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FRAUD AS AN INCENTIVE FOR CHANGE IN CORPORATE AMERICA

by
Sharon Abimbola Salu

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

Oxford
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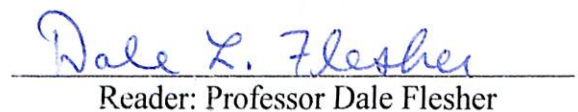
Approved by

Advisor: Professor Mark Wilder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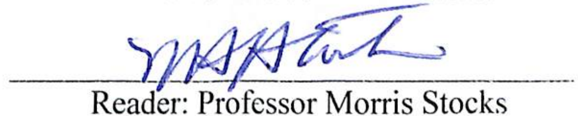
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ABSTRACT

SHARON ABIMBOLA SALU: Fraud as an incentive for change in Corporate America
(Under the direction of Dr. Mark Wilder)

In this work, I explore the relationship between fraud and related changes in Corporate America with the express intention of showing that in spite of the negativity associated with fraud, it can still act as a mechanism that sets the wheels of change in motion in Corporate America. Of all the different kinds of fraud, this research focused on fraudulent financial reporting in corporations. In order to accomplish this goal, several research questions were examined which were aimed at examining the methods by which fraud is perpetrated, the relationship between fraud and business ethics and the effects fraud has had on various aspects of the society, including government regulation and public confidence in the accounting profession. With regards to government regulation, there was particular focus on the Sarbanes-Oxley Act as one of the major legislations dealing with fraud in corporations. The research findings showed that having a weak corporate ethical culture as well as a weak personal code of ethics were factors that increased the likelihood of perpetrating fraud. The proliferation of cases of accounting fraud has encouraged the growth and development of a new area of accounting called forensic accounting. In addition, this increase has also encouraged government involvement in corporations, which has changed the face of corporate governance. The research concludes by asserting that fraud could act as an incentive for change in the American corporate world.

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I: Introduction

Definition of Fraud

The word 'fraud' carries a negative connotation, and to argue otherwise would entail overriding public opinion. At the same time, there are many different definitions of fraud depending on the context of the fraud. To put it in the words of Jack C. Robertson and Timothy J. Louwers, "several kinds of fraud are defined in the laws, while others are matters of general understanding."[1] For the purpose of this research, I will examine various definitions of fraud from an accounting, or specifically, an auditing perspective.

The first definition of fraud is based on one of the Statements on Auditing Standards (SAS). Statements on Auditing Standards are issued "in a numbered series"[2] by the Auditing Standards Board (ASB) and they are formally treated as "interpretations" of the ten Generally Accepted Auditing Standards required for public accountants.[3] If an external auditor does not follow the stipulations specified in the auditing standards, it can be assumed that he or she performed an incomplete audit.[4]

According to Statement on Auditing Standards (SAS) 99, fraud can be defined as "an intentional act that results in a material misstatement in financial statements that are the subject of an audit."[5] This definition is quite similar to another definition that states that "fraud consists of knowingly making material misrepresentations of fact, with the intent of inducing someone to believe the falsehood and act upon it and thus, suffer a loss or damage."[6] This definition encompasses all the varieties by which people can lie, cheat, steal and dupe other people.[7] Both of the two foregoing definitions highlight two inherent

aspects of fraud: it is intentional and it involves making material misstatements or misrepresentations.[8] These two aspects of fraud differentiate it from errors, which "are **unintentional** misstatements or omissions of amounts or disclosures in financial statements."[9] The third definition of fraud sums up the preceding points by describing fraud "in the context of auditing financial statements"[10] as "an intentional misstatement of financial statements."[11]

When people discuss or think about fraud, several terms are used and they include the following:

> **Employee Fraud** - the use of fraudulent means to take money or other property from an employer. It usually involves falsifications of some kind—false documents, lying, exceeding authority, or violating an employer's policies. It consists of three phases: (1) the fraudulent act, (2) the conversion of the money or property to the fraudster's use, and (3) the cover-up.
>
> **Embezzlement** - a type of fraud involving employees' or nonemployees' wrongfully taking money or property entrusted to their care, custody, and control, often accompanied by false accounting entries and other forms of lying and cover-up.
>
> **Larceny** - simple theft—for example, an employee taking an employer's money or property that has not been entrusted to the custody of the employee.
>
> **Defalcation** - another name for employee fraud, embezzlement, and larceny. SAS 82 also calls it "misappropriation of assets."
>
> **Management fraud** - deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements.

The class of perpetrators is management; the class of victims includes investors and creditors; and the instrument of perpetration is financial statements. Sometimes management fraud is referred to as "fraudulent financial reporting."

Fraudulent financial reporting - defined by the National Commission on Fraudulent Reporting (1987) as *intentional or reckless conduct, whether by act or omission, that results in materially misleading financial statements.*

Direct-effect illegal acts - violations of laws or government regulations by the company or its management or employees that produce direct and material effects on dollar amounts in financial statements.[12]

For this study, the focus will be on two types of fraud, fraudulent financial reporting and misappropriation of assets,[13] with more emphasis on the former. I have already defined fraudulent financial reporting, but there is a need to spell out what constitutes misappropriation of assets and also to discuss fraudulent financial reporting in more detail.

According to Arens, Elder and Beasley, misappropriation of assets "is fraud that involves theft of an entity's assets."[14] Most of the time, amounts that are immaterial to the financial statements are involved but management is particularly concerned with the loss of company assets.[15] In addition, when people refer to misappropriation of assets, they usually refer to employee theft as well as theft involving people within the organization.[16] However, in many cases, this type of fraud involves people outside the organization such as suppliers.[17]

Fraudulent financial reporting, on the other hand, is "an intentional misstatement or omission of amounts or disclosures with the intent to deceive users"[18] and in most cases, amounts (not disclosures) are deliberately misstated. [19] Assets and income are overstated in a majority of these cases. In other cases, liabilities and expenses are omitted so that income appears to be better than it really is.[20] However, some companies also intentionally understate income for various reasons. [21] Some companies that are privately held understate income in order to pay lower income taxes.[22] Some other companies may understate income "when earnings are high to create a reserve of earnings or "cookie jar reserves" that may be used to increase earnings in future periods. This practice is called income smoothing or earnings management."[23] A formal definition of earnings management states that it "involves deliberate actions taken by management to meet earnings objectives"[24] while income smoothing can be defined as "a form of earnings management in which revenues and expenses are shifted between periods to reduce fluctuations in earnings."[25]

Before fraud can be perpetrated, there are some conditions that are necessary to facilitate it or encourage its perpetration. The three conditions for fraud that facilitate fraudulent financial reporting and misappropriation of assets are referred to as the fraud triangle[26] and they include:

- Incentives / Pressures. Management or other employees have incentives or pressures to commit fraud.
- Opportunities. Circumstances provide opportunities for management or employees to commit fraud

- Attitudes / Rationalization. An attitude, character, or set of ethical values exists that allows management or employees to commit a dishonest act, or they are in an environment that imposes sufficient pressure that causes them to rationalize committing a dishonest act.[27]

According to David P. Hoffman, an Ernst and Young partner working under the investigative and dispute services practice in Atlanta,[28] there are some factors that can clearly indicate fraud and they include:

- excessive pressure on management to meet analysts' expectations that leads to pressure to bend the rules with respect to financial statements;
- pressure on management to keep growth and profitability going in a competitive market that is saturated with a shrinking customer base for which it is competing;
- ineffective monitoring of management due to a weak board or audit committee;
- formal or informal restrictions placed on an auditor that inappropriately limit his or her access to people in a company, specifically the audit committee or the board;
- management that is controlled by a single, domineering person;
- significant related-party transactions that are not made in the ordinary course of business;
- unusual legal entities or inappropriate managerial lines of authority in a complex organizational structure;
- inappropriate or marginal accounting;

- frequent disputes with auditors;
- changing auditors; and
- management that has no financial expertise.[29]

A General Overview of Fraud

Given that fraud has been formally defined and fraudulent financial reporting specified, it is important to note that a discussion of this nature is incomplete without mentioning the role of fraudsters in this whole process.[30] We usually think of fraudsters as people who have limited education and are from poor family backgrounds. [31] Today, however, "the average fraudster is increasingly more sophisticated; he or she is well-educated, well-spoken, well-traveled and well-connected."[32] In fact, according to Robertson and Louwers, fraudsters do not differ in appearance from most people and this is apparent from the following characteristics that they have outlined: [33]

- Likely to be married
- Probably not tattooed
- Educated beyond high school
- Range in age from teens to over 60
- Employment tenure from 1 to 20 or more years
- Not likely to be divorced
- Member of a church
- No arrest record
- Socially conforming
- Usually act alone (70 percent of incidents).[34]

As an example, Jeff Skilling, the former Chief Executive Officer of Enron Corporation, "received his B.S. in applied science at Southern Methodist University, and his M.B.A. at Harvard Business School. He was a consultant at McKinsey & Company before moving to Enron (around 1987), helping the company create a forward market in natural gas."[35] Clearly, he was well educated. As another example, Bernie Ebbers, the former CEO of WorldCom was described as "a hard guy not to like."[36] In fact, he was a very active member of his church, regularly teaching Sunday School and he also began each business meeting with prayer.[37] In addition, he was well-educated beyond high school, having obtained a bachelor's degree in physical education as well as an honorary doctorate from Tougaloo College.[38] Samuel Waksal, the former Chief Executive of ImClone Systems had both a bachelor's degree and a doctorate degree in immunology from Ohio State University.[39] As a final example, Kenneth Lay who was the Chairman of Enron Corporation is currently sixty-four years old, still married to his wife, Linda Phillips Lay, and like the other people mentioned in the preceding examples, he was also well-educated, having a bachelors, masters and doctorate degrees in economics from the Universities of Missouri and Houston.[40] From all these examples, it is clear that today, fraudsters are well-educated and well-connected.

Another aspect of fraud in the corporate world pertains to the means by which it is detected. Some ways in which fraud is detected have changed, but in many respects, this change is just a modification of old detection methods.[41] An example of this is whistle blowing.[42] Whistle blowing hotlines are now available, but there is increasing concern over the security of the whistle blower's job, in the case of uncovering fraudulent dealings in a corporation.[43] However, laws for the protection of whistle blowers are

insufficient,[44] thereby discouraging the compilation of important data from such a lucrative source.[45]

Recently, the Justice system has played a more prominent role in the evolution of fraud and fraud detection techniques. In the past, the Justice system avoided issues related to fraud in the corporate world.[46] That changed, however, with the emergence of the Corporate Fraud Task Force in July 2002, which was established "to coordinate the government's response to the parade of accounting scandals started by Enron Corporation."[47] So far, the task force has met with success, and has "transformed how corporate fraud cases are prosecuted, marshaling the government's resources into a multiagency, multioffice approach."[48] However, the task force, like the fraudsters themselves, is changing its approach to fraud. It is now focused on using a prevention-based approach instead of just directing all its attention on the detection and correction of fraud.[49]

Fraud is not limited to one aspect of a corporation's life. Both the employers and the employees play a role in the perpetration and extension of fraud. This role may be active or even passive. Thus, the problem of fraud also stems from the efficiency of corporate governance.[50] In addition, it was recently reported that "commercial banks may be fuelling corporate fraud, by denying investigators access to accounts of clients that might be linked to fraud."[51] This is, of course, an ethical issue but it also raises the question of how to apply the cost-benefit rule. In this case, is it more important to protect the privacy and identity of clients who may be involved in fraud or is serving justice on potentially guilty parties a greater benefit in the long run? This illustrates how an ethical concern could be a limitation to the correction of fraud.

Inasmuch as the solution to fraud is clearly a matter of prevention,[52] this is more or less just a theoretical view, because the idea of preventing fraud is not familiar to corporations. In fact, "convincing businesses to think ahead of time about what might go wrong is difficult"[53] in spite of the present corporate climate.[54] However, this has encouraged the development of specialized skills which has led to the establishment of professional bodies, aimed at curbing this problem, such as the Association of Certified Fraud Examiners.[55]

Purpose of the Research and Research Question

The purpose of this research is to provide evidence that there are some positive sides to the crime of fraud. In fact, fraud can actually set the wheels of change in motion so that the corporate world and ultimately, the society are changed for the better in tangible and positive ways. These "positives" do not in any way encourage the idea of fraud, but this research provides evidence that fraud does have some uses that actually improve the corporate structure in the long run.

Related to the purpose of the research, several questions have been identified which should provide greater insight into the concept of fraud. These questions will also provide a framework for the research and are as follows:

a. If fraud is a negative thing, can it have ANY positive effects? If so, what are its positive effects and how have they changed the face of accounting in the corporate world?

b. What efforts are corporations making to prevent and detect fraud? How effective are these measures and are they sustainable in the long run or are they short-term goals that will be revised frequently due to social changes?

c. What does the current trend in accounting fraud say about the role of business ethics in the corporate world? Is there a correlation or relationship between business ethics and fraud or is fraud influenced primarily by other factors? Will a greater regard for business ethics result in a decline in cases of fraudulent financial reporting?

Importance of Research / Contribution of Thesis

The importance of this research stems from the inescapable reality that as long as financial reporting is required in the corporate world, fraud will always be an imminent threat to the proper presentation of financial information. Fraud and social change represent a vicious cycle because as new measures of preventing and detecting fraud are developed to ensure the correct and proper presentation of financial information to users, those who perpetrate fraud will also continue to seek and develop new ways of getting around the system. Hopefully, the current research will highlight the changes that are effective and sustainable as well as the areas of change that have remained ineffective for various reasons.

II: Accounting Fraud Based on Recent Scandals

Types of Accounting Frauds / Scandals with specific examples:

The following section deals with specific instances of fraudulent financial reporting that have taken place over the last decade in the corporate world. These examples are limited to American corporations. A later section will examine the international cases as they relate to accounting fraud on the international level.

Accounting scandals have been the subject of various news stories because of the importance of accurate and reliable financial reports. These reports must be kept in accordance with Generally Acceptable Accounting Principles (GAAP) and failure to abide by these rules is what usually leads to these scandals. These scandals are a reflection of fraud on the part of the offending company because companies strive to present a financial picture to their shareholders and stockholders that is better than what actually exists. Because companies face this paradox between giving accurate financial reports and pleasing shareholders, "mistakes" or deliberate attempts by companies to misrepresent financial information have been very costly. Scandals have been separated into two categories – financial reporting scandals and other scandals.

Financial Reporting Scandals

i. Capitalizing Expenses:

One type of financial information misrepresentation involves reporting current expenses in future periods and this practice is usually referred to as capitalizing expenses. In other words, one aspect of improper accounting involves "not booking expenses

immediately but pushing them into the future."[56] Specifically, capitalizing expenses gives companies the opportunity "to defer certain business costs by amortizing them over a number of years, which makes current operating income appear greater than it actually is."[57] While this is a relatively simple procedure, it is fraudulent because it simultaneously understates expenses and boosts net income and assets.[58]

Capitalizing expenses has been practiced in many different industries such as the telecom and cable industries for a very long time.[59] The problem is that different industry observers have their own opinions on how the Generally Accepted Accounting Principles (GAAP), which govern this practice, should be interpreted.[60] As a result of this disagreement, each case of capitalizing expenses is subject to different kinds of interpretation.[61] This disagreement calls for government intervention in the form of continuous analysis of this practice.[62] The end result of government's intervention is that companies are now more likely to adopt a more conservative approach to the capitalization of expenses.[63]

However, a conservative approach for financial reporting purposes may not necessarily work well for tax purposes,[64] as was illustrated in a 1992 Supreme Court case dealing with the merger of two companies – Unilever United States Incorporated and the National Starch and Chemical Corporation.[65] In that case, the court made it mandatory for the companies to capitalize certain mergers and acquisitions (M & A) costs.[66] The reasoning behind this decision was that if the companies had not capitalized those expenses, they could have reported lower earnings and made certain tax deductions they were not permitted to make.[67] Another case of capitalizing expenses, which was an extreme case, involved WorldCom.[68]

In June 2002, WorldCom Inc., a telecommunications company found itself in the middle of a serious accounting scandal.[69] One of its internal auditors, Cynthia Cooper, had been asked to conduct a financial review by the chief executive and this involved "spot-checking records of capital expenditures."[70] She discovered that in consecutive quarters in 2001, Chief Financial Officer Scott Sullivan had been using fraudulent means to account for one of the company's major expenses – "charges paid to local telephone networks to complete calls."[71] These were operating expenses worth $3.8billion, but he treated them as capital expenditures, and according to the Wall Street Journal, "the maneuver was worth hundreds of millions of dollars to WorldCom's bottom line, effectively turning a loss for all of 2001 and the first quarter of 2002 into a profit."[72]

After making this discovery, Cynthia Cooper promptly reported her findings to Max Bobbitt who headed the audit committee. Consequently, the CFO was fired, the U.S. Justice Department conducted a probe on the key people involved and the SEC "filed civil fraud charges against WorldCom."[73] The company filed for bankruptcy and later re-emerged as MCI Incorporated.[74] Presently, the eleven WorldCom directors are required to pay $20.25 million from their personal funds in order to settle the lawsuit that former investors brought against the company.[75] However, to date the investors have only been able to recover a portion of their losses.[76]

In spite of the preceding cases just mentioned, it may be the case that companies will not stop capitalizing costs in the near future. In fact, there is the possibility that "companies will become more aware of investors' increased skepticism about corporate balance sheets, which could make management continue to capitalize expenses, but be more likely to spell out the justification for such accounting treatment in the footnotes."[77]

ii. Off Balance Sheet Financing:

Off balance-sheet-financing is used to refer to "the non-reporting by a company on its balance sheet of debt related to costs incurred (but likewise reported), or ownership, or control, or at least the use of, cash or other assets."[78] All the various methods of practicing this type of financing have one common characteristic: They give a company the ability to omit certain obligations from the balance sheet, and in many cases, without running the risk of violating the GAAP that is currently in place.[79] However, the various methods of off-balance-sheet financing depend heavily on carefully organizing the following:[80]

- Separate entity relationships, or
- The executory nature of certain transactions where it can be argued that the actual receipt of goods or services has not yet occurred, or
- Innovative financial instruments or arrangements.[81]

The extensive use of off-balance-sheet financing by companies suggests that they perceive numerous benefits from this practice, including:

- Improvement in the company's debt-to-equity ratio. For many companies this is important not only for borrowing purposes but also for reducing the perceived "riskiness" of their stock, thus affecting the market value of their stock favorably.
- Borrowing capacity. Sometimes, preventing liabilities from appearing on the balance sheet will enable a company to borrow more than it otherwise could, especially if there are contractual debt limit

restrictions related to what actually appears on the company's balance sheet.

- Borrowing costs. A more attractive-looking financial position may result in lower borrowing costs. Lower borrowing costs also may result from certain off-balance-sheet financing methods such as project financing arrangements and interest rate swaps.
- Management compensation. To the extent that management compensation plans are tied to ratios or reported earnings that are affected favorably by off-balance-sheet financing, management benefits directly from the use of these arrangements.
- Risk-sharing and tax management. The use of limited partnership arrangements provide means for a company to spread the risk associated, for example, with research and development activities and to defer tax payments.[82]

From the foregoing advantages, it is not very difficult to see why companies would adopt this practice. However, in practicing off-balance sheet financing, companies are supposed to make sure that they provide sufficient disclosures of these activities so that their financial statements do not deceive users[83] in any way. Unfortunately, this is where some companies have gone wrong and Enron serves as an example of a company that adopted this practice[84] for fraudulent purposes.

The Enron scandal, like the WorldCom scandal, took place in 2002, and it embodies off-balance-sheet financing as well as several other deceitful accounting practices. First of all, Enron established a new Special Purpose Entity (SPE) called

Chewco and the administration of this company consisted of Enron executives and some investors from outside the company.[85] In doing this, Enron followed a practice of off-balance-sheet financing, common among US companies, whereby "companies establish SPEs by having outside investors contribute 3% of capital of these SPEs so that they can be considered independent and off the balance sheets for those corporations who contribute 97% of the invested capital."[86] By adopting this strategy, Enron managed to exclude several expenses and liabilities from its financial statements (balance sheet and income statement) and instead, it "included false gains on its speculative investments in various technology-oriented companies."[87] The effect of these actions was that it projected an illusion of a favorable and desirable financial position, which misled investors.[88]

In addition, Enron used derivatives and SPEs to cover up some speculator losses it experienced on technology stock.[89] By using a "price swap derivative," it made an agreement with Raptor, one of its SPEs, to the effect that if the value of Raptor's assets declined, it would swap its stock for a loan from Raptor.[90] Eventually, whenever Raptor's assets declined, Enron was also able to justify a decline in its own assets by conversely issuing stock.[91] Consequently, Enron concealed major losses and debts that arose from investing in unprofitable businesses while simultaneously "inflating the value of other troubled businesses, including its new ventures fiber-optic bandwidth."[92]

Arthur Andersen, Enron's accountants, was fully aware of what was going on and backed up their client. However, "Enron collapsed because of the derivatives deals it entered into with its more than 3,000 off-balance sheet subsidiaries and partnerships-such as JEDI, Raptor and LJM."[93] As a result of the scandal, Enron filed for bankruptcy and

Arthur Andersen informed the SEC of its decision to stop auditing public companies.[94] Also, the scandal has affected Enron's competitors such as Dynegy by eliminating credit support for energy trading.[95]

iii. Accelerated Booking of Future Revenues:

Another improper accounting practice that constitutes fraud is frontloading income,[96] that is, "booking uncertain future revenues."[97] Halliburton Inc., an oil services company, was accused of frontloading income while it was under the leadership of Vice President Dick Cheney.[98] Apparently, in 1998 and 1999, "when a big construction project, like a natural gas processing plant, went over budget, the company booked the over-budget charges as revenue under the assumption that the customer would pay later, ignoring possible disputes."[99] Under this method, it increased its pretax income and misled investors for a period of eighteen months.[100] When the SEC looked into this issue, it criticized Halliburton's failure to report this new method but decided that the new method was acceptable.

Later, Halliburton was accused of "serial accounting fraud"[101] from 1998 to 2001 and underreporting its asbestos liability, another form of off balance sheet financing.[102] As a result, "Halliburton has been forced to place a unit into bankruptcy and create a $4.6 billion fund to compensate asbestos victims."[103] In addition, The SEC filed enforcement actions against Halliburton's CFO and controller.[104]

Another revenue-related accounting scandal involved Xerox Corp., the copier company. Like Enron's case, with Xerox one scandal led to another so that eventually there was a culmination of various scandals the company had to deal with.[105] First, "Xerox used complex maneuvers to accelerate the booking of revenue from office

equipment that it leased in long-term deals."[106] This practice continued well into the late 1990s because it was facing several problems, including increased competition from computer printers.[107]

In 2002, the SEC forced Xerox to make a restatement of its revenue for that time period (1997-2000) which caused a reallocation of $2 billion of its revenue for that period.[108] In June 2001, the company also had to restate revenues because between 1998 and 2000, it had overstated profits by manipulating $100 million reserved for merger costs.[109] By overstating profits in this way, it succeeded in making its financial statements look better in the periods of overstatement than in later periods.[110] This restatement was triggered by an internal probe that KPMG, Xerox's accountants at the time, had forced Xerox to conduct, and this eventually led to the dismissal of KPMG as the firm's auditor.[111]

Initially, Xerox had heightened suspicions by emphasizing that an external audit or review must be limited to its Mexican office. Xerox never acknowledged the questionable accounting practices mentioned above. Instead, its CFO, Mr. Romeril, condemned the financial statement issue in a Xerox news release but carefully stated in a worldwide news release, that no other Xerox office faced these problems.[112]

iv. Meeting Analysts' estimates

Sometimes, accounting scandals arise from the pressure to meet financial analysts' estimates. The case of HealthSouth Corp. is a good example of this case. Its CEO Richard Scrushy was "charged with conspiracy, mail, wire and securities fraud, false statements, false certifications and money laundering."[113] Scrushy did not disclose the true financial state of the company to shareholders or the general public.[114] Instead, he

chose to lie and dress the financial statements to the extent that he personally endorsed and affirmed their accuracy to the SEC.[115] His actions were based on the fact that he and other top officials of HealthSouth received their bonuses, compensation and other benefits based on the financial performance of the company. [116] By misrepresenting the information in the books, he presented a false picture of the company's financial state.[117] In other words, the company looked better than it actually was, financially.[118]

In carrying out this fraud, "during 1996 and 2003, internal reports by HealthSouth's corporate accounting staff showed that the company routinely failed to produce sufficient net income to meet the expectations of Wall Street securities analysts, the market and its own internal budgets - a failure that Scrushy and others referred to as "not making the numbers."[119] Therefore, they made fictitious entries on the books to support their actions. Subsequently, over the period of time that this fraud was committed, the company's income was overstated by $2.7 billion.[120] "The fraud allegedly included false entries in income statement and balance sheet accounts, including property, plant and equipment accounts, cash accounts and accounts receivable, among others...and they referred to those methods as "filling the hole" or "filling the gap."[121] Apparently, Scrushy was so obsessed with covering his tracks, that he monitored his employees and accessories via e-mail and other means.[122] In addition, he also encouraged the propagation of the fraudulent activity by providing them with incentives to commit fraud such as giving them large compensation packages.[123]

Another case in focus, the Rite Aid case, serves as a very good example of overstating net income in order to meet market expectations.[124] In the late 1990s, Rite Aid was one of the first companies to be involved in a major accounting scandal.[125] It

nearly filed for bankruptcy because it overstated its net income by $1.6 billion.[126] "Its stock price plunge from a high of $60 in 1999 to a low of just $1.85 a share in late 2000. Former Rite Aid Chief Executive Martin Grass, former Chief Financial Officer Frank Bergonzi and former Vice Chairman Franklin Brown faced charges of mail fraud, wire fraud and lying to the Securities and Exchange Commission."[127] Mr. Brown was accused of "ripping-off" the company at a time when the company was crippled by its dire financial state.[128] "Bergonzi served as Grass' "pencil" in recording entries such as pharmaceutical rebates that helped fill a $100 million earnings shortfall in Rite Aid's fiscal 1999 fourth quarter."[129] "Grass was held responsible for a loss of $53.1 million from additional credits that were charged to vendors for damaged and outdated goods, called "upcharges" by the government."[130]

In mid-2000, Xerox was involved in another scandal (this time related to meeting analysts estimates) where it was discovered that there was a question as to "whether top Xerox management prepared financial statements "to achieve certain earnings" rather than trying to "get it right."[131] This information was uncovered as a result of several probes conducted by Xerox's auditors' law firm of Akin, Gump, Strauss, Hauer and Feld.[132]

(v) Round-tripping and Network capacity swapping:

Another malpractice that has led to several scandals is round-tripping and network capacity swapping.[133] A round trip transaction is said to have occurred when "one company sells or exchanges goods or services or monetary assets with another company and, in return, buys similar goods, services, or monetary assets from the other company for equal-or almost equal-value."[134] Consequently, each company has little or no gain on

the sale.[135] Not all round trip transactions are used for illegitimate purposes.[136] To cite an example, broadcasters usually exchange air-time for goods or services.[137] In such transactions, "the broadcaster will credit revenue for the fair value of on-air advertising while debiting accounts in equal amounts for the nonmonetary goods or services it received."[138] Even though some of these transactions appear to be economically sound, the problem with this practice is that some companies actually manipulate it as a means of increasing the income and volume that is reported in their financial statements.[139]

Thus, in an effort to meet or surpass earnings, energy trading companies have discovered "how to inflate revenue by fake trades known as "round-tripping," whereby one company sells energy to another company, which sells it back to the first company at the same price, allowing both companies to report a sale even though nothing was actually purchased."[140] Similar to round-tripping, network capacity swapping is usually practiced by telecommunication companies whereby "telecom companies trade equal amounts of telecom capacity, and record a revenue increase -- to bolster financials."[141] Several companies have been found guilty of both practices, including, Qwest, Global Crossing, Dynegy, CMS Energy and Reliant Resources.[142]

Other Scandals

i. Insider trading:

A common malpractice that has resulted in several scandals is insider trading, which involves trading or making investment decisions based on information that is not generally and widely available to the public.[143] Even though the preceding statement gives a general idea of what insider trading is, it is necessary to answer the following questions in order to get a better understanding of this practice: First of all, "who are the

insiders?"[144] Secondly, "what is illegal insider trading?"[145] Based on the definition provided by the Securities and Exchange Commission (SEC),[146] insiders "are chairmen, directors, officers, etc., and principal shareholders with 10 percent or more of their own firm's common stock."[147] Insiders are also thought to have access to privileged information of the companies they work for.[148]

A major presumption about corporate insiders, especially those who constitute the management of a company, is that they possess highly privileged and important information concerning a firm's potential for success in the future, which is not accessible to other users of financial statements such as investors and shareholders.[149] Thus, it is not hard to see why corporate executives would use this information to their own advantage by engaging in trading activities.[150] However, insiders may have other reasons for buying or selling the shares of their firm.[151] The important point to note is that not all insider trading is done because people have access to privileged information.[152] Therefore, not all cases of insider trading are considered to be illegitimate or wrong.[153]

Based on past research, the following reasons have been given as to why insider trading is practiced:

- To diversify portfolios and to adjust for liquidity.[154] Corporate management usually exercise stock options or use a plan to purchase stock.[155] Later, they may sell the stock they purchased in order to diversify their portfolios or to raise money for financial reasons.[156] This accounts for more sales than purchases of stock by insiders.[157]

- To increase corporate control.[158] By buying the shares or stock of a company, the corporate executives of that company can increase their proportion of total stockholders' equity and thereby have more voting power in the company.[159]
- For sentimental reasons.[160] For example, two insiders in Titan Corporation sold all the firm's shares that they owned soon after they left the company.[161]

- As a result of insider trading that is based on privileged information.[162] This case of insider trading can be divided into two smaller categories:[163] "First, insiders may purchase the firm's stock because they genuinely believe the stock is a good investment. Second, insiders may trade prior to announcements that will generate abnormal returns for themselves."[164]

The first three reasons outlined above, present no cause for concern over ethics,[165] and even the fourth reason provides a good illustration that "only insider trading with prior knowledge of forthcoming announcements is obviously motivated by insiders' desire for exclusively personal gain."[166] Since most people do not see the reasons that compel corporate executives to practice insider trading, their response to the "average level of insider trading"[167] may be based on the presumption that insider trading occurs because corporate executives misuse privileged information.[168] However, this should not lead the public to conclude that all cases of insider trading are unethical and should be prohibited by the law.[169] The reason behind this argument is that "the manager's ownership of a firm's stock may motivate him to improve firm performance and therefore increase firm value. Furthermore, the manager should have the same rights as other

shareholders to trade his stock, as long as such trades are not motivated by private information."[170] For these reasons, the SEC only prohibits the use of "non-public, material information"[171] in insider trading.[172]

Several companies have engaged in this form of insider trading and of notable mention is the ImClone scandal. In 2002, ImClone, a drug-making company, developed a new drug for cancer called Erbitux.[173] While it was waiting for FDA approval, the company hyped its product and even "Bristol-Myers Squibb paid about two billion dollars for a stake in Erbitux."[174] These 'unsubstantiated claims'[175] were not deemed to be illegal because the law did not allow the FDA to contact the SEC about them, and therefore, prevent ImClone from increasing the value of its stock through these claims.[176]

However, the FDA announced that it was not going to review ImClone's new drug, but before the news came out officially, ImClone's CEO, Samuel Waksal and his family and friends, sold their shares.[177] This was obviously a case of insider trading and Waksal admitted this. However, one of Waksal's friends, Martha Stewart, who also sold 4,000 shares of ImClone at the same time as Waksal, denied any involvement in insider trading.[178] Also charged with insider trading is President George W. Bush, "who sold 212,140 shares of Harken stock on June 22, 1990, when he was a company director."[179] Apparently, he had not received a letter, dated June 15, 1990, from Harken's outside lawyer, warning the directors not to sell any of the company's stock in the event that they should receive any bad news concerning the company.[180] Unfortunately, that letter arrived one day after George Bush had been cleared of all the charges made against him by the SEC.[181]

ii. Insider loans:

Another malpractice involves overcompensating company officials through the use of insider loans, which do not have to be reported or disclosed to the shareholders[182] (a practice now prohibited by the Sarbanes-Oxley Act).[183] Insider loans are quite common in banks located in small towns because "the local business people are often the best candidates to serve on the board."[184] Unfortunately, they are also problematic because they are usually "based on less stringent credit standards than loans to others."[185]

Two examples of insider loans involve Tyco International Limited., and Adelphia Corporation. The Tyco scandal of 2002 involved the company's CEO, Dennis Kozlowski, and the CFO, Mark Swatz, who were both accused of stealing $600 million from the company. [186] The case was filed in September 2002 charging the CEO and the CFO with "grand larceny, conspiracy and falsifying business records."[187] It was alleged that they stole $170million from the company and spent it on a wasteful lifestyle.[188] In addition, they earned $430million dollars by fraudulently selling Tyco shares by withholding information from shareholders and thereby artificially keeping up the stock prices.[189] As part of his extravagant lifestyle, Kozlowski bought a $6,000 shower curtain and threw a $2 million dollar, 40th-birthday party for his wife, Karen in Sardinia.[190] He paid for the party with the corporate funds, which was illegal.[191] He also evaded more than $1 million in sales taxes for the State of New York for art paintings.[192]

As another example of fraud via insider loans, Adelphia Corp's Rigas family (John, Tim and Michael),[193] along with Michael Mulchahey,[194] were accused of looting $263 million from the company, which became bankrupt after this scandal was revealed.[195] "All four were accused of conspiring to lie to investors, to hide more than $2

billion in debt, and to divert more than $100 million in corporate funds to personal use."[196] According to the Wall Street Journal, "the Adelphia trial, in many ways, may best epitomize the era of corporate corruption, because it represents a full range of alleged abuses -- from lying to investors about the number of cable subscribers to the Rigas family's hidden use of Adelphia's credit to buy stock in the company."[197] John Rigas faced charges of using the company's funds for personal uses ranging from employing a $40,000-a-year masseuse and buying seventeen cars, to spending $25 million to secure timber rights.[198] Michael Mulchahey was accused of approving the illegal transactions and making illegitimate adjustments to financial information, all of which were characterized as 'fraudulent manipulations.'[199] Even with the accusations brought forth against them, Mr. Mulchahey insisted that they did not steal the money.[200] In his own opinion, they were loans.[201] Timothy Rigas was accused of inflating financial data and lying to investors.[202] In other words, he misrepresented the information reflected in the financial statements to make the company's financial position look more prosperous than it really was.

International Cases of Accounting Fraud

On the international level, there has also been a number of financial accounting scandals which are quite similar to the types of accounting fraud perpetrated in America.[203] Of notable mention is the Ahold financial scandal. Royal Ahold, a Dutch-based International company,[204] is the world's third-biggest food retailer, after Wal-Mart and Carrefour"[205] and before it was accused of fraud, Europeans believed that corporate fraud was an American thing that could not happen in Europe.[206] On the 24th of February 2003, Ahold discovered that it had overstated its profits over the preceding two years by

more than $500 million (euro463 million)[207] and subsequently "announced the resignation of its chief executive and finance director."[208] On the same day, its market value fell to euro3.3 billion from more than euro30 billion in 2001, a decline of 63%.[209]

Other scandals in Europe such as the Comroad and EM.TV scandal in Germany, and the Lernout & Hauspie scandal in Belgium[210] pale in comparison to the Ahold scandal because these companies were very small and much younger than Ahold which was 115 years old at the time of the scandal and had estimated sales of euro77 billion in 2002 before the scandal[211] Behind Ahold's growth and fraudulent behavior was its CEO, Cees van der Hoeven, who "won a formidable reputation from turning a dull company into a growth machine," but who also became addicted to this reputation.[212] Since 1993, he had acquired about fifty firms for euro19 billion in total and he also "notched up 23 quarters of double-digit profit growth in a row."[213] However, when the company's growth began to slow down, it seemed that he could not own up to Ahold's true state.[214] Subsequently, like many American companies during "the bubble years,"[215] "Ahold started to bend the accounting rules, claiming profits of acquired firms as "organic growth", booking capital gains from sale-and-leaseback deals as profit, and keeping billions in debt off its balance sheet."[216] Even though these techniques were not illegal, they should have raised suspicion in the minds of investors.[217] Some observers were troubled by these techniques and this was made evident by the release of the first of six reports by the Centre for Research and Analysis in Maryland in June 2001,[218] "detailing questionable accounting at Ahold, going back to 1999."[219]

The $500 million overstatement of profits was mainly attributable to Ahold's US FoodService Unit "which supplies food to schools, hospitals and restaurants--although

there are also issues over its Disco subsidiary in Argentina and several other units."[220] As a result, some observers have argued that Ahold's scandal is actually more of an American accounting failure than a European problem.[221] The problem with such a claim is that it "absolves Ahold's bosses of responsibility for their acquisitions and ignores the persistent, firm-wide tendency to test the limits of acceptable accounting."[222]

The deeper issue, in Ahold's case, pertains to accounting methods dealing with rebates.[223] Like many companies that buy in bulk, it gets discounts from suppliers if it can meet targeted sales.[224] In such cases, the discreet practice is to wait until the targeted sales are met before accounting for rebates.[225] Ahold, like many other failing firms, jumped the gun by recording the payments before it had actually earned them.[226] It is also believed that Ahold may even have "booked entire rebates as profit in the first year of multi-year agreements--or simply made them up."[227] Many people expect the Ahold scandal to shock Europe into "accounting and corporate-governance reform, just as the Enron scandal did America."[228]

Another accounting scandal on the international level involved Parmalat Dairies Company, an Italian company that manufactures dairy products.[229] The Parmalat scandal involved the deception of investors, regulators, auditors, bankers and other people who managed the company, for more than 30 years.[230] This deception was the handiwork of the executives of the company, including its founder, Calisto Tanzi[231] and it was "simple and amateurish in nature"[232] compared to Enron's elaborate fiasco with special purpose entities and partnerships.[233] The supposed fraud was used to serve a simple purpose with two objectives: (1) "To hide losses, particularly those of Parmalat units in Latin America, by inflating the company's purported assets at far-flung subsidiaries-personnel

systematically created assets and records to accompany them, which were nonexistent."[234] (2) "To funnel money to Tanzi family businesses."[235]

In 1998, assisted by Grant Thornton's Italian business, Parmalat formed Bonlat Financing Corporation in the Cayman Islands, one of the foremost tax havens.[236] Grant Thornton then became the auditor for Bonlat and Parmalat's other subsidiaries even though Deloitte Touche Tohmatsu had replaced Grant Thornton as Parmalat's main auditor in 1999.[237] According to Italian law, companies needed to change auditors after nine years,[238] but "breaking out pieces of the audit to subcontractors was legal."[239]

In 1999, Parmalat began to move false transactions and credits from its Dutch companies (those that were based in Antilles) to Bonlat.[240] Parmalat executives made up fictitious documents "after correctly surmising that Grant Thornton would not send third-party confirmation letters to verify them in connection with the audits."[241] It was alleged that the auditors sent the verification request through the internal mail system of Parmalat.[242]

For a simple, clear-cut business, Parmalat had a complex financial structure, engaged in off-balance sheet financing and used special purpose vehicles that lacked transparency for the sole purpose of making its position in general very incomprehensible.[243] Its financial structure began to fall apart in December 2003,[244] "when Parmalat was unable to redeem a maturing 150 million bond. Shortly thereafter, Bank of America informed Parmalat that an account purportedly held by Bonlat containing about $5 billion in cash and securities did not exist."[245] Subsequent to this revelation, Parmalat fell apart.[246] "More than $12 billion was missing from the company's accounts" which accounted for about 0.8 percent of Italy's Gross Domestic

Product (GDP).[247] Therefore, based on analysis from the standpoint of relative GDP, the Enron scandal is minor and insignificant compared to Parmalat's case.[248]

III: Examining Accounting Fraud from the Standpoint of Business Ethics

Business Ethics

Since fraud involves "deception made for personal gain,"[249] it is only logical that a discussion of fraud also include a discussion of ethics, specifically business ethics, which "examines ethical rules and principles within a commercial context."[250] The proliferation of cases of fraudulent financial reporting, constituting unethical practices over the past decade,[251] raises the question of the relevance and effect of business ethics on the corporate world. Is business ethics a factor in deterring fraud or has accounting fraud advanced so far that business ethics no longer plays a role in checking it? Is the alleged decline in business ethics over the past years responsible for the increase in accounting fraud and other scandals?[252]

Relationship Between Business Ethics and Accounting Fraud

Many studies indicate that the type of training offered to those in business schools is partly responsible for the unethical behavior that those people exhibit over time.[253] However, other studies also show that by the time people go to college, they have already inculcated the basic ethical beliefs system and any attempt to provide fresh ethical training at that point, is doomed to fail.[254] These studies illustrate the views held by two groups of people (business school educators and business leaders) on the issue of business ethics[255] Generally, "business educators seem to attach major importance to the

"bureaucratic" ways of dealing with ethical issues whereas business executives tend to prefer the least possible outside intervention in their dealing with ethical questions."[256]

The view of the business leaders is particularly relevant to this discussion because of the nature of accounting fraud in the corporate world. Studies show that in most cases of fraudulent financial reporting, the corporate executives are responsible for committing the fraud, not necessarily the employees.[257] Even though an employee might detect fraud, many employees would not have witnessed the fraud being committed or they may not even know about it.[258] However, according to the findings of the research project of the Committee of Sponsoring Organizations of the Treadway Commission, the CEO, CFO and controller were the top three officers named in most of the fraud cases. Lower level personnel were named in much fewer cases (but this could be because SEC enforcement actions may be aimed at exposing fraud committed by top executives more often than for lower level personnel). In some cases, outsiders such as customers and external auditors were named as being involved in the fraud.[259]

According to David Wolfe and Dana Hermanson in their article titled "The Fraud Diamond: Considering the Four Elements of Fraud," one of the necessary traits of a fraudster is the ability to tell lies "effectively and consistently"[260] Telling lies is clearly unethical, but in the same article, the authors explain that a fraudster will also rationalize that the "fraudulent behavior is worth the risks."[261] This shows that while a fraudster might have a personal code of ethics, in rationalizing the fraudulent act he is committing, he puts his ethical beliefs aside and inadvertently, he puts business ethics aside as well. This is summed up in the popular saying that "an executive who cheats in golf will cheat in business."[262]

The Sarbanes-Oxley Act "puts corporate executives at risk for the unethical behavior of their employees - unless they can show they provided ethics training."[263] As a result, there is now a new approach to ethics that is becoming quite common in the corporate world of America. This approach stems from the assumption that ethics, in general, can be taught as a way of minimizing the instances of unethical behavior by corporate executives.[264]

However, this assumption does not take into consideration two significant characteristics of business ethics, according to Noah Pickus, associate director of the Kenan Institute for Ethics at Duke University.[265] The first aspect is that the most troubling cases of ethical misconduct in the corporate world did not arise because the individuals involved did not have adequate knowledge of the rules.[266] Instead, those cases arose from deliberate and premeditated attempts to bypass the rules in question.[267]

The second aspect of business ethics is that corporations usually "enforce, for good or ill, their own ethical standards."[268] Pickus suggests that if companies really enforce ethical standards, it will be evident in every aspect of their corporate culture, not only in the rules and regulations.[269] So, if this is the case, does it mean that companies wasted "the money they [spent] on ethics training - an estimated $6.1 billion [in 2005] just to meet the requirements of Sarbanes-Oxley?"[270] Pickus' answer to that question is that "it is fair to say that scaring people into improving their behavior may be one effective tool, but clearly for the long run, it has nothing to do with the way your company operates. Indeed, it suggests that the whole problem is about bad people rather than about poorly designed structures."[271] Essentially, he suggests that accounting fraud

occurs as a result of unethical people, or people who make unethical choices, as opposed to a company having a weak ethical framework or a poor system of business ethics.

An aspect of the relationship between business ethics and accounting fraud, which is probably the most obvious, is that committing fraud is a direct violation of the rules of business ethical conduct.[272] Milton Friedman, a contemporary of Adam Smith, spelled this out in his article about the profit-making function of business.[273] In this article, Friedman highlights several factors that impose limitations on a business that concentrates on making profits:[274]

- The company must obey the rules set by society (i.e., government).
- It must engage in open and fair competition.
- It must not practice deception or fraud.[275]

Clearly, corporations that were involved in accounting scandals such as Enron and WorldCom broke these basic rules that Friedman had set forth in relation to business ethics.[276]

The relationship between business ethics and fraud was also emphasized in a survey conducted by Vicky B Heiman-Hoffman, Kimberly P Morgan, and James M Patton.[277] In their study, they asked 130 practicing auditors to "rank 30 commonly cited potential warning signs as to their relative importance in spotting fraudulent financial reporting."[278] The results of this survey showed that "auditors generally "perceived" attitude factors to be more indicative of fraud than situational factors. In fact, the highest ranked factor was client dishonesty."[279] In addition, in the September/October 2003 Issue of *The Journal of Corporate Accounting and Finance*, the authors state that "there appears to be a correlation between ethics and fraud. For example, certain ethics-related

attitudes, such as dishonesty and overaggressive behavior, seem to be antecedents to fraud. Therefore, effective [business] ethics are the antithesis of conditions favorable to fraud."[280]

Finally, in another survey conducted by Tommie Singleton, Brett King, Frank M. Messina, and Richard A. Turpen, the researchers took a survey of real cases of fraud to pinpoint the various ethics activities that could serve as efficient ways of preventing and detecting fraud.[281] The respondents pinpointed several reasons which helped to explain why fraud occurs.[282] The most highly ranked reason for fraud was "insufficient internal controls."[283] Next on the list was "Other"[284] and "the third item was weak ethics policy or code of conduct. Apparently, a weak ethical environment has the potential to weaken internal control systems and lead to fraud."[285]

Business Ethics and Factors Contributing to Fraudulent Financial Reporting

Before discussing the effect of business ethics on fraudulent financial reporting, it is necessary to identify the factors that contribute to accounting fraud. According to Roy T Van Brunt, formerly an assistant chief accountant with the Office of the Chief Accountant of the Securities and Exchange Commission,[286] these factors include:

- Management that has poor tone at the top, does not emphasize controls, chooses not to punish identified embezzlers, and does not communicate to employees its values or a clear position regarding conflicts of interest;
- Senior executives that are not restrained on expenditures or gifts and whose salaries do not justify their lifestyles;

- A weak internal control environment where internal auditors do not have investigative authority; and
- Accounting policies and procedures that are "lax, liberal, and not [properly] enforced."[287]

Based on the history of government's attempt to regulate the accounting profession through legislation, Howard Rockness and Joanne Rockness assert that "attempting to impose transparency, integrity, and honesty as underlying values in corporate management and financial reporting has failed to prevent periodic systemic ethical failure."[288] In other words, they suggest that using regulation and legislation to impose ethical conduct on the management of corporations does not prevent fraudulent financial reporting in the long run. Instead, management of corporations and the auditors who audit their financial statements have reacted to increasing regulation, by discovering innovative ways to hide relevant financial information from the people who need this relevant information, by making the statements difficult to understand.[289]

It is important to note that "business ethics is not a set of impositions and constraints but rather is the motivating force behind business behaviors and that virtues are social traits even though they are reflected in individual actions."[290] Having said this, three corporate trends resulting from ethical behavior of management executives and the external auditors that work for them should be discussed. These corporate trends allow us to see how instances of unethical conduct have increased in spite of the code of ethics that is established in corporations, as well as the threat of suffering serious repercussions for such fraudulent acts.[291]

The first trend relates to how people view ethics.[292] Increasingly, it is becoming customary to see ethics as "just a matter of having rules and playing by the rules."[293] In fact, there was a competition to see who could "most creatively stay within the letter of the law while bending the rules for personal gain."[294] It became acceptable to focus on doing what was correct in principle, without considering whether or not the action was morally right.[295] The second trend was that internal issues were more important to people than were external issues.[296] In an effort to achieve personal satisfaction, people began to focus more on becoming rich and being successful instead of personal fulfillment.[297] The third trend was that as people became more obsessed with getting quick results, they became more impatient and were less modest in their expectations.[298]

Dobson, in his article titled "The Role of Ethics in Global Corporate Culture," asserts that a weak belief system and a culture that lacks a basic ethical foundation and framework are the inevitable end-products when the management and employees of corporations lack proper ethical mind-sets.[299] The changes that result from this situation will occur as a result of needs that are economically-based instead of ethical needs.[300] Therefore, if corporations do not build a strong culture, or if they build a culture that does not challenge unethical behaviors, then these behaviors will spread within the corporation in such a way that major fraud is very likely to occur.[301]

IV: Effects of Accounting Fraud

Overview

The various accounting scandals and malpractices mentioned in the previous section above have had different effects on the involved companies, industries and even on the economy. The Enron and WorldCom scandals led to the legislation of the 2002 Sarbanes-Oxley Act, which has "increased the penalties for fraudulent and misleading conduct."[302] In reference to the malpractice of overcompensating officials using insider loans, "according to the Corporate Library, 1,133 of the top 1,500 companies (roughly 75 percent) have now disclosed insider loans."[303]

A survey conducted at three large public universities in the Southeast in 2002 revealed that contrary to media speculation, the collapse of Enron as a result of the aforementioned scandal, will not deter students from majoring in accounting (65%).[304] In light of the various accounting scandals already mentioned, a survey conducted by one of the big four accounting firms, PricewaterhouseCoopers, revealed the "expectations by 3 out of 4 senior executives at major companies that boards of directors will play a more active role in corporate oversight. In addition, over half of the respondents reported that the audit committee of their board already has, or will, make changes in its makeup or procedures."[305]

Changes in Financial Reporting As a Result of Recent Scandals

The corporate world has been affected by many of the recent accounting scandals and as a result, companies have had to implement changes in the way they report

financial information. Perhaps one of the most important changes in financial reporting in the corporate world as a result of the recent accounting scandals relates to the Sarbanes-Oxley Act of 2002.[306] This is because the act was passed in order to help "restore public confidence in the financial reporting process."[307] Based on this objective, one of the requirements of SOX is that the Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs) of companies must certify financial statements, in order to emphasize the accountability of management and top executives, with regards to how financial and accounting information is reported and recorded.[308]

In addition, one of the proposed areas where changes are necessary is in the area of revenue recognition, according to the Financial Accounting Standards Board (FASB).[309] This is because revenue is the "largest entry"[310] on the financial statements of most companies and in most cases involving fraudulent financial reporting, it is usually the item that is most affected or tampered with.[311]

More importantly though, the rise in the number of accounting scandals has had two different but rational effects on the corporate world.[312] First, forensic accounting skills now play a critical role in unraveling the complex accounting methods that have made financial statements very complicated and difficult to understand[313] Second, the public's demand for accountability and change, followed by the government's subsequent legislative involvement, has changed the face of corporate governance.[314]

Existing Problems With the Corporate System

Before continuing a discussion on the changes in financial reporting in the corporate world, it is necessary to discuss the existing problems within the corporate reporting system.[315] First of all, there is an inadequacy of a well-developed and corporate

governance policy that can be put into practice.[316] The main purpose of corporate governance is to "enhance the value of a company through ethical behavior, espousing a policy of openness and fairness and ensuring informed decision making throughout the company."[317] Regrettably, the board of directors who were expected to be ethical became involved in unethical practices.[318] Due to pressure from stockholders to ensure that the returns on their investment continued to increase, certain boards of directors and audit committees have resorted to disreputable ways in order to ensure that their earnings figures stay high.[319] In addition, pressure from executives to "maximize bonuses based on stock performance,"[320] as well as the attractiveness of the stock market which was growing at a very fast rate, are two factors that have also encouraged management of companies to maintain high earnings figures at any cost.[321]

Second, many corporations are not transparent and honest in reporting financial information to users.[322] Even though the United States has the most rigorous financial reporting standards in the world, several factors such as the abuse of corporate power by top executives, and fraudulent accounting practices show that the present financial system is under significant pressure.[323] By relying on overstated stock prices to pay for acquisitions and by depending on the potential of a brilliant future, several companies have experienced tremendous growth and development.[324] However, in some other companies, it appears as if the measures that are instituted to protect the interests of shareholders have been relegated to the back because of these companies' focus on the bottom line.[325]

The traditional role of auditors in financial reporting is to express an opinion on whether or not financial statements are presented in accordance with GAAP.[326] In direct

contrast to the expectations of the public regarding the role of auditors, the auditor has no absolute duty to expose fraud even though SAS 99 makes suggestions as to the steps auditors should take to make sure that the planning and execution of their audits takes care of issues relating to fraud.[327]

The third area of weakness[328] or problem area within the corporate reporting system is the lack of an effective and efficient internal control system.[330] If an internal control system is effective and efficient, it will usually aid a company in attaining its profitability goals and reduce the loss of capital and assets.[331] Nevertheless, internal control cannot improve a management system that is innately weak or completely guarantee that financial reporting is reliable.[332]

As a result of SOX, many companies are now forced to deal with a rising number of conditions ranging from legal and regulatory conditions to economic reporting conditions.[333] They are now spending large sums of money scrutinizing their existing systems, and "adopting or improving their governance and internal controls to meet the standards set by [Sarbanes-Oxley Act] sections 403 and 404."[334] As the current face of business changes, accountants and corporations must put less emphasis on the traditional approach that focused on complying with GAAP, and instead, they should put more emphasis on studying and exploring the core traits that form the backbone of corporate behavior and management.[335] This might help prevent future meltdowns and provide assurance as to the maintenance of the two main qualities of corporate reporting – transparency and honesty.[336]

Issues Related to Government Legislation

Apart from passing the Sarbanes-Oxley Act, the government has played an active role in implementing new legislation and amending existing legislation in order to limit the opportunities that companies may have to fraudulently report financial statements. The Sarbanes-Oxley Act itself amends Chapter 73 of Title 18 of the U.S Code "dealing with obstruction of justice within the context of crimes and criminal procedure."[337] The amendments affect any one who defies the sections that have just been added, and they include:

- A fine and/or imprisonment of not more than 20 years for "whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede , obstruct, or influence" an investigation or proceeding by a federal department or agency or any case filed in bankruptcy court.
- A fine and/or imprisonment of not more than 10 years for the failure of any accountant who conducts an audit of a publicly traded company to "maintain all audit and review work papers for a period of five years from the end of the fiscal period in which the audit or review was concluded."
- "Whistleblower" protections for employees who, among other things, lawfully "provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the

employee reasonably believes" violates specific sections of the U.S. Code or any rules or regulations of the SEC.

- A fine and/or imprisonment for not more than 20 years for 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 use in an official proceeding" or "otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so."[338]

At this point, it is important to note that there are certain people who believe that increased government regulation of the accounting profession will only have harmful effects.[339] According to James Sheehan, the author of *Global Greens,* in his article titled "Real Accounting Fraud," he asserts that the legislators who are making new rules regarding financial reporting, do not have "even a basic understanding of business."[340] In his opinion, "all members of Congress are direct participants in the biggest accounting fraud going – the federal government – and have never lifted a finger to bring it under control."[341] In other words, he asserts that the legislators should not be the ones making rules to correct or minimize accounting fraud because they are involved in other forms of accounting fraud themselves. Some of these lawmakers are quite ignorant about the underlying issues behind even the most publicized accounting scandals such as the Enron and WorldCom scandals.[342]

This was made evident when one of the legislators could not name any other "high profile bankruptcy besides Enron (he said the word "and" about 10 times before giving up)."[343] Another legislator thought that WorldCom had lost $3.8 billion when in

actual fact, it had capitalized $3.8 billion of operating expenses.[344] He displayed his flagrant ignorance by asking over and over again, "Do you know where that money went?"[345] to the utter disbelief of those who witnessed him make this statement.[346] These instances where politicians have displayed their ignorance about business led Sheehan to conclude that "their biggest illusion is that they have the power to force companies to be "truthful."[347]

In Sheehan's opinion, the problems that we are presently dealing with in the accounting profession, stem from following accounting standards that are too strict because they are products of the past efforts of the government to reform the standards.[348] Accounting that is based on principles works well, but the combination of lawsuits and the SEC's sweeping efforts to regulate the accounting profession, have forced auditors to shift their focus to other approaches.[349] Presently, the SEC attempts to handle almost every situation that falls in a gray area, by imposing rules and regulations.[350] Ultimately, it hopes that this will help prevent any kind of fraud, but the problem with this approach is that when accounting rules are too rigid, people usually find easy ways to evade them.[351] Companies evade accounting rules for different reasons - some companies do it to improve accuracy and other companies do it to increase their earnings by falsifying the numbers.[352] Changing the nature of a transaction, however slightly, can create new issues that cannot be resolved by applying accounting standards that are too rigid.[353] This is the reason why fraudulently misstated financial statements can meet all the requirements of Generally Accepted Accounting Principles.[354]

Because some aspects of accounting are dependent on the judgment of management, we can expect that accounting will always be inaccurate.[355] However,

limiting managerial discretion more than likely will not cause accounting to be more informative than it presently is.[356] While some companies "develop a reputation for forecasting ability, others develop a reputation for missing their numbers."[357] In some cases, forecasting accuracy will go unnoticed for many years or fiscal periods and for legislators to act as if this is not going on shows that they are merely deceiving themselves.[358]

Because the government is focusing more attention on regulating accounting standards, there will be a serious decline in the quality of earnings.[359] In addition, virtually no company will have the ability to make forecasts that are uncertain or even assert any notions in its financial reports.[360] Therefore, the company will completely leave out of the management's discussion and analysis (MD & A) of its own record-keeping, "internal forecasts and assumptions the company [which] actually uses in its internal planning."[361] Consequently, information that investors might find useful and important, more than likely, will not be disclosed in case the forecasts eventually end up being a little inconsistent or ill-timed.[362]

Thus, as legislators are poised to accumulate and exert great new powers over the accounting profession, in the form of regulations, they need to understand that these rules and regulations may only worsen the current state of affairs.[363] This is because these legislators have no real understanding of accounting and they do not even appropriate any of the accounting standards to themselves via the government.[364] Sheehan concludes that we should therefore, expect these legislators and government officials to "demagogue the issue and propose even more stringent regulatory controls, when the unintended consequences come to pass."[365]

Conclusion of Thesis:

After conducting research, there is a need to re-evaluate whether or not I have answered the research questions I listed at the beginning of this thesis and also whether or not the purpose of this thesis has been fulfilled. I will therefore conclude this thesis paper by answering those questions explicitly:

1. **If fraud is a negative thing, can it have ANY positive effects? If so, what are its positive effects and how have they changed the face of accounting in the corporate world?** From the very introduction, I have made it clear that fraud is definitely a negative thing because it destroys public confidence in the accounting profession, destroys companies in the long run and causes major losses to shareholders and investors. It is very ironic that even though fraud is perpetrated, in many cases, to make a company's financial position look better than it really is, when it is finally exposed, the price that the individuals involved in the fraud pay, in terms of serving prison sentences, losing jobs, tarnishing formidable reputations and facing the full wrath of the law in other ways, is much greater than the 'good' that was intended by committing the fraudulent acts. In other words, the costs of fraud far exceed its benefits.

However, fraud can have many positive effects in spite of the negativity that surrounds it and those positive effects include:

- Increased regulation of accounting in the corporate world. The passing and subsequent implementation of the Sarbanes-Oxley Act of 2002 provides a good illustration. It has helped to make management of companies more accountable to

investors and creditors and it has also helped to increase the effectiveness of the audit committee in corporate governance, among other things.

- Increased government intervention and participation in corporate governance by establishing committees and other structures designed solely to focus on preventing and detecting fraud. The Corporate Fraud Task Force provides a good example of this.
- Reduced opportunities in which fraudulent financial reporting can be committed and increased ways in which it can be prevented and detected. The increased emphasis on internal controls serves as an illustration of this point.
- Development of specialized skills leading to the establishment of professional bodies specifically aimed at preventing fraud such as the Association of Certified Fraud Examiners. In addition, forensic accounting is a developing area of accounting that will be more relevant as a result of fraud in the corporate world.

These positives have changed the face of accounting in the corporate world by challenging established rules such as GAAP to the point that such rules are either improved or completely discarded in favor of rules which encourage more pragmatic solutions to existing problems.

2. **What does the current trend in accounting fraud say about the role of business ethics in the corporate world? Is there a correlation or relationship between business ethics and fraud or is fraud influenced primarily by other factors? Will a greater regard for business ethics result in a decline in cases of fraudulent financial reporting?** From the various research studies detailed above, it is obvious that the current trend in accounting fraud points to a need for business ethics in the corporate world. The

concepts of fraud and business ethics are related in that applying business ethics in less cases or matters of decision in the corporate world will more than likely result in one form of fraud or the other. Research also suggests that if companies actually enforce ethical standards, the results will be evident in every aspect of their corporate culture including the rules and regulations. Thus, it can be concluded that when people are ethical and choose to make ethical decisions, accounting fraud is less likely to occur.

Finally, in conclusion, based on the foregoing research, I believe that I have provided convincing evidence that in spite of the negative aspects of fraud, it can ultimately have some positive aspects, which can set the wheels of change in motion in the American corporate world.

APPENDIX

Accounting Fraud in the 1980s and 1990s

I. COSO Research

Overview

When cases involving fraudulent financial reporting draw public attention, concerns over the credibility of the U.S financial reporting process are raised, and the roles of professionals in financial reporting, including auditors, are also called into question. In light of the proliferation of such cases, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) decided to conduct a research project to provide much needed broad and up-to-date information on how to deal with fraudulent financial reporting and related cases involving fraud. The focus of this research was on Accounting and Auditing Enforcement Releases (AAERs) involving a suspected violation of Rule 10(b) – 5 of the 1934 Securities Exchange Act or Section 17 (a) of the 1933 Securities Act, since they are the main antifraud provisions having to do with the reporting of financial statements.

The findings from the detailed analysis of these cases were grouped into five categories:

1. Nature of the companies involved: In comparison to public registrants (which are very large companies), most of the companies who committed financial statement fraud were relatively small. In addition, some of these companies had net losses or were close to their break-even points in the pre-fraud periods. Thus, the fraudulent

2. acts were probably intended to prevent the companies from reporting more net losses or to preserve and improve the current corporate successes of the companies.
3. Nature of the Control Environment (Top Management and the Board): In many of these cases, top senior executives of the company such as the CEO and the CFO, were involved in the fraud and there was either no audit committee, or else the audit committee rarely met (i.e., they typically only met once a year). The members of the Boards of Directors were mostly insiders or "grey" officers with significant interest in the companies and little or no relevant experience. It was also quite common for the directors and other powerful officers to have family relationships with one another.
4. Nature of the Frauds: The combined total of the fraud amounts were quite large in comparison to the sizes of these companies. These frauds took place over two or more fiscal periods and in most cases, the fraud was perpetrated by overstating revenues and assets.
5. Issues related to the External Auditor: Both large and small audit firms were associated with these companies and they issued all types of audit reports. In some cases, the external auditors were named for direct or indirect involvement in the fraud and some companies switched auditors during the period the fraud was perpetrated.
6. Consequences for the Company and Individuals Involved: The consequences of committing fraud to the company ranged from bankruptcy to imposed financial penalties. For individuals involved, the consequences included forceful resignation and class action legal suits.

In addition, the research team analyzed the findings to come up with relevant implications for specific individuals such as internal and external auditors. These

implications, which were related to the categories of the findings, were inherently suggestions of ways that the standard and quality of financial reporting could be raised and enhanced. Interestingly, many of these suggestions were obviously not adequately addressed by Corporate America because they were precisely the same problem areas that led to the enormous scandals of the early 2000s. Some of these suggestions were:

- The directors and top key officers in small companies need to be more independent and the audit committee practices need to be more rigorous.
- Interim reviews of financial statements and the related controls are very important and as a result, should be taken more seriously.
- Auditors need to approach the audit by acquiring information from different sources, as this will help them establish the proper professional skepticism towards each engagement.
- The fact that the companies involved in the acts of fraud were relatively small (relative to other public companies) suggests that by not implementing cost-effective internal controls, the companies were more likely to commit fraud.

Description of Research Approach

The first step undertaken by the researchers was to identify all alleged instances of fraudulent financial reporting documented by the SEC via an AAER issued between 1987 and 1997. The research focused on fraud cases involving SEC registrants and which led to the issuance of an AAER because the researchers wanted information that was widely available about the companies involved in fraud. An inherent limitation of this approach was the possibility that some important cases involving fraudulent financial reporting would be omitted, but the researchers justified their use of this approach by

asserting that there was no better source of widely available cases involving financial statement fraud.

In this report, fraudulent financial reporting was examined, holding material misstatements in perspective. Using the AAERs issued between 1987 and 1997, they came up with a random sample of 200 companies, on which they collected detailed data including: a list of the specific misstated financial statements which they used to determine how long the alleged fraud took place, a clue as to what motivated the committing of the fraud and the dollar amounts of the fraud and the key accounts that were involved. They also got copies of and reviewed the audited financial statements filed in the Form 10-K with the SEC before the first known instance of fraudulent financial statements in order to identify the auditor who audited them. In addition, they reviewed the audited financial statements in the Form 10-K filed with the SEC for the last fiscal year the alleged fraud occurred, also known as "last fraud financial statements," in order to identify the auditor at that time and the kind of audit opinion issued during that period. They obtained and reviewed copies of the last proxy statement issued to shareholders during the period the fraud took place, in order to get information on certain aspects of the directors and audit committee. They obtained information on the consequences of the exposure of the fraud for the company and senior management by searching for articles from finance-related journals, magazines and newspapers using the Lexis/Nexis database. Some of the limitations they faced in obtaining these data in this way were the incompleteness of the data sources as well as the quality of their professional judgments.

Detailed Analyses of Instances of Fraudulent Financial Reporting 1987-1997:

As already mentioned, most of the companies in the sample were small relative to other public companies, especially since they operated below the $100 million size range. Some of them were undergoing financial stress in the period before the fraud occurred. In analyzing the income statements, the researchers observed that the net income of 22 companies decreased before the first year of the fraud while the net income of 30 companies increased during the same period. These findings suggest that the frauds may been intended to increase net income for those companies whose net income was decreasing and to maintain the increase in net income for those companies whose net income had already been on the increase. The researchers also found that most of the companies included in this study were traded in Over-the-Counter Markets including the New York and American Stock Exchanges. Most of the fraud companies operated in the following industries: computer hardware and software, other manufacturing, financial services and healthcare/health products. They also discovered that the headquarters of the companies was the most common place where the frauds were committed or where instructions to commit the fraud originated and was coordinated from. In addition, the headquarters were located in such states as New York and California, which are significant areas of business activity in the United States.

In examining the various company representatives and outsiders involved in alleged instances of fraud, the researchers found that even though the names of these individuals were mentioned in an AAER, there was no clear evidence that these people violated the antifraud statutes. Also, these same individuals did not own up to any guilt at all. The CEO, CFO and controller were the top three officers named in most of the

fraud cases. Lower level personnel were named in much fewer cases, but this may be because SEC enforcement actions may be aimed at exposing fraud committed by top executives more often than for lower level personnel. In some cases, outsiders such as customers and external auditors were named as being involved in the fraud.

In the AAERs, some of the reasons most commonly put forward for committing the fraud include: avoiding reporting negative financial events such as a pre-tax loss and to boost other financial results; hiding the misappropriation of assets for personal gain; and raising stock prices in order to increase the rewards of insider trading and to receive more cash for the issuance of new securities. In addition, most of the members of the audit committee were outsiders and in many cases, there were no audit committee members who were insiders. The researchers thus concluded that the audit committees seemed reasonably independent. They also found out, however, that the audit committees of these companies met only once or twice a year and most of their members were *not* accounting or finance professionals. In contrast, most of the members of the Board of Directors were usually insiders and grey directors such as company legal counsel and former company officers. The members of the Board of Directors and other officers usually had a significant financial interest in the company and they met six or seven times annually. In some cases, there was no segregation of duties for certain offices, which should normally be segregated such as the positions of the CEO and CFO. While reviewing the proxy statements, the researchers observed some miscellaneous events, which might signify a greater likelihood of fraud such as the receipt of material loans from the company by the officers, or directors, which were not within the normal course of business, and current legal or regulatory actions against certain officers and directors.

The dollar amount of the frauds ranged from $20,000 (the smallest) to $910 million (the largest). However, since there is no consistency in the report of the dollar amounts in the AAERs, the researchers used information such as asset frauds expressed as misstatements of assets, to come up with the most suitable measure of the fraud amount. The financial statement frauds covered multiple fiscal periods, with the longest fraud period lasting six years.

The two most common ways in which the financial statements were materially misstated were by overstating revenues using improper methods of recognizing revenue, and overstating assets by adopting inappropriate measures. Some of the techniques used to misstate revenues by stating fictitious revenue include: sham sales (employees falsified inventory records, shipping records, and invoices, in order to hide the fraud), recognizing revenue before all the terms of the sale were completed, conditional sales, improper cutoff of sales, improper use of the percentage of completion method, making unauthorized shipments and recording revenues for consignment shipments. In many cases, external auditors did not detect the fraud because the company representatives falsified responses to confirmation requests, directly or indirectly by asking third parties such as customers, to change the confirmation response. In addition, inventory and accounts receivable were the two asset accounts that were usually misstated. Various audit reports were issued during these fraud periods. In the cases where the auditor was named in an AAER, the auditor was said to have either violated or helped others in violating Rule 10b of the 1934 Securities Act or else, the auditor was alleged to have done a poor quality audit.

Subsequent to the fraud period, about half of the companies included in the sample were either non-existent or else the form of ownership and existence that the company operated under was significantly different from the way it had been before the fraud occurred. Some were bankrupt and others were delisted. The total amount of fines and settlements that the sample companies paid was $348 million, and for some of these companies, their top executives had to pay fines to the SEC for actions that were personally taken against them. Other ways in which the top executives were penalized included termination, resignation and criminal prosecution in some cases.

Implications of the Study

The integrity and reputation of executives is important in light of the fact that they may override internal controls and may be willing to manipulate information in inappropriate ways that leads to material misstatements. Auditors need to effectively screen potential risks such as the effect of management's integrity and ethical values, in order to obtain a better evaluation of overall audit risk. CEOs and COOs need to be educated in standard reporting requirements and professionals with expertise in financial reporting need to be involved in the financial reporting process as this may help to educate those who are less knowledgeable or less qualified in such areas. In addition, members of the Board of Directors and auditors should look out for executives who use what they know about financial reporting to conceal fraud.

Due to the importance of the audit committee in performing financial oversight, risk analysis and evaluation of management integrity functions, the audit committees of smaller companies in particular, need to increase the number of their meetings in each year and need to have more experts or professionals on board, in order to function

effectively. In performing its various functions, the audit committee needs to have access to reliable data and information, which it can obtain from top management. In addition, the Boards of Directors of these companies need to be more independent and possess more expertise in order to perform their monitoring function effectively.

Another observation of the researchers was that the frauds were often started in a Form 10-Q with relatively small amounts but usually, the amounts later increased significantly over two or more fiscal periods if the fraud remained undetected. In light of this, external auditors and audit committees need to examine quarterly financial statements more closely. In addition, management and internal auditors need to review the processes and controls surrounding the preparation of interim reports in order to determine if they are adequate or if they need to be as rigorous as the processes and controls related to the preparation of annual financial statements. When there is a focus on the control environment, useful information may be provided with regards to the possible improper accounting for revenue transactions. In addition, evidence that company managers made important decisions in the process of valuation may indicate the existence of the use of overly aggressive and inappropriate valuation techniques. Auditors should focus on the control environment and be aware that there is a possibility that greater audit risk exists for companies with weak audit committees and Boards of Directors.

II. The Focus on Fraudulent Financial Reporting

The National Commission on Fraudulent Financial Reporting issued a major report called the "Report of the National Commission on Fraudulent Financial Reporting" in October 1987, as a way of bringing more focus on and dealing with concerns about

fraudulent financial reporting. Ten years later, there were many efforts geared towards reducing the instances of fraudulent financial reporting. The focus of those efforts was mainly on the parts played by auditors, managers, members of Boards of Directors and audit committees.

The importance of the auditor's role in detecting fraud in financial statements cannot be undermined because the public places confidence in them to provide reasonable assurance that the financial statements are free from material misstatements. In light of this, the auditing profession has made many good faith efforts to improve the way auditors detect financial statement fraud, and they include: the issuance of SAS No. 53 (designed to reduce the expectation gap between the reasonable assurance that auditors provide and the expectations that financial statement users had for detecting fraudulent financial statement reporting); the Public Oversight Board's 1993 Special Report (focused on improving the way auditors detected management fraud); the AICPA Board of Director's 1993 Report (endorsed the previous proposals to help auditors in detecting material misstatements in fraudulent financial statements).

In addition, AICPA SEC Practice Section Initiatives gave directions about rising and unanswered questions related to the auditing practice, which came up through litigation analysis, peer review or internal examination. The issuance of a new fraud standard: SAS No. 82 clarified the auditor's responsibility for detecting fraud in financial statements, gave more guidance to auditors on how to improve their performance and particularly identified more risk factors which were frequently known to be connected to fraudulent financial reporting cases. The researchers believe that the Auditing Standards

Board (ASB) will find the "Report on Fraudulent Financial Reporting: 1987-1997" useful in reviewing SAS No. 82.

According to the 1987 report of the Treadway Commission, in order to prevent and detect fraudulent financial reporting in advance, the company that prepares the financial statements must initiate this process of prevention and detection. COSO's 1992 Report, which was a framework for internal control, is increasingly becoming a standard for assessing internal controls for various entities. All in all, the board of directors has primary responsibility for ensuring that the internal control system is effective. In many cases, the BOD delegates its oversight function to the audit committee and various national stock exchanges have specific rules governing the composition of the audit committees of the companies listed on their exchanges.

Based on the Institute of Internal Auditors' (III's) study on the effectiveness of audit committees, it was noted that the most important way that the audit committee can be more effective is if the members are given more background information and training. This is because when they truly understand what they are supposed to do, then they will carry out their responsibilities effectively. In the opinion of the advisory panel of the Public Oversight Board (POB), the independence of the BODs should be increased in order to encourage them to perform their oversight function properly. It also advised auditors to issue objective reports within a reasonable period, which addresses the quality and adequacy of a company's financial reporting system. The Independence Standards Board (ISB) and the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees were both established to help strengthen and give more credence to the role of the audit committees and BODs.

III. Overview of Findings From Academic Research

Research that had been conducted in the past on fraud risk factors was limited because there was no solid conceptual model, which examined the connection between these factors and the likelihood that financial statements would be materially misstated due to fraud. In light of this, Loebbecke and Willingham proposed a model, which described the possibility of fraudulent financial reporting as a function of three factors, which centered on conditions, motivation and attitudes that encouraged or allowed management to commit fraud. The research conducted by Bell and Carcello on the validation of fraud risk factors illustrates the difficulties that accompany the grouping of many fraud risk factors when trying to assess the likelihood of financial statement fraud. The Picnus study on the effectiveness of audit tools for fraud detection discovered that auditors who used "red flag" checklists performed less well than those who did not use them. Bernardi discovered that the integrity and proficiency of the client did not affect the ability of the auditor to detect fraud except for managers who are highly responsive to ethical circumstances. Bloomfield discovered that the auditor finds it hard to assess fraud risk when faced with great legal liability for audit failure and conducts an audit for a firm with very effective and efficient internal controls. There is convincing and reliable evidence showing that the internal control environment of the firm being audited is important when evaluating the possibility of management fraud. In general, research findings show that boards of directors of companies that commit fraud are more likely to have fewer members who are outside directors than boards of companies that do not commit fraud.

The research study conducted by DeZoort and Lee revealed that financial statement users recognize that the auditor has greater responsibility to detect financial statement fraud under SAS No. 82 than under SAS No. 53. Loebbecke et al concluded that the because actual material cases of fraud are rare, auditors must train themselves to perform audits in such a way that even if they do not come across a material case of fraud, they do not become so unconcerned that they do not recognize it when it actually occurs. Based on this assertion, Deshmukh et al found that auditors must accept inconsistent false alarm rates so that the audit remains effective in spite of management fraud. Palmrose discovered that management fraud accounted for almost fifty percent of all lawsuits brought against auditors. Bonner et al found supporting evidence to show that there are more lawsuits brought against auditors when fraud schemes occur often or involve phony transactions and events. Finally, when companies first own up and disclose fraudulent practices, their stock prices decline greatly. In addition, fewer analysts follow the firm and fewer institutions hold its common stock subsequent to the disclosure of such practices.

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