the mergers with Brooks Fiber Properties Inc. and CompuServe Corp. WorldCom and Sprint Corp. agreed to merge in 1999; however, in 2002 the merge was blocked by regulators in both the U.S. and Europe out of fears the company was becoming too large (foxnews.com). The company's growth-through-acquisition strategy was stunted by this; however, the 65 acquisitions that had already taken place made the company very competitive. At the height of the company's success, WorldCom's stock was trading above $64 per share (money.cnn.com). However, the company's steady growth and profits came to a halt when fraudulent financial reporting was eventually uncovered.

In early 2002, during an internal audit, it was discovered that WorldCom had made several transfers that were not in accordance with generally accepted accounting principles, or U.S. GAAP (money.cnn.com). In March of 2002, shortly after the internal audit, the SEC requested documentation from WorldCom in connection to these transfers. It was discovered that throughout 2001 and the first quarter of 2002, WorldCom had improperly accounted for almost $3.8 billion in expenses. Cash flows of $3.055 billion from 2001 and $797 million from the first quarter of 2002 had to be taken off the books, erasing all profits WorldCom had reported for that period (money.cnn.com). The incorrect accounting used involved internal transfers within expense and capital expenditure accounts, as well as large personal loans by the company totaling around $400 million. The nearly $3.8 billion had been recorded as capital assets on the balance sheet rather than line cost expenses on the income statement, allowing the company to spread the costs over several years and therefore resulting in an overstatement of net income and cash flows. Had WorldCom reported these transactions correctly, the company would have recorded a net loss for the period. The personal loans included a $341 million loan to President and CEO Bernie Ebbers, which was the largest personal loan to date made by a public company to its CEO (Patra 174). Arthur Andersen, who was trying to distance itself from further accounting scandals following the Enron case, failed to do so as it was the auditor for WorldCom for all five quarters involved in the fraudulent financial reporting case.

The SEC officially filed fraud charges against WorldCom on June 26, 2002. Immediately following this news, the stock price of WorldCom shares plummeted. Stocks had recently been trading around $15 per share, but fell to $0.20 following reports of the fraud charges (cbsnews.com). Not only were investors affected in the immediate aftermath, but also employees. Within three days of the announcement, 17,000 general WorldCom employees were fired. This was expected to save the company $900 million annually (Pandey 114). Within a month of the SEC fraud charges being filed, WorldCom declared Chapter 11 bankruptcy on July 21, 2002. However, the company was able to successfully create a reorganization plan and emerged from bankruptcy under the name MCI, freeing itself of the stigma associated with the

WorldCom name. This emergence from bankruptcy took almost two years, as it did not occur until April of 2004 (www.foxnews.com).

Many top management officials were blamed and investigated for the fraudulent reporting that had transpired. WorldCom Chief Executive Officer Bernard Ebbers, who had been President and CEO since 1985, had resigned in April of 2002 in the midst of the SEC investigation, specifically because he was largely involved in the $400 million of personal loans being investigated. Chief Financial Officer Scott Sullivan was fired the day before the SEC charges were filed and senior vice president and controller David Myers resigned (cbsnews.com). In August of 2002, ex-CFO Scott Sullivan, controller David Myers, former director of general accounting Buford Yates, and two other WorldCom directors were indicted on criminal fraud charges (foxnews.com). Sullivan eventually pleaded guilty in 2004 to criminal charges of conspiracy, fraud, and making false statements to regulators about WorldCom's financial situation. Sullivan agreed to cooperate in the criminal case against ex-CEO Ebbers. He also resolved charges with the SEC, agreeing to a lifetime ban from ever being an officer of a publicly traded company again.

Charges were filed against WorldCom and ex-CEO Ebbers by the Oklahoma Attorney General in August of 2003, citing a violation of securities laws by providing investors with falsified financial information. Ebbers pleaded innocent, but was found guilty of the charges and faces 25 years in prison for his crimes. In July of 2004, Ebbers was also sued by MCI for the $341 million in personal loans (foxnews.com).

The element of the fraud triangle most influential in the WorldCom case is motivation. Top management of WorldCom had personal financial incentives to fraudulently report financial statements in order to inflate the financial position of the company. They had a motivation to make the company look successful and record income, which would not have occurred if the true losses had been recorded. As stated in WorldCom's Filing Proxy Statement from May 2000, the company's executive compensation plans had three elements: base salary, annual incentive compensation, and long-term incentive compensation. The base salary was set by the Committee each year and was based upon the responsibility level of the position and pay levels of similar executive positions in comparable companies. As for annual incentive compensation, the Proxy Statement states that "the key components in determining the amount of such awards include the financial performance of the Company in the context of the overall industry and economic environment, generally as evidenced by the individual growth and success of the Company as measured primarily by revenues and other performance goals." This means that without showing strong financial performance and profits, the top executives would be sacrificing large amounts of personal compensation. For example, CEO Bernie Ebbers received $7.5 million in bonuses in 1999, while CFO Scott Sullivan received $2.76 million. That was very strong motivation for them to commit fraud. For the long-term incentive compensation, the Proxy statement explains that "the Committee believes that long-term incentive compensation in the form of stock options is the most direct way of making executive compensation dependent upon increases in shareholder value. The Company's stock option plans provide the means through which executive officers can build an investment in Common Stock which will align such officers' economic interests with the interests of shareholders." In terms of their long-term compensation, committing the fraud would have benefited them because the stock price of the company would have increased as profits did. Their personal wealth would have increased and they have had the potential to sell their shares during the periods of earnings manipulation.

Considering it was top management and accounting personnel of WorldCom who perpetrated the fraud, opportunity definitely existed. These individuals simply had to override the internal controls in place in order to commit the fraud. The rationalization most likely used by the perpetrators was that it was a one time thing and they would make up for it in the future, so there was no need to hurt investors now if things were going to turn around soon.

b. Tyco International Ltd.

Another notable accounting fraud case from the early 2000s is that of Tyco International Ltd. While the case of WorldCom involved fraudulent financial reporting, Tyco International involves the misappropriation of assets at the hands of two top executives. Tyco International was founded in 1960 by Arthur J. Rosenburg. The company was originally an investing and holding company specializing in government and military research. In 1964, the focus of Tyco's products charged to the commercial sector and the company became publicly traded (tycofis.co.uk). However, the main focus of the company remained on high-tech research and development.

Tyco has been involved in numerous acquisitions over the years. The first notable acquisitions were those of Simplex Technologies in 1974, Grinnell Fire Protection Systems in 1976, and Wormald International Ltd. in 1990. Following these, Tyco was involved in a rapid period of large acquisition, with Thorn Security in 1996, ADT in 1997, and AMP in 1999 (tycofis.co.uk). Tyco Laboratories Inc. underwent a name change in 1993 and became Tyco International Ltd., which the company remained until 2007.

In the midst of continued growth and expansion at Tyco arose a corporate scandal. In 2002, CEO Dennis Kozlowski, CFO Mark Swartz, and general counsel Mark Belnick were indicted on charges of fraud and conspiracy. They were suspected of conning investors out of hundreds of millions of dollars that they had paid themselves in unauthorized bonuses and compensation since 1992. In total, approximately $170 million had been taken by the three (lawyershop.com). Although Tyco did have an employee loan program in place at the time, these personal loans were never approved and were kept off the financial statements of the company. Therefore, they were not considered an asset on the company's balance sheet. Combined, Kozlowski and Swartz had also sold $430 million worth of company stock without informing investors (lawyershop.com). Kozlowski, especially, was known for his lavish lifestyle and habit of spending corporate funds. He reportedly held a $2 million birthday party in Italy for his wife using company funds. There were also rumors of a $10,000 shower curtain he had purchased with company funds.

Both Kozlowski and Swartz were for guilty of fraud, conspiracy, and grand larceny charges in June of 2005 (nytimes.com). The jury decided that, together, the two had defrauded shareholders of over $400 million between 1996 and 2002 by failing to disclose loans and compensation they granted to themselves. Dennis Kozlowski was sentenced to 25 years in prison and fined $70 million, while Mark Swartz was sentenced to 8 1/3 years in prison and fined $35 million (nytimes.com). Together, they paid restitutions of approximately $134 million to Tyco. In addition, Kozlowski and Swartz both came to an agreement with the SEC in July 2009 that neither could ever be an officer or director of a publicly traded company again (nytimes.com). Belnick, who was said to have failed to disclose $14 million worth of loans, was acquitted on criminal charges, but paid $100,000 in civil charges for his role in the situation.

The Tyco International fraud scandal was mostly fueled by opportunity and intense greed at the hands of Dennis Kozlowski and Mark Swartz, but also Mark Belnick. These individuals had the opportunity to swindle millions from the company and they took full advantage of that for several years before being stopped. These were the top executives at Tyco so although others knew what was going on, they did not come forward and stand up against the executives committing fraud. The internal controls in place were not enough to stop the fraud from occurring and because the tone from the top within the organization was that behavior of that type was okay, others did not come forward to stop it either. The rationalization used by the perpetrators could have been that they worked hard for the company and therefore deserved the extra compensation. Also, they may have thought they would eventually pay it back. Overall though, the main motivation in the scandal was greed.

The scandal did not have devastating effects on Tyco. Although share prices did drop significantly at points, there was never any threat of bankruptcy for Tyco. As of 2007, Tyco was split into three separate companies, consisting of Covidien Ltd. (formerly Tyco Healthcare), TE Connectivity Ltd. (electronics), and Tyco International Ltd. (formerly Tyco Fire and Security and engineering products) (nytimes.com). Each is now a separate publicly-traded entity.

c. Adelphia Communications Corporation

The 2002 fraud case of Adelphia Communications Corporation involves both fraudulent financial reporting and misappropriation of assets. This case involves almost exclusively the founding family of the company perpetrating the fraud. Adelphia was founded by John Rigas in 1952 in Coudersport, Pennsylvania. Adelphia remained entirely in the hands of the Rigas family until 1986, when the company went public. By that time, Adelphia had 370 full-time worker and over 250,000 subscribers (money.cnn.com). Even after going public, John and his three Ivy League-educated sons, Michael, Timothy, and James, held the top executive positions at

Adelphia. According to the 2001 Proxy Statement for Adelphia, John served as Chairman, President and CEO; Michael served as Executive Vice President of Operation and Secretary; Timothy served as Executive Vice President, CFO, Chief Accounting Officer, and Treasurer; and James served as Executive Vice President of Strategic Planning. The Rigases seemed competent and reliable, but they had long been fooling investors.

When it was revealed in March 2002 that between 1991 and 2001 they had deliberately excluded $2.3 billion in bank debt from the financial statements, the whole situation unwound (sec.gov/news). It was discovered that Adelphia, in fact, did not have the highest operating cash margins in the cable industry at 56% (money.cnn.com). The debt did not appear as a liability on the company's balance sheet because it was hidden in the accounting records of off-balance sheet affiliates (sec.gov). It was also discovered that Adelphia had funded the Rigases' $150 million purchases of the Buffalo Sabres, along with the purchase of 17 "company cars" intended for personal use, $12.8 million for John's wife Doris to decorate and buy furniture, and many other things. As stated in the complaint SEC vs. Adelphia Communications Corporation, the company "inflated earnings to meet Wall Street's expectations, falsified operations statistics, and concealed blatant self-dealing by the family that founded and controlled Adelphia, the Rigas Family." (sec.gov).

Once the $2.3 billion exclusion was revealed, the company was doomed. By 2002, before its dissolution, Adelphia was the sixth largest cable company in the United States, but it forced to file Chapter 11 bankruptcy shortly after the fraud was reported. The company was not able to emerge from bankruptcy and subsequently many assets of the company were acquired by Time Warner Cable.

John Rigas and two of his sons, Timothy and Michael, were indicted on criminal charges. John and Timothy were found guilty of 15 charges of conspiracy, bank fraud, and securities fraud. They had been charged, along with Adelphia employee Michael Mulcahey, of hiding the $2.3 million in company debt and gradually stealing company funds for personal use (msnbc.msn.com). Michael Rigas was acquitted on most charges, while the jury was undecided on others (msnbc.msn.com). Michael Mulcahey was found not guilty of conspiracy and securities fraud.

In this fraud scandal, the Rigas family had motivation to hide the debt in order to report earnings and keep the company running. As previously mentioned, they were trying to meet Wall Street expectations. They wanted to make Adelphia look like the strongest cable company in the country. Also, although the Adelphia Proxy statement from 2001 does state that no part of executive compensation was tied to company performance, it does state that the executives had performed well. Since they received bonuses and other compensation for running the company successfully, that still served as motivation to commit the fraud that occurred. Therefore, this was not a motivating factor in hiding the $2.3 billion in debt. With regard to the personal gifts and cash that the Rigas family allotted to themselves, this was motivated mostly by greed. Their family founded the company, so they may have justified that they deserved what they took, especially since they also worked hard for the company. Furthermore, opportunity existed for them to commit the fraud considering the top executives were primarily from the Rigas family. There was even more opportunity when considering the significant internal control weaknesses that existed as well. Other Adelphia employees should have been checking the validity of the personal purchases made by the Rigas family.

IV. Sarbanes-Oxley Act of 2002

Although Enron is often the first company noted when accounting fraud is discussed, the cases above prove that Enron was not alone. In addition to the scandals at Enron, WorldCom, Tyco, and Adelphia were those of HealthSouth, Global Crossing, and Xerox, among others. In light of such large corporate fraud cases, the Sarbanes-Oxley Act was signed into law on July 30, 2002 by President George W. Bush. President Bush called SOX "the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt." The Sarbanes-Oxley Act was named after its chief sponsors, Democratic U.S. Senator Paul Sarbanes of Maryland and Republican U.S. Representative Michael G. Oxley of Ohio. The main purpose of the act was to "enhance corporate responsibility, enhance financial disclosures, and combat corporate and accounting fraud" (sec.gov/about/laws.shtml). The act is arranged into eleven "titles", each of which describes a specific guideline, regulation, or penalty for auditors and public companies. The introduction to SOX states that it is an act intended "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes" (Sarbanes-Oxley 1).

Title I of the Sarbanes-Oxley Act, known as Public Company Accounting Oversight Board, involves the creation of the PCAOB. The PCAOB was formed as an independent, non-profit body that would be subject to SEC regulation. The intent of the PCAOB was to improve the quality and reliability of audits performed on public companies through increased oversight of the auditors of these companies. Section 101 of Title I grants certain authorities to the PCAOB, each of which is described in detail throughout the subsequent four sections. The first of these was the authority to mandate registration of public accounting firms that prepare audit reports for public companies (Prentice 19). Section 102 further explains that it is unlawful for an unregistered firm or individual to take part in any stage of the audit. Also granted in Section 101 was the authority for the PCAOB to "establish and/or adopt, auditing, quality control, ethics, independence, and other standards" (Prentice 19). Section 103 expands upon this, stating that the PCAOB may adopt these standards from other accounting groups such as the AICPA or FASB, but that the PCAOB has the main authority over these standards. The third authority granted in Section 101 is the authority for the PCAOB to inspect registered public accounting firms. These inspections are to ensure that the accounting firms are in compliance with all regulations, including those laid out in the Sarbanes-Oxley Act, as well as those of the SEC and PCAOB. It also states that the PCAOB is required to inspect firms with over 100 public company audits annually and firms with less than 100 public company audits every three years (Prentiss 20). The final authority granted in Section 101 is that the PCAOB can "conduct investigations and disciplinary proceedings and, where justified, impose appropriate sanctions on auditors and audit firms" (Prentice 19). Section 105 further describes the sanctions that the PCAOB is authorized to enforce, including: permanent or temporary revocation of an accounting firm's registration, suspension or disbarment of an individual from working at a registered firm, various fines for firms or individuals, the requirement of additional professional training, etc. (Prentice 20). These sanctions are meant to serve as not only a punishment for wrongdoing, but also to defer undesired actions from occurring in the first place.

Furthermore, Section 106 explains that foreign accounting firms are subject to the regulations within SOX when they register accounting records with the SEC. Section 107 gives the SEC authority over the PCAOB. The SEC can therefore amend any rules established by the PCAOB, as well as review all disciplinary actions imposed by the PCAOB. This, in part, prevents the PCAOB from gaining too much power over accounting regulation. Section 109 involves the funding of the PCAOB, which was intended to come mostly from various fees imposed on public companies and registered accounting firms (Prentice 21).

Title I could have helped prevent previous fraud cases because it increases the oversight and authority over public accounting firms, which was lacking before SOX was enacted. Firms were not being watched as closely as they are today, which meant they had a lot more freedom to act in their own best interest. The mandated registration of public accounting firms and the annual inspections (or every three years form firms with less than 100 clients) of these firms would have helped encourage firms to act professionally and in accordance with all standards set forth by the PCAOB, SEC, and FASB. If the impending inspections were not enough to make the firms act properly, the inspections may have caught any wrongdoing occurring at the hands of the firms. Furthermore, the potential for sanctions or disciplinary actions being handed down from the PCAOB may have deferred bad behavior from occurring, whether by individual auditors or entire firms. The auditors would not have wanted to face these strict sanctions, such as hefty fines or removal of CPA licenses.

Title II of the Sarbanes Oxley-Act, known as Auditor Independence, involves improving not only the actual independence of auditors, but also the perceived independence. Whether an auditor is independent or not, and whether something would actually change their procedures and opinion, is irrelevant if outsiders do not feel the auditor is actually independent. Section 201 involves services provided for audit clients that are outside the scope of the actual audit. The following nine services are specifically prohibited to be performed for a public audit client:

> ‘‘(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;
> ‘‘(2) financial information systems design and implementation;
> ‘‘(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
> ‘‘(4) actuarial services;
> ‘‘(5) internal audit outsourcing services;

‘‘(6) management functions or human resources;
‘‘(7) broker or dealer, investment adviser, or investment banking services;
‘‘(8) legal services and expert services unrelated to the audit; and
‘‘(9) any other service that the Board determines, by regulation, is impermissible.” (SOX p 28).

These nine restrictions were implemented in order to uphold the integrity of the auditing process. If an auditor were to perform these services, they would be auditing their own work in the future, deeming the purpose of an independent audit irrelevant. Also, by performing these non-auditing services, the public accounting firm would have the potential to generate significantly more revenue from their clients, which could create an incentive to overlook fraud or other illegal acts during the auditing process. This occurred in the case of Enron, when Arthur Andersen was not willing to stand up to the company due to the vast loss in consulting revenue that would most likely have occurred for the firm (Prentiss 23). Any other non-audit services, other than those specifically prohibited, provided by an auditor for a public audit client are required to be approved in advance by the audit committee (SOX 28).

Section 202 of SOX requires all public companies to have an independent audit committee. It further states that all audit and non-audit services must be preapproved by the audit committee before they are performed (SOX 28). Before the Sarbanes-Oxley Act, CEOs and CFOs of companies typically handled communications with the auditor, involving hiring, compensation, and firing. This led to a great deal of power for the top officials, leaving the auditors at their mercy (Prentiss 26). With the requirement of audit committees, this leverage over auditors was essentially eliminated.

Section 203 requires the audit partner to rotate every five years. This was implemented in order to prevent the formation of close relationships that may influence the partner’s independence. Section 204, expanding upon Section 202, requires the auditor to communicate "all critical accounting policies and procedures to be used; all alternative treatments discussed with management and their ramifications; and other material communications between the auditor and management" to the audit committee (Prentiss 28). This is intended to keep the audit committee up to date and well-informed throughout the audit process. Section 209 allows state regulatory boards to supervise small and medium nonregistered accounting firms and decide which standards shall be applicable to them (SOX 31).

Title II could have reduced the prior fraud cases because it involves eliminating various conflicts of interest in the audit process. By prohibiting certain non-audit services from being performed by an auditor, it reduces the potential for wrongdoing or fraud to be overlooked by an auditor in order to gain more revenue from consulting, for example. As previously mentioned, that is what occurred in the case of Arthur Andersen with Enron. Also, by requiring an independent audit committee, Title II would have eliminated much of the leverage that CEOs and CFOs had over the auditor. Now, these executives no longer participate in the hiring, firing, and compensation processes. Finally, in some of the past fraud cases, close auditor/client relationships probably existed. By requiring that audit partners rotate every five years, this may have reduced the formation of these close relationships that lead to incorrect opinions being given or certain information being overlooked.

Title III, entitled Corporate Responsibility, discusses various roles and responsibilities within the company relating to corporate responsibility. Section 301 involves the audit committee, which is to be made up of independent members from the Board of Directors. In order to remain independent, the audit committee members may not accept any consulting, advisory, or other compensatory fees from the company or be an affiliated person of the company (SOX 32). The audit committee is deemed responsible for the "appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer" (SOX 32). The audit committee is also responsible for resolving disputes between management and the auditor. In Section 301, the audit committee is also granted the authority to hire advisers when it is necessary to complete their work properly. Also, the audit committee is granted proper funding from the company to compensate the hired accounting firm and any advisers.

Section 302 involves increasing the responsibility of CEOs and CFOs when certifying financial statements. Prior to the implementation of the Sarbanes-Oxley Act, these top officials were not held accountable, even if they knew errors or misstatements were present. Therefore, any incentive to prevent or report potential errors was very weak. "Section 302 now requires each public company's CEO and CFO to certify that they have reviewed the quarterly and annual reports their companies file with the SEC, that based on their knowledge the reports do not contain any materially untrue statements or half-truths, and that based on their knowledge the financial information is fairly presented" (Prentice 33). If these individuals could potentially be held accountable and face jail time for material misstatements, they would be more likely to ensure these errors do not exist. The CEO and CFO are also required to certify that they are responsible for establishing and maintaining effective and efficient internal controls, that these controls will ensure relevant material information is revealed to them, that the controls have been tested within 90 days, and that a report on internal controls was given to the auditor (SOX 33). Any significant deficiencies or material weaknesses in internal controls must be revealed to the auditor.

Section 303 deems it illegal for any officer or director of a public company to "fraudulently influence, coerce, manipulate, or mislead" the auditor in order to release materially misleading financial statements (SOX 34). Section 304 states that, in the case that financial statements are restated due to material noncompliance as a result of misconduct, the CEO and CFO are required to reimburse the company for all bonuses and incentive-based compensation (cash or stock) paid in the 12 month period following the first issuance of the incorrect financial statements (SOX 34). This creates another incentive for the top officials to act properly, as they could potentially be required to return very large amounts of money.

Section 305 makes it easier to ban officers or directors of public companies from ever holding such positions again. The requirement to ban such individuals was reduced from "substantial unfitness" to simply "unfitness". Section 306 makes it unlawful for any director or officer to buy or sell the company's stock during a blackout period where over 50% of pension plan participants are banned from doing so as well for over 3 days (Prentice 37). Section 307 aims to place more responsibility on the lawyers of publicly traded companies. It requires lawyers to report violations of laws to higher and higher officials within the company if each subsequent person informed does not act. This can go all the way to the Board of Directors; however, the lawyer does not need to inform anyone outside the company if the Board does not respond (Prentice 38). Section 308 is intended to enable victims of fraud to receive compensation for the wrongdoing against them. In the past, most of the money paid in restitution during civil lawsuits went into the U.S. Treasury because it was difficult to determine who should be paid.

Title III has many sections that are intended to reduce fraud, with most of them relating to the CEOs and CFOs of public companies. Within Title III, CEOs and CFOs are given more responsibility in certifying the financial statements. They must now certify that, to the best of their knowledge, the financial statements being filed are presented fairly. They also must take responsibility for maintaining efficient and effective internal controls. In theory, these things should reduce fraud because top executives will want to ensure errors do not exist so they do not face jail time or fines. These responsibilities now placed on top executives could have prevented the various past fraud cases because the CEOs and CFOs would most likely not have certified the falsified financial statements if they knew they had a greater personal risk by doing so. Title III could also have reduced fraud by reducing leverage over auditors. It makes it unlawful for officers of a public company to influence, coerce, manipulate, or mislead the auditor. Furthermore, since CEOs and CFOs now have to pay back bonuses and/or incentive-based compensation when misstatements occur due to misconduct, more fraud could have been reduced if this existed sooner because top executives would not have wanted this to happen. Since performance-based compensation was a significant motivation for fraud in the past, it may not have occurred as much if the top executives were not going to get to keep the money anyways. Top executives now have increased personal financial incentive to ensure the financial statements are correct and fair.

Title IV, concerning Enhanced Financial Disclosures, improves upon many ideas laid out in the previous three titles in order to improve the financial reporting of public companies. Section 401 involves preventing companies from using varying methods to make the financial position look better than it really is. All off-balance sheet transactions that have a material effect on the financial statements must be disclosed and all pro forma financial statements must be devoid of misstatements or half truths and be reconciled to the U.S. GAAP financial statements (Prentice 40). Section 402 prohibits publicly traded companies from making personal loans to executive officers and directors. As seen above in the cases of Tyco and Adelphia, these loans were most often not repaid when a company either failed or experienced financial distress

(Prentice 41). There are a few minor exceptions, including the issuance of charge cards, lines of credit, and home improvement loans (SOX 43). Section 403 requires that most transactions by insiders be electronically reported to the SEC within two business days. This change occurred because under the previous requirement, most transactions needed to be filed within 10 days, but some did not need to be until 45 days after the following fiscal year, meaning by that point it was normally too late to fix any problem. Also, companies must now post these filings on their company website by the end of the business day.

Section 404, what many professionals consider to be the most important section of SOX, involves significantly increasing internal controls within public companies in order to improve the reliability of the financial information being reported. This section goes along with Section 302 in that management is required to establish and maintain these internal controls, as well as report on their effectiveness at the end of each fiscal year. Furthermore, auditors are required to report on management's assessment of these internal controls (SOX 45). Section 404 has proven to be quite controversial due to the vast expenses incurred by firms in order to establish and maintain proper internal controls. General Electric estimated that initial expenses incurred in order to comply with Section 404 were around $30 million. Various studies found that, on average, the one-time fees to set up proper internal controls totaled between $3 and $4 million for public companies and audit fees for these companies were increased by about $2.3 million annually (Prentice 45).

Section 406 involves adopting a code of ethics for senior financial officers within public companies. These officers include "CFOs, comptrollers, principal accounting officers, or persons performing similar functions" (SOX 45). Each company is required to report if a code of ethics exists for their highest financial officers. The code must include requirements of honest and ethical conduct, fair and accurate disclosures, and compliance with applicable laws and regulations. If a code does not exist, the company must explain why (Prentice 47). Section 407 involves increasing the financial knowledge on audit committees. At least one member is required to be a “financial expert”, meaning they have served as an accountant, auditor, principal financial officer, comptroller, or principal accounting officer (SOX 46). The individual must have an understanding of GAAP and financial statements, experience preparing or auditing financial statements, experience with internal accounting controls, and an understanding of audit committee functions (SOX 46).

As mentioned previously, the SEC had been underfunded for many years prior to the enactment of SOX, leading to minimal review of filings. Section 408 requires the SEC to perform a “regular and systematic review” of periodic disclosures by financial statement issuers. These reviews must take place at least every three years and involve reviewing materially restated financial statements, emerging companies with disparities in P/E ratios, companies that have a large market capitalization, companies that have experienced significant stock price volatility, or companies whose operations significantly affect any material sector of the economy (Prentice 48). Section 409 simply involves requiring issuers to disclose, in a timely manner, any other information the SEC deems necessary.

Some aspects of Title IV may have been effective at preventing fraud in the past, but not all. As laid out in Section 402, personal loans to executive officers and directors are no longer allowed. Since this was an issue with Bernie Ebbers at WorldCom and both Dennis Kozlowski and Mark Swartz at Tyco, this may have been effective at preventive both these fraud cases and others as well. Also, the time allowed to report transactions by insiders has been reduced to two days, which creates greater transparency in the securities markets. This may have reduced some instances of fraud in the past, for example the situation with Tyco where Kozlowski and Swartz did not reveal the sale of $430 million worth of their shares of company stock to investors. Section 404, which involves increased internal controls, may not have been very helpful considering it was mostly top executives who committed the fraud and they could have also overridden stronger controls. The requirement of a code of ethics for public companies also may not have been very effective because the individuals committing the fraud were not very concerned with ethical behavior, whether there was a code or not.

Titles V through VII do not directly affect the accounting profession, but rather consist of various reforms for Wall Street. Title V, Analyst Conflicts of Interest, involves an increase in rules for the securities analysts who faced increased pressure from employees to misreport on securities. Title VI, Commission Resources and Authority, discusses the underfunding experienced by the SEC in years prior to the issuance of SOX. The budget for the SEC was increased to $776,000,000 for 2003 so that more employees could be hired to review necessary documents and so technology could be improved (SOX 49). It also reinforced the SEC's right to punish accountants and attorneys who are either not qualified or have not acted properly in their duties. Title VII, Studies and Reports, explains that due to the urgency of the Sarbanes-Oxley Act being implemented, many things had not been properly researched and reported it. The SEC was ordered to undertake various studies involving the impact of the consolidation of accounting firms, the SEC's enforcement over financial statement reporting, etc. (Prentice 55).

Title XIII is entitled Corporate and Criminal Fraud Accountability. Section 802 aimed to reduce tampering with evidence and document alteration by creating two new statutes. The first involves the "destruction, alteration, or falsification of records in federal investigations and bankruptcy" (SOX 56). A crime of this type is punishable by up to 20 years in prison. The statute is not limited to fraud cases, and has been used in child pornography cases as well. The second statute requires auditors of public companies to maintain work papers for five years. However, an SEC ruling has changed this to seven years (Prentice 60). Knowing and willful violations are punishable by up to 10 years imprisonment. Section 803 makes debt incurred due to convictions of securities fraud violations non-dischargeable in the case of a bankruptcy filing. This means that individuals forced to pay civil damages or other funds cannot avoid payment by filing for bankruptcy. Section 804 increases the statute of limitations to file a securities fraud suit. The time a plaintiff has to sue after the discovery of the fraud was increased from one year to two years and the time a plaintiff has to sue after the occurrence of the fraud has increased from three years to five years (Prentice 62).

In Section 805 of Title VIII, the United States Sentencing Commission is ordered by Congress to review and amend, as necessary, the Federal Sentencing Guidelines (FSG) in order to properly deter and punish obstruction of justice perpetrators (Prentice 62). Section 806 provides additional protection to whistleblowers within public companies. It provides civil damages action for employees who experience retaliation from their company after providing information or participating in an investigation. The employee has 90 days from the discriminatory act to file a complaint with the Secretary of Labor (Prentice 63).

Title XIII has certain elements that could have been effective at preventing fraud. Tampering with evidence can now carry a prison sentence of up to 20 years. Although this may not necessarily have prevented fraud, it could have if accounting firms acted properly knowing that they could not just destroy evidence that showed they had overlooked certain facts. At the very least, it may have prevented public accounting firms such as Arthur Andersen in the Enron scandal from shredding documents. The same also holds true because work papers now must be held for seven years or a ten year imprisonment could be faced. Title XIII also has a whistleblower section to protect those who come forward. This could have prevented such disastrous results from occurring because whistleblowers would have been encouraged to come forward sooner than was actually happening.

Title IX, entitled White-Collar Crime Penalty Enhancements, aims to increase penalties handed down to perpetrators of fraud. Section 902 involves individuals who attempt or conspire to commit mail, wire, or securities fraud. Under this section, these individuals will get the same punishment as others who actually commit these acts. It is intended to defer people from even considering committing fraud, as if it the plan is revealed, they will be punished even if they decided not to proceed with the fraud. Section 903 increases the maximum possible jail sentence for mail and wire fraud from five to 20 years (SOX 61). Section 905 lists amendments to the sentencing guidelines that the United States Sentencing Commission should make. Section 906 goes along with Section 302 and 404 in that it is increasing the accountability of CEOs and CFOs. This section adds the criminal punishments for those who intentionally certify misstated financial filings to the SEC. In circumstances where the individual "knowingly certifies" the misstated financial statements, they may face a fine of up to $1,000,000 and imprisonment of up to 10 years, or both. When the individual "willfully" certifies the misstated financial statements, they may face a fine of up to $5,000,000 and imprisonment of up to 20 years, or both (Prentice 68).

Title IX imposes very severe punishments on perpetrators of fraud, which could have been very effective at preventing some of the fraud scandals that happened in the early 2000s. The maximum sentence for mail and wire fraud was increased by four times from five to 20 years. That is a very significant difference. If someone was weighing the risks of getting caught, five years in prison is very different than 20 years in prison, so that would be a very strong deterrent. Also, imprisonment can now be handed down for not only committing fraud, but also conspiring to do so. This could have resulted in less people considering committing fraud and therefore, even less people actually committing it. Furthermore, the fines and maximum imprisonment for executive officers who knowingly certify or willingly certify misstated financial statements have also been increased significantly. This could have prevented many of the top executives during the early 2000s from committing the fraud that they did. Greater personal risk is also a strong deterrent from bad behavior.

Title X, Corporate Tax Returns, simply states that the chief executive officer of a corporation should sign the Federal income tax return for the corporation (SOX 63).

In Title XI, specifically Corporate Fraud and Accountability, other criminal provisions are added in order to limit obstruction of justice. Section 1102 involves tampering with records and impending official investigations. Anyone who corruptly "alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for us in an official proceeding" or "otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so" will be fined or face up to 20 years in prison, or both (SOX 63). Section 1103 give the SEC the authority to temporarily freeze the funds of a company if it appears that, during an investigation, those funds are likely to be paid as bonuses or other to directors, officers, or other individuals within the company (Prentice 71). Section 1105 authorizes the SEC to permanently or temporarily bad individuals from serving as officers or directors of public companies. Section 1106 increased penalties for individuals intentionally violating sections of the Securities Exchange Act of 1934 from $1 million to $5 million and from a maximum sentence of 10 years to a maximum of 20 years. For corporations in violation, the maximum fines were increased from $2.5 million to $25 million (Prentice 72). Section 1107 makes it unlawful to retaliate, or cause other harmful actions against, a person who provides any truthful information to law enforcement regarding the commission of any Federal offense. The perpetrator of the retaliation may face fines and up to 10 years imprisonment (Prentice 72).

Title XI contains some sections similar to others within SOX. Section 1102 involves tampering with records, which being similar to tampering with evidence, carries a maximum prison sentence of 20 years. This could have reduced fraud if accounting firms were prevented from allowing tainted records to exist in the first place. Section 1107 goes along with the increased protection for whistleblowers by making it unlawful to retaliate against such individuals and therefore encouraging them to come forward. This could have prevented such large losses from being incurred if the whistleblowers had come forward sooner.

a. Analysis of SOX: Costs vs. Benefits

A few significant benefits of the Sarbanes-Oxley Act include: an increase in the disclosure of material weaknesses in internal controls; an increase in conservatism in financial reporting, including re-issuances when necessary; and an increase in the perceived independence of auditors. In a study performed in September 2005, 261 companies that had disclosed an internal control weakness following the August 2002 effective start date of SOX were investigated (Ge 138). The material weaknesses commonly cited were related "to deficient revenue-recognition policies, lack of segregation of duties, deficiencies in the period-end reporting process and accounting policies, and inappropriate account reconciliation. In a way, SOX scared companies who were afraid of punishments for leaving something out. This led to increased conservatism with respect to gains and other items.

Furthermore, considering non-audit services allowed to be performed by an auditor were significantly reduced, this limited the conflicts that arose between giving the correct audit opinion and losing revenues for the accounting firm. This led to increased perceived independence of auditors.

Costs of the Sarbanes-Oxley Act include: the requirement to rotate audit partners every 5 years and the actual expense to companies to comply with the act, especially Section 404. Public companies experienced significantly increased audit fees and increased internal fees to implement and maintain requirements of SOX. Retraining a new partner every five years is both costly and time consuming. Once a partner knows the business really well, it is time for them to leave and someone else to come in.

With regard to excessive costs for companies, "between 2001 and 2004, total audit and audit-related fees increased 103% for 496 of the S&P 500 companies" (nysscpa.org). That means audit fees more than doubled for companies in this time period. Also, as previously stated, General Electric estimated that their initial costs to comply with Section 404 alone were around $30 million (Prentice 45). The company and investors will most likely never reap enough benefits to justify those costs.

Overall, it appears that some aspects of SOX have been beneficial, but it does not appear to have been as successful as anticipated. Many companies feel that the millions they spent to comply with the act have not been worth it for either the company or investors.

i. Interview of a Current CPA

In a personal interview with Mr. John McNamara, a certified public accountant for over 30 years and partner at Sullivan Bille PC, he revealed many of his opinions on the Sarbanes-Oxley Act. After working in the field for many years (and at Arthur Andersen during its collapse), he has much insight on the topic. When asked if he believes the benefits of SOX have outweighed the costs for companies, he stated that overall, he thinks SOX has been completely worthless and was simply an overreaction to the Enron scandal. He pointed out that SOX was not successful at preventing the banking meltdown, but has still cost many companies millions of dollars. Mr. McNamara does not believe the Act is cost effective because it involves testing all risk, rather than just enterprise risk that could actually ruin a company. He believes that only fraud that could destroy the company matters. He pointed out that in most cases of fraud (Enron, WorldCom, Lehman Brothers), internal controls are not effective anyways because it is management override of those controls that allows the fraud to occur. He stressed the issue of management override very much and the importance of controlling the power of top employees and officers. Mr. McNamara explained that if the owner steals, this creates a bad control environment for the whole company because if the tone from the top is that it is okay to steal, then it spirals down from there. However, Mr. McNamara did point out that SOX was good for accounting firms because their fees doubled and many firms gained several clients after the fall of Arthur Andersen.

In Mr. McNamara's opinion, most people put too much emphasis on Section 404 of SOX. He believes that Section 302, holding top officials of public companies legally accountable for the financial information disclosed, is more important. He said that before SOX, most officers of public companies would say they did not know what was going on if fraud or something else occurred, but now they no longer have that excuse to fall back on. However, he does agree that Section 302 and 404 go hand in hand, as Section 404 is simply explaining how to implement the testing of what management has been required to certify through Section 302. Mr. McNamara believes that 404 involves testing too much and testing the wrong things. He thinks the focus should be on testing the decision makers and every time they override a control rather than testing everything.

When asked if he thinks SOX has increased conservatism in financial reporting, Mr. McNamara was quick to point out that one person's definition of conservatism is different than another person's. One person may think something should be included in the financial statements, while another person might not think it is necessary. He also believes that conservatism is too relative and that consistency is more important. In some instances, he feels the desire for more conservatism is not necessary. Mr. McNamara gave an example saying, "Gains should be reported when gains should be reported. We're too conservative in that way. But all losses should be recorded." He also pointed out that, even with increased regulation of the accounting profession, there are still financial factors influencing decisions. If the auditor believes the client should add or alter something in order to be conservative and the client does not want to, the auditor may not press the issue (especially if it is immaterial) because they do not want to get fired and therefore have to fire employees and lose revenues from the client.

Overall, Mr. McNamara does not believe that SOX has been as effective as intended. He sees some positive outcomes, but not enough to justify the large costs that have been incurred through satisfying the requirements. Mr. McNamara's opinion on the Sarbanes-Oxley Act is very informative and insightful. It is important to add, however, that Section 906 goes along with Section 302 and 404. Section 302 requires CEOs and CFOs of public companies to certify the financial statements and Section 404 requires them to maintain effective and efficient internal controls, while Section 906 places criminal punishments on these top officials who are involved in wrongdoing. The maximum fines and prison sentences are significantly burdensome, therefore making them effective at preventing fraud. As previously mentioned, knowingly certifying misstated financial statements can result in a fine of up to $1,000,000 and imprisonment of up to 10 years, or both and willfully certifying misstated financial statements can result in a fine of up to $5,000,000 and imprisonment of up to 20 years, or both (Prentice 68). Overall, these three sections of the Sarbanes-Oxley Act are aimed at putting more responsibility on top management of public companies and making them more accountable for actions of the company. These individuals can no longer hide behind lack of knowledge when something goes wrong and they will be significantly punished for intentional misstatements.

V. Recent Case of Fraud

The Sarbanes-Oxley Act has proven to be somewhat successful, but there have still been significant cases of fraud since it was enacted in 2002. Even with the act in place, audits are still only performed on a sample basis, so there is always the possibility that fraud will not be uncovered. Also, considering the nature of fraud, it is often harder to discover than errors because it is intentional. Someone is actively trying to hide it from the auditors and other employees of the company.

a. Bernie Madoff Ponzi Scheme

BERNARD L. MADOFF
Investment Securities LLC

Bernard Madoff, typically referred to as Bernie Madoff, began working as a lifeguard on Long Island in his early years. Following his graduation from Hofstra University and a brief stint at Brooklyn Law School, Madoff started Bernard L. Madoff Securities LLC on Wall Street in 1960 with the money he had saved from lifeguarding (topics.nytimes.com). Over the next four decades, Madoff turned into a trading powerhouse, gaining much notoriety on Wall Street throughout his long career.

However, on December 11, 2008, Bernie Madoff was arrested for running the largest Ponzi scheme in history. A Ponzi scheme is a fraudulent investment operation in which investors are paid returns from either their own money or that of other investors. Although these schemes can go on for a very long time, they will eventually collapse due to the fact that the actual earnings (if there even are any) are less than those being paid to investors. At the time the scandal was uncovered, the investor statements to Madoff's clients totaled almost $65 billion. However, it has since been revealed that only about $17.3 billion of this had actually been legitimate (topics.nytimes.com). The scheme had been going on for around 20 years by the time it was uncovered. On March 12, 2009, Bernie Madoff pleaded guilty to all 11 federal felony charges against him (topics.nytimes.com). These included charges of securities fraud, money laundering, and perjury. Madoff was eventually sentenced to 150 years in prison, with the judge stating his crimes were "extraordinarily evil".

In the wake of the scandal, over 1,000 lawsuits have been filed in the U.S. Lawsuits totaling around $15.5 billion were settled with various banks outside the U.S. in May of 2010 (topics.nytimes.com). Irving H. Picard is the court-appointed trustee representing Madoff's victims in the U.S. At first he was seeking $100 billion in damages, but it has since become clear that it will be a feat to even recover the $17.3 billion originally invested. It was ruled by a federal judge that Picard cannot file claims against banks or other third parties on behalf of the victims, so the $20 billion sought from JP Morgan Chase, UBS, and HSBC will not be recovered (topic.nytimes.com). So far, around $9 billion has been recovered, but only around $330 has actually been paid to victims due to pending appeals holding up the other funds. Much of the lawsuits involve recovering funds from "net winners", investors who came out with more than what they originally invested, and paying it to "net losers", investors who ended up with less than they originally invested. The largest example of this was when New York Mets owners Fred Wilpon and Saul Katz settled at $162 million (topics.nytimes.com). There had also been a willful blindness claim involved, stating they knew fraud was occurring but they did not act because of the large sums they were receiving. This claim was dropped by Picard upon reaching the settlement.

Among the victims of Madoff's Ponzi scheme were: Elie Weisel, famous for surviving the Holocaust and going on to win a Nobel Peace Prize; Steven Spielberg, the renowned Hollywood director; and former New York Governor Eliot Spitzer, whose real estate business was involved (topics.nytimes.com). Much to the dismay of his victims, Madoff has failed to recognize the destruction his actions have caused. Although he pleaded guilty and has taken responsibility for his actions, he often focuses on the large banks and their role in failing to uncover the scheme when they should have been able to rather than expressing any personal sympathy or regret.

On December 20, 2012, Bernie Madoff's brother Peter Madoff was sentenced to 10years in prison for his role in the fraud scandal. Peter Madoff had served as the senior lawyer and chief compliance officer at Bernard L. Madoff Securities LLC for over 30 years. Although he never admitted to knowing about the fraud or being involved in it, he admitted to crimes including "falsifying documents, lying to securities regulators, and filing sham tax returns" (topics.nytimes.com). Others convicted so far include Frank DiPascali, Madoff's longtime aide who admitted that he helped carry out the fraud for at least 20 years, and David G. Friehling, who was the independent auditor at the firm who admitted to never auditing the company properly or being completely independent.

Eventually, it became clear that there was evidence of the fraud long before it was uncovered. The SEC released a report with the findings that they had received six substantive complaints since 1992, but that each investigation had failed due to lack of due diligence (topics.nytimes.com). It was also revealed that JP Morgan Chase had suspicions for up to 18 months prior to the discovery, but had continued to do business with Madoff.

When analyzing the fraud triangle elements with regards to the Bernie Madoff's ponzi scheme, it is clear that opportunity existed because he was the head of the company. Although others had suspicions, no one seriously question him, allowing his scheme to go on for years. The motivation behind the fraud was to continue to making the company look successful in order to gain more clients and allow his vast personal income to continue. However, Madoff was forced to forfeit $170 million in personal assets following his criminal trial. Madoff may have rationalized that the investors were at least getting their returns for now and he would be able to reach the reported assets eventually, so why destroy the company when it could be resolved in the future. That was very unlikely though, considering was a nearly $50 billion difference between actual and reported assets.

VI. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act was introduced in 2010 to improve upon some sections of the Sarbanes-Oxley Act, as well as introduce many new standards and regulations to the financial sector. The act is extremely lengthy, comprised of 848 pages compared to just 66 pages in the Sarbanes-Oxley Act. The introduction to the act states that it is intended "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ''too big to fail'', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes" (Dodd-Frank 1). Following the lending crisis of 2008 and the subsequent recession, stricter regulation within the financial sector was needed. The Bernie Madoff scandal, the housing bubble, irresponsible lending practices, and the auto giant bailouts had shifted the United States into a financial crisis that still casts a shadow over the country's economy today.

The Dodd-Frank Act is comprised of sixteen titles, of which not all relate to accounting or fraud. The titles are as follows:

Title I- Financial Stability
Title II- Orderly Liquidation Authority
Title III- Transfer of Power to the Comptroller of the Currency, the Corporation, and the Board of Governors
Title IV- Regulation of Advisers to Hedge Funds and Others
Title V- Insurance
Title VI- Improvements to Regulation and Bank and Savings Association Holding Companies and Depository Institutions
Title VII- Wall Street Transparency and Accountability
Title VIII- Payment, Clearing, and Settlement Supervision
Title IX- Investor Protections and Improvements to the Regulations of Securities
Title X- Bureau of Consumer Financial Protection
Title XI- Federal Reserve System Provisions
Title XII- Improving Access to Mainstream Financial Institutions
Title XIII- Pay It Back Act
Title XIV- Mortgage Reform and Anti-Predatory Lending Act
Title XV- Miscellaneous Provisions
Title XVI- Section 1256 Contracts

Title III, known as "Transfer of Power to the Comptroller of the Currency, the Corporation, and the Board of Governors", abolishes the Office of Thrift Supervision (OTS) and transfers the supervision of depository institutions to the Office of the Comptroller of the Currency (OCC), the Federal Depository Insurance Corporation (FDIC), and the Board of Governors of the Federal Reserve System (law.cornell.edu). The OCC now has authority over federal savings institutions, while the FDIC has gained authority over state-chartered savings institutions. The Federal Reserve now has regulatory and rulemaking authority over savings and loans holding companies. Title III has four main purposes, which are to: "(1) provide for the safe and sound operation of the banking system; (2) preserve and protect the dual banking system; (3) ensure fair and appropriate supervision of depository institutions, without regard to the size or type of charter; and (4) streamline the supervision of depository institutions and their holding companies." (law.cornell.edu). The title also permanently increases the insurance amount under the FDIC from $100,000 to $250,000.

Title XII, known as "Wall Street Transparency and Accountability", aims to improve regulation of the swaps market, which was largely at fault in the financial crisis of 2008. The Securities and Exchange Commission (SEC) now has authority over securities-based swaps, while the Commodity Futures Trading Commission (CFTC) holds authority over all other swaps (law.cornell.edu). Registration requirements are being place on swaps dealers and major participants in order to ensure that swap dealers who deal in amounts that could affect the economy are being properly monitored. Additionally, capital and margin requirements have been placed on dealers to ensure they have the proper funding and liquidity. Title XII also amends the reporting requirements laid out in the Commodity Act (law.cornell.edu). It now requires swap transactions to be reported to an approved reporting or registration data depository.

Title IX, known as "Investor Protections and Improvements to the Regulations of Securities", imposes various changes to executive compensation. Public companies now have additional requirements for what they must disclose about executive compensation and corporate governance. Furthermore, companies are now required to give shareholders the power to vote on executive compensation plans. Public companies are also now required to enact a "clawback" policy through which they can recover any compensation paid due to erroneous or noncompliant financial reporting (law.cornell.edu). Title IX also includes sections involving improvements to credit rating agencies. These agencies now must implement stronger internal controls, adhere to stricter credit rating procedures and processes, and file additional disclosures about the accuracy of prior credit ratings (law.cornell.edu).

The success and effectiveness of the Dodd-Frank Act is still relatively unknown, as it was enacted just over two years ago. The act will ideally have the intended effect of promoting financial stability within the United States and protecting American investors and consumers. The Sarbanes-Oxley Act has resulted in some improvements to investor confidence and the public sector, so hopefully the Dodd-Frank can build off that and help improve the overall financial situation within the U.S.

VII. Conclusion

When it comes to fraud, there are many preventative measures that can be taken, but it is nearly impossible to fully extinguish it. If someone wants to commit fraud, they will most likely find a way to do it no matter what controls are in place. That is why preventing opportunities, through internal controls or otherwise, is the most important part of the fraud triangle. Once an individual has established a rationalization and motive, they will commit the fraud once an opportunity presents itself.

As all of the cases discussed have shown, it is typically the highest individuals in an organization that have the power to commit the most damaging fraud. Internal controls cannot be effective if the executives in charge have to power to override them. The tone from the top within an organization needs to be positive and even the top employees need to be overseen. It appears true that more accountability and increased responsibility for these top executives of public companies is a successful way of preventing fraud, at least at the highest levels of an organization. Personal risk is typically a great deterrent from bad behavior. With the exception of the Bernie Madoff scandal, accounting fraud seems to be declining since the early 2000s.

It appears that recent accounting legislation, namely the Sarbanes-Oxley Act and Dodd-Frank Act, is heading in the right direction, but more can be done to prevent fraud. As accounting standards within the United States converge with IFRS, there is the potential that fraud can be reduced even more. With the rules-based accounting laid out in U.S. G.A.A.P., individuals are expected to follow exactly what is laid out. If there is not a specific rule about something, it can be argued that it was not clear what should have been done, even if an action was clearly immoral. Under a principle-based system such as IFRS, more discretion in decision making is placed on the individual. Therefore, moral actions are expected to be chosen, often leading to less fraud. Overall, accounting in the United States seems to be heading in the right direction, even if fraud will never really vanish entirely.

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