ISCTE BUSINESS SCHOOL

FINANCIAL ACCOUNTING SCANDALS AND THE ROLE OF AUDITORS

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Abbreviations List

AICPA	American Institute of Certified Public Accountants
Big 4	Four largest accounting firms Deloitte, EY, KPMG and PwC
Big 5	Accounting firms Arthur Andersen, Deloitte, EY, KPMG and PwC
BMIS	Bernard Madoff Investment Securities
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CMA	Competition and Markets Authority (UK)
EPS	Earnings Per Share
EU	European Union
FRC	Financial Reporting Council (UK)
FTSE	Financial Times Stock Exchange (UK)
FTT	Fraud Triangle Theory
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
IPO	Initial Public Offering
PCAOB	Public Company Accounting Oversight Board
PSG	Professional Standards Group
SEC	Securities and Exchange Commission (US)
SFAS 140	Statement of Financial Accounting Standards 140
SOX	US Sarbanes-Oxley Act of 2002

Abstract

Financial accounting scandals are common in business. Also common is the role of auditors in the financial scandals. Auditors' role in the collapse of companies such as Enron and Worldcom damaged the reputation of audit firms, decreased investor trust in the financial markets, and reduced the reputation of regulators and managers running the world's largest public companies. The 2008 financial crisis alone impacted the global economy an estimated $22 trillion.

Auditors should ensure all stakeholders that a company is operating in a transparent and reliable way, ultimately providing assurance. Hence the concept of assurance is used interchangeably with audit. Besides reviewing financial statements, auditors also review internal controls following professional guidelines. Despite the general view often portrayed by the media, that auditors are to blame for financial scandals, auditing is not meant to detect fraud. Fraud detection is allocated to market regulators, fiscal authorities and other authorities (e.g. the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB), in the US).

This thesis discusses how the client-firm relationship often leave room for conflicts of interest that, allied with the three pillars of the Fraud Triangle Theory, may lead to the occurrence fraud, which jeopardizes the whole audit industry's reputation. We use real cases of financial fraud to illustrate how assurance provided by auditors is important for well-functioning of financial markets. The recent 2008 financial crisis left a sour taste in the public´s mouth and hindered trust in the entire financial system. Auditors have a key role in restoring that trust.

Resumo

Escândalos e auditores estão interligados desde o início do século XVIII. Desde os anos 70, os escândalos financeiros têm sido cada vez mais comuns. O papel dos auditores no colapso de empresas como a Enron e a Worldcom prejudicou a reputação das empresas de auditoria, a confiança dos investidores, reguladores em todo o mundo e gestores que lideram as maiores empresas públicas do mundo. É estimado que a crise de 2008 tenha retirado cerca de US $22,000,000,000 dos mercados mundiais.

Os auditores devem garantir a todos os stakeholders que uma empresa opera de forma transparente e confiável. Além de rever as demonstrações financeiras, os auditores também podem rever os controlos internos, mantendo constantemente um nível profissional de ceticismo. Apesar de a descrição típica do trabalho do auditor e do seu papel, não faz parte das suas obrigações detetar fraudes. Essa função é desempenhada por reguladores e outras autoridades, como a SEC e o PCAOB.

As relações cliente-empresa deixam espaço para conflitos de interesse que, quando aliados aos pilares da Teoria do Triângulo de Fraude, podem levar à ocorrência de táticas ilegais que resultam em fraude, comprometendo a reputação de todo o setor de auditoria. A garantia dada pelos auditores sustenta todas as características dos frágeis mercados financeiros que geralmente dependem exclusivamente das grandes empresas de contabilidade que informam o mercado sobre seus clientes. A crise de 2008 deixou um gosto amargo na boca do público e prejudicou a confiança em todo o sistema financeiro. Os auditores têm um papel fundamental no restauro dessa confiança.

1. Introduction

Whether it be due to creative accounting, pure fraud or malicious use of international accounting standards, scandals seem to be the order of the day (Barnes, 2011). One common misconception is that accounting scandals happen solely under instances of criminal fraud, the one described and defined in the US Fraud Act 2006. But scandals tend to happen due to managers' manipulation of accounting information. On the one hand, managers have discretion to use financial information in a "creative", but still legal way. That practice, known as earnings management, is often viewed by markets participants and regulators as being deliberately misleading or unethical. On the other, there is unlawful, fraudulent manipulation of accounting information. The power play and arm-wrestle between the auditors and the information manipulators makes for an extremely interesting chain of events worth analysing.

While one party is trying to "read between the lines" to detect accounting wrongdoing, the other is using all tools at their disposal to omit and deceive the auditor. This never-ending game of catch-up explains why creative and fraudulent accounting tactics are constantly changing. Hence the key role of auditors and their need to adapt to these ever-developing environments. Instances of formerly accepted accounting practices may, eventually, have to be changed to adapt to misuse on the part of creative and fraudulent accounting.

Take mark-to-market accounting on Enron's case as an example. While still legal, the sheer misleading use of that accounting treatment allowed the managers to pull off one of the biggest financial scandals of the 21st century. The perpetrators got away with hundreds of millions and left billion-dollar holes in the company and compromised the well-being of its employees, some of whom lost everything they had invested in the company.

As discussed by Barnes (2011), each country is unique in its history of both creative and fraudulent accounting, meaning it is pertinent to analyse scandals from different geographic locations. Since each country, continent and culture is different, it is important to also assess how key indicators such as corruption, justice effectiveness against white collar crimes, tax evasion and corporate fraud influence the occurrence of these scandals. As scandals may vary by geography, their type also changes according to the different stages in the trade cycle (Barnes, 2011). During an economic "boom", a company may do what's called an "income smoothing". According to Bragg (2018) "Income smoothing is the shifting of revenue and expenses among different reporting periods in order to present the false impression that a business has steady earnings". To contrast, while going through an economic recession, companies will likely overstate income and net worth to make up for actual losses.

Public companies have had to strengthen their policies, and management followed suit. Accounting frauds throughout the 21st century have taken trillions from all markets and economies worldwide. Once great companies have fallen when involved with such scandals. Former Big 5 Arthur Andersen fell along with Enron in 2001, and Lehman Brothers collapsed following the US house market crash, leading to the 2008 financial crisis.

As regulation is approved to mitigate the risk of more major scandals, the more attentive financial supervisors and investors are. With the approval of the Sarbanes-Oxley act and creation of the Public Company Accounting Oversight Board (PCAOB) after the Enron scandal, things seemed to be headed in the right direction. However, as the years went by, the problem seemed to persist. Bernard Madoff's 2008 Ponzi scheme scammed thousands out of billions of dollars, and the victims were spread worldwide. All these events lead up to the questioning of the auditors' role in detecting potential fraud or financial wrongdoing. Accounting scandals and major frauds have changed the way all stakeholders deal with companies and who is running them. As the number of scandals rises, investors back away from the market, and they lose trust. Financial watchdogs and supervisors such as the SEC lose credibility as each new scandal unfolds under their watch.

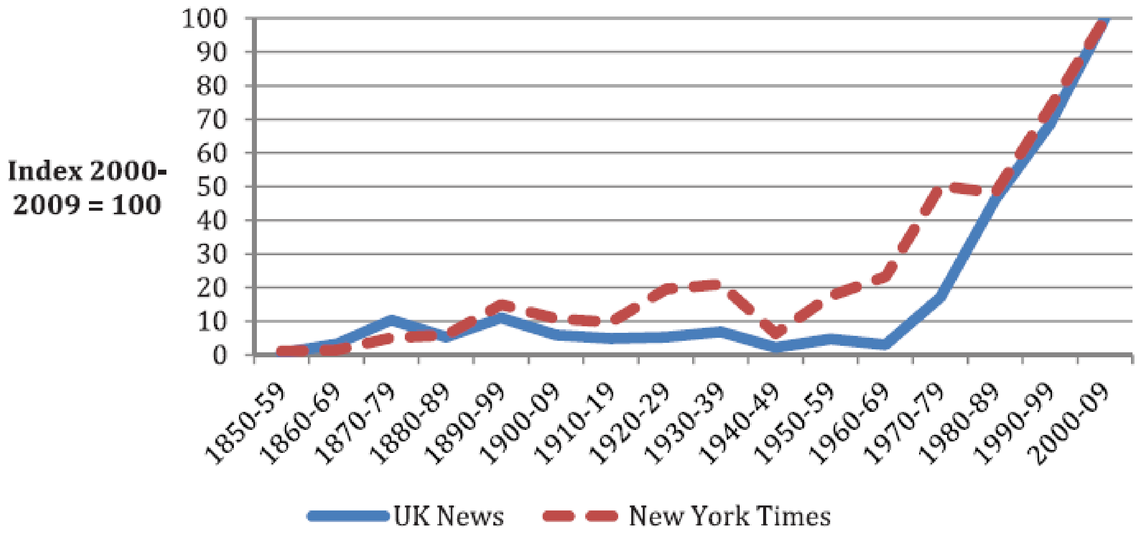
Whether in the United States, where most major scandals were reported, or in Europe, the losses resulting from financial scandals amount to hundreds of billions of Euro. Hence, it is pertinent to study cases of financial fraud, the role of auditors, and what we can learn from it. This thesis analyses some of the major accounting scandals of the 21st century and what role auditors played in the unfolding of such events.

2. The Economic Implications of Financial Fraud

Financial fraud has been a constant arm-wrestle between key stakeholders such as shareholders, managers, audit firms and regulators. According to Toms (2019), accounting professionals have succeeded in limiting and controlling fraud opportunities up to the mid-1970's. Since that time, fraudsters have evolved, and their methods have been increasingly challenging the accounting profession and regulators' work in mitigating financial wrongdoings. As shown in Figure 1, financial scandals have grown both the UK and US, having skyrocketed from the seventies up to today. While financial accounting and reporting is helpful in reducing the risk of fraud in companies featuring a rather simple group structure, the task get increasingly more difficult as internal group structures start getting confusing and the web of almost-untraceable connections thickens. The finance and banking sector seems to be the most prone to fraudulent activity due to the sheer complexity of its structures and ease of moving capital internationally. These acts are perpetrated by intermediaries typically incentivized and/or pressured by shareholders, superiors or pure greed. To those who specialize in accounting and financial reporting, this profession can be used as both a way of preventing but also enabling fraud due to its often-ambiguous role, sometimes contributing to the occurrence of significant financial scandals.

As Azam (2018) put it “there is no organization immune to fraud.” Companies may attempt to tackle fraudulent acts by resorting to improved internal control systems, sound corporate governance allied to strong ethical standards, audit committees, incentivizing whistle-blowers and both internal and external auditors. Despite those efforts, fraud is still likely to occur as fraudsters

Figure 1 - Frequency of Financial Scandals in both UK and US from 1850–2009



Source: Toms, S. 2019. Financial scandals: a historical overview, Accounting and Business Research, 49:5, pp. 477-49.9

and their tricks evolve along with the times. Fraud is exactly why auditors emphasize the importance of applying professional scepticism. As Firth et al (2005) stated, auditors’ responsibility is to exercise due care leading to the eventual detection of fraud and report other material misstatements detected during the due diligence process. One key issue with fraud is that its amount is either hidden or difficult to accurately calculate due to the complex and often subjective connections in a fraudulent operation. While a bribe can be quantified, the impact it had on the business is quite difficult to assess due to all the possibilities and inability to accurately predict sales that did not actually go through. Ways to commit fraud are constantly being invented. Fraud triangle theory (FTT) provides insights on the effects of opportunity, pressure and rationalization, and how it these effects lead to fraud due to the gathering of ideal conditions to perform such acts.

Throughout the 21st century, financial scandals became so common that they are close to no longer being newsworthy (Mansor, 2015). Giant scandals including Enron and Worldcom served as evidence of how fraud can severely impact businesses and have a harsh ripple effect on other stakeholders such as employees, businesses relying on those large companies and even pension funds, some of which lost people entire retirement savings by investing in these companies' stock. These scandals are costly since they contribute to the erosion of billions of dollars in shareholder value, they undermine investors' confidence in the overall financial system and its corresponding financial markets. The impact of the 2008 financial crisis followed by Lehman Brothers' collapse is estimated to have wiped out $22 trillion from the global economy (Melendez, 2013). The general public's confidence is also affected by these scandals, which deters investment in capital markets, which may lead to an economic slowdown and eventual crisis.

To most, fraud prevention measures seem to be the ideal solution to preventing this type of scandals from ever happening again. In addition to that argument, it would be less expensive to prevent fraudulent behaviour before it happens rather than spending considerable amount of money investigating large-scale, complex webs of fraudulent acts. This applies especially to large corporations, in which fraud investigations would consume significant amounts of resources such as time, and money. Even when these scandals are taken to court, investors' chance of recouping their capital in its entirety are slim, truly hurting those who took chances and invested in, once upon a time, flagship companies.

Thanasak (2013) argues that it is key for businesses to identify the factors leading to fraud in the first place rather than trying to invest in fraud prevention and risk management for the sake of it. Companies could go through with this identification process by understanding who the potential fraudsters are, why they would commit fraud and when those actions would take place. Only then would a company be able to proactively manage risks and implement fraud preventing practices.

One of the most cited theories on the reasoning behind fraud is the Fraud Triangle Theory developed by Cressey (1950), a renowned criminologist. It is believed that Cressey's theory originated in the time during which he was Edwin Sutherland's (1939) student (Dorminey et al., 2010). The term "white-collar crime" was coined by Sutherland and his teachings inspired Cressey to develop his Fraud Triangle Theory (FTT). When developing his theory, Cressey focused on the reasons and factors why individuals would engage in fraudulent and unethical activities. The FTT, as shown in Figure 2, consists of three main pillars that need to coexist to create an ideal fraud scenario, these pillars are pressure, opportunity and, lastly, rationalization.

Cressey argued that there is a reason or set of reasons behind people's behaviour. After interviewing over 200 criminals, Cressey found two common denominators in their behaviour. Firstly, all accepted responsibilities "of trust in good faith" and secondly, the circumstances surrounding them made them violate said trust. Perceived pressure relates to the factor(s) that lead to the fraudulent and unethical behaviours. These pressures can be financial or non-financial, with financial pressures being responsible for 95% of fraud cases (Albrecht et al., 2008). Other types of pressure include personal, employment stress and other external pressures (Lister, 2007). In addition, both corporate and personal motivations may act as incentives to commit fraud, some being greed, wanting to live beyond one's means and other monetary pressures.

Perceived opportunity makes up the second element of the fraud triangle and it comprises inefficient controls and corporate governance, possibly allowing someone in a position of power to commit fraud in an organization. This conceived opportunity concept claims that people will take advantage of the privileged circumstances given to them (Kelly and Hartley, 2010). Similarly to perceived pressure, perceived opportunity does not have to be concrete and clearly stated. Hence the use of "perceived", as in a sort of pressure felt by the targeted individual, despite the pressure or opportunity not being clearly presented to them. Cressey argued that the lower the risk of an individual getting caught, the most likely they were to engage in fraudulent behaviour. It has also been argued that the opportunity component of the FTT consists of an employee's ability to detect an organizational weakness and take advantage of such weakness to commit fraud. The combination of poor internal controls, governance and supervision create the ideal set of conditions for a fraud opportunity to appear.

The third and final component of Cressey's FTT is Rationalization. This concept argues that, when committing an immoral or unethical fraudulent act, an individual must come up with a somewhat morally acceptable idea to justify their unethical behaviour. Rationalization helps fraudsters justify and excuse their actions, creating a mental separation of their acts away from criminal activity.

Figure 2 - Cressey's Fraud Triangle Theory

Source: Cressey (1950). Sourced from Jim Wilkinson's article, published on December 2, 2015 at strategiccfo.com/tag/fraud-triangle

Giving their actions a defined purposed of excuse placed in the forces exerted by the FTT's other two components (pressure and opportunity) allows one to be fine with the unethical behaviour they are engaging in. Fraud perpetrators may even use their family and having to provide for them as an excuse to commit fraud, they end up rationalizing it and making it excusable in their minds. Cressey (1953) also added excuses such as "some people did it, why not me too." As stated by Kenyon & Tilton (2012), "The propensity to commit fraud depends on ethical values as well as on their personal attitudes of individuals."

Fraud and financial scandal's impact on a company and ultimately a country's economy is influenced by each nation's regulatory approach. Such approach would ideally improve over time, which has been proven to be failing in some countries, as analysed by Hail's work (Hail el al., 2018) and been connected to the crisis theory of regulation. This theory states that, since regulators are both less informed and flexible than firms, they are ultimately forced to act in a reactive fashion only after scandals are discovered and the damage is already done. Hail's findings suggest that in countries where regulatory activity against corporate financial scandals is typically seen as being reactive (according to the crisis theory), there is a lack of evolution in the country's regulatory approach.

The U.S. Sarbanes-Oxley act of 2002 is a prime example of crisis theory of regulation put into practice since North American regulators only acted after both Worldcom and Enron collapsed and wiped billions from the country's economy, investor's pockets and lost thousands of people's retirement savings that had been invested in those companies' stock. Other examples of the crisis theory of regulation include the 1993/1994 U.S. Securities and Exchanges Acts right after the 1929 crash and the Great Depression, the creation of the China Securities Regulatory Commission after the Shenzhen Development Bank's botched IPO in 1992, after corrupt officials pre-sold certificates meant to be sold to hungry investors.

3. Case Studies of Financial Scandals of the 21st Century

3.1 - Xerox

Background

Xerox Corporation was started in 1906, in New York, and was initially called the Haloid Company (Butala & Khan, 2008). The company started producing and selling special photographic paper in New York city and its "electro-photography technology" granted Haloid a patent. This technology would later be renamed xerography, derived for Greek terms used for "dry and writing"). In 1948, "Xerox" was trademarked. During the fifties, Haloid's state-of-the-art Xerox 914 office copier was beating competitors, including Kodak, and placed the company on the map. In 1961, the business was renamed "Xerox Corporation" and listed its stock on the New York Stock Exchange (NYSE). Xerox's famous copier machine was so popular during the late fifties and sixties that the company reported profits of almost $60 million in 1961 which quick escalated to around $500 million by 1965. In the following decades, Xerox expanded into a wide range of markets such as traditional printing, disk drives and laser printing. Even though the company experienced growth, competition from Canon, Kodak, Hewlett Packard and Ricoh was fierce, resulting in Xerox struggling to stay afloat during the nineties.

As the new millennium began, Xerox's problems from the late 1990s proved to be too serious to ignore or simply wait out. The company was accused of overstating profits and counted on auditor KPMG's help to omit relevant information that had to be disclosed to the SEC. The financial supervisor eventually made amendments to Xerox's latest financial statements, where profits were overestimated by hundreds of millions. Xerox was responsible for engaging in the practice of previously mentioned "income smoothing", a type of accounting information manipulation when, in 2002, The newspaper Guardian reported the company admitted overstating its revenues for the past five years in a $2bn scandal (Pratley & Treanor, 2002).

SEC Investigation

In April 2002, the Securities and Exchange Commission (SEC) filed a civil fraud suit against Xerox related to an alleged four-year scheme to trick investors and other stakeholders. The SEC claimed that, from 1997 up to 2000, the company used a wide range of one-off accounting tactics to either meet or exceed Wall Street's expectations and analyst forecasts (SEC, 2002)[1]. Practically speaking, Xerox was hiding its actual performance away from its investors. As expected, most of the accounting tricks used by Xerox went against and violated the Generally Accepted Accounting Principles (GAAP). Collectively, all tactics used by Xerox to boost its numbers resulted in an over $3Bn equipment revenue recognition and $1.5Bn in exaggerated pre-tax earnings.

Xerox called these tactics "one-time actions," "one-offs," "accounting tricks and opportunities," and these were typically approved by Xerox's senior management, resulting in enormous changes made to the company's financial statements and reported performance. In 1998 and 1999, the SEC claimed close to 40% of Xerox's pre-tax revenue was generated by these accounting actions. Had it not been for these tactics, Xerox would have fallen below market expectation, which would impact the company's stock performance.

How They Did It

Xerox resorted to various types of accounting tricks to "close the gap" between actual performance, operating results and market expectations from 1997 to 2000. The goal was to boost revenues and earnings "at the expense of future periods." The arguably irresponsible actions undertaken by the company mislead investors into thinking Xerox was both meeting and exceeding expectations when it, in fact, was not. The accounting tricks used throughout the years could eventually comprise Xerox's future performance. Most of the accounting actions involved customer leasing arrangements, which was made up of three components. The first one would be the value of the "box" (term used by Xerox to refer to equipment), the second would be revenue received by Xerox for servicing and maintaining the equipment over the duration of the lease and,

[1] https://www.sec.gov/news/headlines/xeroxsettles.html

finally, the financing revenue the company received when its lessees engaged in loans. According to the Generally Accepted Accounting Principles, Xerox had to book the “box” revenue when the lease started, which would then be gradually complemented with the servicing and financing revenue over the life of the lease.

According to the SEC’s complaint, Xerox used a set of accounting tricks to justify a higher revenue justified in the “box” since that revenue would be recognized immediately rather than over the years. The main tactics used by Xerox that impacted its financial statements were “margin normalization” and “return on equity.” Resorting to these tricks, Xerox overstated revenues on equipment by $2.8Bn and $660 million in pre-tax earnings from 1997 to 2000. In a nutshell, using return to equity allowed Xerox to reallocate revenue from financing into the “box” revenue, which was recognized that same period, immediately. By using margin normalization, Xerox reassigned servicing revenue to the “box” revenue once again, giving them the green light to recognize those revenues that same period rather than having to wait years and report them gradually.

The SEC claimed the lack of disclosure of these methods, resulting in artificially inflated profits, was fraudulent. In addition to these two tactics, Xerox used close to $1Bn in another one-off accounting action to, once again, boost the company’s revenues. Xerox used “cookie jar” reserves to spread the gains out as they found convenient, even if those revenues were obtained in one-time events. Xerox reached a settlement with the SEC after having consented to the claim and paid a $10 million penalty followed by a restatement of its financial statements from 1997 up to 2000. After the restatements were issued and new calculations were made, the size of the fraud had apparently escalated from the SEC’s estimated $3Bn to an astounding $6.4Bn, which caused a 10% drop on the company’s stock at the time the news broke. Even though Xerox justified around $2Bn were due to other revisions of their accounts, the company still admitted an overstatement of $1.4Bn over the four-year period.

The Auditor: KPMG

After a 30-year long business relationship, Xerox fired Big 4 firm KPMG. Xerox was being accused by the Xerox of misleading and betraying investors in a master plan internally known as “Project Mozart” due to its sheer brilliance (Pratley & Treanor, 2002). After Xerox paid the $10 million penalty, the SEC informed some executives and KPMG that they planned on going after them as well. Later, in 2003, the SEC filed civil charges against KPMG for the auditors’ role in the accounting fraud perpetrated by Xerox. KPMG described the charges as a “great injustice.” These charges added to the already rocked audit industry, just a year after the Arthur Andersen scandals with Enron and WorldCom, which resulted in the audit firm’s bankruptcy. The investigation focused on whether KPMG’s close relationship with Xerox’s people affected their role as their accounting watchdog. After KPMG’s firing, PricewaterhouseCoopers (PwC) was responsible for the financial restatements which revealed the $6.4Bn in restated revenues.

3.2 - Enron

The rise of Enron as a blue-chip stock, praised by investors, financial analysts and overall finance experts worldwide started off in 1985 from a merger between two small regional companies, InterNorth and Houston Natural Gas. Kenneth Lay, usually referred to as Ken Lay, founded the company and lead it throughout its entire life. The decade had barely started when Enron’s financials started raising questions about its all-star company that had analysts and Wall Street thrilled.

Background and How It All Came to Be

In 1985, the merger of two natural gas transmission companies, InterNorth Inc. and Houston Natural Gas, started Enron (Edel Lemus, 2014). Its 38,000-mile network of pipelines was the biggest in the United States. Kenneth Lay, an emblematic figure in the Enron corporation and a key player in how things later unfolded was appointed CEO soon after the merger. Even though Enron’s most well-known scandals happened in the early 2000s, the company had some background in the “profit over ethics” area. Its first scandal happened in 1987 when both Arthur Andersen, Enron’s external auditing firm, and Enron Key Lay’s vague response hinted at the companies’ prioritization of profits over ethics, along with intent to hide bad news.

This first scandal was related to one of Enron’s subsidiaries located in New York called Enron Oil, which was ran by Louis Borget. Despite being profitable, fraudulent behaviour such as moving profits between different periods based on Houston’s order gave light to the manipulation happening there. On top of the company itself, Artur Andersen was also investigated and found to be involved in unusual and potentially fraudulent business transactions. While Arthur Andersen reported directly to Enron’s audit committee, they would not point out any illegality of Enron’s acts. If they had done so, Enron would be forced to report it to the SEC (Securities and Exchange

Commission) and re-calculate their earnings, which could lead the company to bankruptcy. Instead of going down that road, Enron minimized the apparently fraudulent acts and transitions, ultimately not reporting them to the SEC.

As what seems to have become a pattern, Arthur Andersen agreed to and went along with Enron's decision of not disclosing things to the SEC. Despite being made aware of the corrupt acts over at Enron Oil, Borget managed to stay in charge. It seemed to be that, if a crooked operation was profitable, there was no problem in its fraudulent and unlawful acts.

While having Borget running things seemed positive for Enron, the problem was his hidden agenda and personal interests. These interests translated into Borget appropriating $4 million of Enron's profit for him and close circle of associates (Giroux, 2008). Louis managed to do that by registering sham transactions, a web of offshore accounts and other fraudulent transactions in a crooked book made specifically for Enron's Houston office. On top of that, Borget was speculating with amounts way beyond the one's established by Enron. While some of his trades went well, he eventually made a wrong bet on the direction of oil's price. Those poor trades resulted in losses of close to $1 billion before Borget confessed, leading Enron to recognize an $85 million loss in 1987. Despite the major losses, CEO Ken Lay resisted taking any blame for Borget's reckless behaviour and involvement in fraudulent activities. As a result, both the SEC and US attorney's office opened an investigation on Enron, mainly targeting Borget and his accomplices.

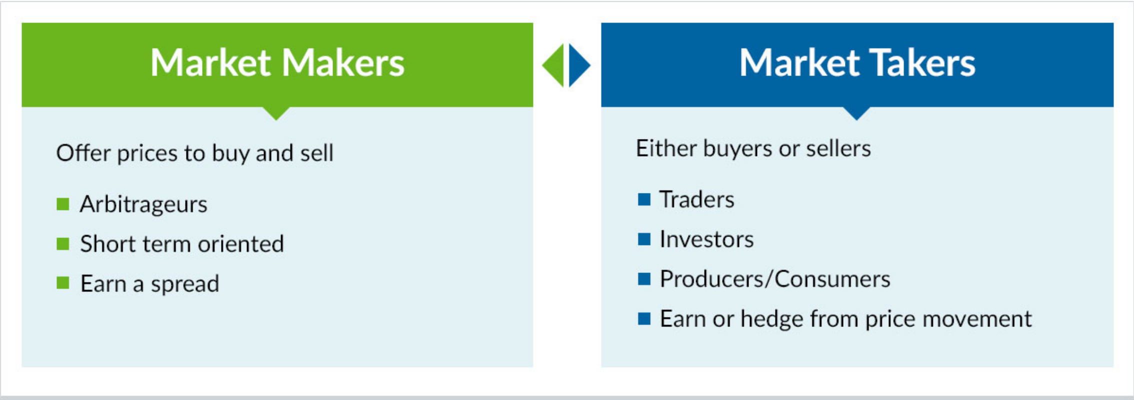
Ultimately, Borget spent 1 year in prison, resulting in the consequent shut down of the trading operation. Despite having to restate earnings in 1988 and jeopardize their honesty, Enron survived. Unlike most managers who would take this sentence as a lesson for ensuring transparency, Ken Lay took it as reminder to improve cover-ups and omit whichever shady activities may be going on. The ineffective internal control and policies stayed the same, as they allowed for behaviour such as Louis Borget's.

Enron's Areas of Operation

Up until the eighties, the natural gas market was highly regulated, and prices were tightly controlled. As the typical gas contract was long term and presented very little risk for both buyers and sellers, profits derived from those contracts was low but dependable. A couple of years later, that all changed with deregulation of energy markets. Prices were now volatile, which incentivised consumers to look for natural gas in the spot market (typically in monthly contracts) rather than the traditional long-term contracts. Shortly after the introduction of deregulation, the newly unstable market saw an initial price fall, which was followed by a drop un supply and consequent rises in gas prices.

While these market conditions did not provide a profitable environment for the traditional pipeline companies, Key Lay's strategy took advantage of this new reality. Enron's strategy moved on to the unregulated gas market, focusing on selling it. By buying and selling pre-defined, standardised amounts of gas, Enron quickly became a market maker (explained in Figure 3), meaning the company was profiting from the spread in bid-ask offers in the very short term. As the Chicago Mercantile Exchange (CME) puts it, Enron was playing the role of an arbitrageur.

Figure 3 – Chicago Mercantile Exchange's Short Definition of Market Makers and Market Takers



Source: Chicago Mercantile Exchange (CME) Group

As Enron's gas industry knowledge grew along with their expertise, they started offering long-term contracts, which contrasted to their strategy at the time. To the company's benefit, they could charge customers a premium over the spot prices on such contracts. By the early nineties, Enron had grown to be the US's largest gas trader. As with any sound business practice, companies aim to hedge against any risks and uncertainties. In the recently deregulated natural gas market, this hedging took the form of Enron providing forward contracts, like futures, to its customers.

Later, New York's Mercantile Exchange, commonly referred to as the NYMEX, compiled those forwards contracts into gas futures contracts. Although that proved to be profitable for Enron, they wanted more. So, the company moved even more complex derivates, which included both options and swaps. As discovering and selling gas was riskier than before, most banks were reluctant to lend money to smaller natural gas companies. To tackle this issue, Enron created the Gas Bank in the late eighties with the aim stabilizing the market and securing Enron's position as the middleman. Former McKinsey consultant Jeffrey Skilling ran the Gas Bank. Enron would provide the cash up front, the producers would then drill to find gas, which would be partly used to pay off their debt to Enron.

As the company was on both ends of the transaction, buying and selling, they could comfortably lend more money to the producers since they were the aware of the future prices since they provided the platform in which sell contracts for future gas sales were negotiated. As a result, both price and supply were guaranteed, as well as Enron's returns, resulting in a somewhat stable market. However, Skilling wanted more and come up with an innovative business idea: trading gas contracts.

Being a fan of what he called "asset-light" strategies, this was the direct reflection of it in this new business idea. Skilling wanted to actively trade these contracts rather than outright owning the infrastructure and resources. The contrast with Enron's asset owning strategy was clear since the company was invested in pipeline and major assets including heavy machinery. Enron also owned significant debt which made it possible for them to fund and maintain those assets. Despite that, Jeff Skilling insisted on his active trader idea, and the market seemed to go along with it, as both analysts and investors were pleased with the new strategy.

Mark-to-Market Accounting Treatment

Ever since Jeff Skilling took over as the head of energy trading at Enron, it was a demand of his that the company started using mark-to-market accounting[2]. Skilling defended that energy futures contracts did not differ from contracts which were written to trade securities, justifying Enron's decision of using mark-to-market. In hopes of getting approval for such an accounting treatment, Skilling wrote a letter to the SEC in June of 1991 informing the Commission that Enron would start using "mark-to-market accounting for its energy futures contracts". Shortly after in 1992, newly appointed SEC Chief Accountant Walter Schuetz, responded to Skilling's letter saying, "the SEC would not object to its use of mark-to-market accounting for its natural gas trades." In a nutshell, market-to-market accounting would allow Enron to value its long-term gas delivery

[2] For further information on Enron's fraudulent tactics and tools, please refer to: Abdel-Khalik (2019)

contracts at fair value rather than the traditionally used historical cost, in which the value of the asset would be spread out throughout its useful life. Applying mark-to-market to energy futures contracts was not really considered an option in 1991 since the market for such future was close to non-existent. With Enron having taken the lead on that market, the company was able to garner significant influence in the pricing and trading of those futures contracts that were traded on a very illiquid market.

As Skilling was the one in charge, he was able to take advantage of mark-to-market accounting to freely set contracts' prices without needing approval from other external sources. During one of Robert Herz's (chair of the Financial Accounting Standards Board - FASB) testimonies before the US Congress he confirmed Skilling's freedom to decide on the prices of the futures contracts. As one might have expected due to such freedoms being given to Enron, things went south quite quickly. Neal Batson (Bankruptcy Court Examiner) gave the suggestion that Enron had gone into an energy future writing frenzy, all whilst secretively applying mark-to-market accounting to other asset classes and contracts. In addition, Enron was being accused of having fabricated the claimed market valuations of such assets and contracts. In the 2000, the company reported that close to 40% (35%) of its assets were being measured at market values. Values that were determined solely by Enron's management, requiring no outside validation.

One of Enron´s first uses of mark-to-market accounting happened in 1991 when the company had brokered a 20-year power supply contract in the state of New York. Instead of reporting the revenues of the contract on a yearly basis, Enron chose to report the entire 20-year revenues and corresponding profits in one single financial year. A major incentive for Enron's management to use mark-to-market was the how greatly it benefitted executive compensation (which was based on Enron's inflated earnings). Audit firm Arthur Andersen seemed to be in silent approval of all these financial wrongdoings since their partner at Enron did not arouse suspicion.

Special Purpose Entities

Enron was able to cover up losses and liabilities by resorting to partner companies created for that sole purpose called Special Purpose Entities, SPE, (Smith & Quirk, 2004). If an SPE is independently owned, it's completely legal to set-up the type of "off-the-books" partnerships like Enron and many others did. Transferring assets or liabilities to SPEs can help companies improve their bottom line, raise capital and better manage their debts since an SPEs' net gains or losses do not have to be present in the parent company's financial statements. This, of course, assuming its independence from the parent company. There were three main criteria that each SPE would have to meet to legitimately be considered an Enron partner. First, Enron could not own at least three percent of the company's stock. Secondly, Enron could not be in control of the SPE. Thirdly, Enron could not be responsible for any of the SPE's losses or loans.

As SPEs could benefits Enron's books, around 3,500 were created by the company to assist in its financial operations and creative accounting tricks. This number was many times as much what other companies tended to deal with. After the SEC conducted investigations on Enron's partnering SPEs, the Commission concluded some could not be considered independent. As an example, an Enron employee named Michael Kopper lead an SPE that went by the name of Chewco.

Rather that recognizing Enron was running Chewco since Michael Kopper worked for the company, no case was made about it. This would violate the second criterion. Another example is SPE JEDI, that was later found out to be 98.5% owned by Enron, violating the third criterion. In addition, JEDI's debt was not stated in Enron's financials statements. Enron dealt with SPEs in obscure ways to ensure the company could boost its earnings and hide losses and debt. One of the SPEs (Raptor) was used to conceal over $1Bn of Enron debt. Despite audit firm Arthur Andersen having turned a blind eye on other Enron wrongdoings, in 1999 they still warned Enron's board regarding the suspicious manipulation of funds using SPEs.

How It Came to An End – Enron's Collapse

It was in late 2001, October 16th, that Enron release its quarterly earnings which included over $1Bn of "non-recurring items" related to "asset impairments", write down of previous energy investments and premature "termination of structured finance agreements." (Hartgraves, 2004) In addition, Ken Lay announced that a billion-dollar reduction in stockholder equity would be necessary to cover the holes created by overstated assets and equity in a finance agreement. In exchange, Enron got notes receivable. The next day, October 17, 2001, the SEC initiated an informal inquiry on Enron's transactions. That enquiry was formalized later that month on October

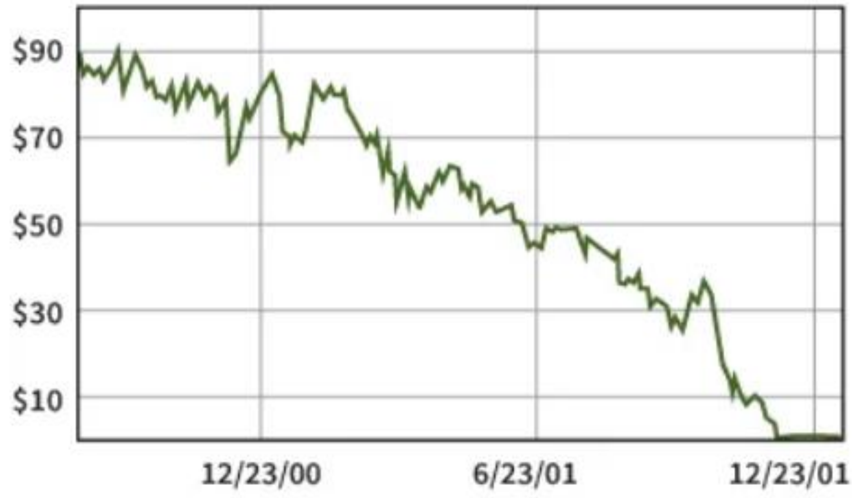
31st. Later that year, on November 8th Enron released a Form 8-K filing[3] in which the company reported the restatement of previously announced figures for years going from 1997 up to 2000, as well as the majority of 2001. The restatements consisted reduction previously recorded revenue of close to $600 million ($586M). According to Enron, those restatements had to be done due to “three consolidated entities that should have been consolidated in the financial statements”, previously recommended “audit adjustments” that Enron had deemed immaterial.

These readjustments resulted in shareholders losing equity in the order of $2.8Bn, which represented around 24% of the total stockholder equity reported earlier that year. This was followed by the major rating agencies downgrading Enron’s debt, an event that was precipitated by this 8-K filing. Less than one month later, in early December 2001, Enron declared bankruptcy and filed for bankruptcy protection via Chapter 11 of the United States Bankruptcy Code. At the time of the filing, Enron’s reported assets were estimated to be valued at over $60Bn, which placed Enron’s bankruptcy as one of the largest bankruptcies ever, the largest at the time (2001). Enron’s bankruptcy left tens of thousands unemployed, billions of dollars in pension fund lost as the stock price tanked and the previously acclaimed management team turned out to be wise conmen with hidden agendas.

Enron’s fall dragged former Big 5 Arthur Andersen with it. The renowned accounting firm had an outstanding reputation and was arguably the most prestigious firm of the Big 5 at the time. As authorities discovered the firm helped Enron cheat in their financial statements, the century-long reputation Arthur Andersen had built up over many decades quickly vanished, leading them to bankruptcy too. Skilling argued that, since he was Chief Executive Officer rather than Chief Financial Officer, he rarely investigated the company’s books due to “not being an accountant”. This allowed him to claim he was caught by surprise when Enron started collapsing and the entire fraud was unfolded before the public eye, eventually leading to a steep fall in stock price, as shown in Figure 4 (Enron’s Stock Price Action).

[3] According to Investopedia, “An 8-K is a report of unscheduled material events or corporate changes at a company that could be of importance to the shareholders or the Securities and Exchange Commission (SEC).” https://www.investopedia.com/terms/1/8-k.asp

Figure 4 - The impact of Enron's scandal on the company's stock (2000-2002)



Source: Benston, George J. (November 6, 2003). "The Quality of Corporate Financial Statements and Their Auditors Before and After Enron", Money Morning Staff Research

Arthur Andersen | Background

Enron's infamous auditor, Arthur Andersen, started in 1913 when a certified public accountant (CPA) named Arthur Andersen opened his own business in Chicago along with his colleague Clarence DeLany[4]. When DeLany left the company five years later in 1918, the business changed names to Andersen & Company. When starting out, Andersen was strict on hiring solely top students from the best universities. Students that Andersen himself taught to "think straight and talk straight." Andersen's reputation was based on these same strict values as they would demand the same behaviour from their clients. The company was able to make a name for itself as the Andersen's efforts in rebuilding Americans' trust in business after the 1929 crash were built on honest, transparent and reliable accounting (Babington & Rigby, 2002). This allowed Andersen to avoid any conflicts of interest while, at the same time, motivating other companies to act transparently. Andersen himself defended the idea that public auditors and accountants should answer to the public rather than the companies paying them for the audit (Craig & Quirk, 2004). Even after Andersen's death in the late forties (1947), his ways of thinking and conducting sound business were deeply ingrained in the companies' culture. Such culture remained strong when Andersen's successor, Leonard Spacek, took over. Under Spacek's leadership, Andersen kept on

[4] For further information on Arthur Andersen and its relation to Enron's collapse, please refer to Smith & Quirk (2004) and Hartgraves (2004).

growing and expanding internationally up until 1979, when it became the world's largest professional services firm.

In a news articles from Reuters in 2002, the author mentions how the market's perception of Andersen as a market leader. The ones setting the standards for honest and lawful accounting, adding "people thought there was the Andersen way – and the wrong way." (Babington & Rigby, 2002). The company's workers built a strong culture of pride and cohesion, engaging in various team building events as part of their annual training, regardless of geographical location. Clients, competitors and overall outsiders would sometimes call Andersen employees "Androids" (Arnold, 2002).

As the M&A craze of the eighties drastically changed the way the Arthur Andersen, Deloitte, KPMG, PricewaterhouseCoopers (PwC) and EY (The Big 5) operated due to introducing management consulting as the more profitable line of service, their pricing strategies changed. Audit was their core activity, allowed them to survive and invest toward signing more lucrative consulting contracts. As competition was fierce, the Big 5 started increasingly lowering their auditing services cost to secure clients. Clients that would ideally hire the audit company's consulting services, bringing in higher profits which made up for the lower price charged for the auditing services.

By the end of the eighties, close to half of Andersen's combined profits were generated by Andersen's consulting arm (Andersen Consulting). This branch of Andersen started after a group of Andersen's accountants decided to create their own consulting firm targeting small firms while keeping the Andersen name, a rough court battle started between Andersen and the new firm. In the turn of the century, in 2000, Andersen Consulting settled by paying $1Bn in compensation and dropping the Andersen name, having then invested $175 million to reboot and rename the company to Accenture. Andersen's amazing growth throughout the eighties and nineties meant the company managed to grow from a small office in Chicago to a global firm with around 85,000 staff, in 84 countries and a combined revenue of over $9Bn as of 2001.

Arthur Andersen's Role in Enron's Fall

Arthur Andersen audited Enron since the early eighties, witnessed the company's evolution from a simple pipeline operating business to a full-fledged energy trader (Squires et al, 2003). Enron was one of Andersen's biggest clients, with the audit firm having collected over $50 million in fees in 2000 alone. And those were expected to double soon. This business relationship lasted until months after Enron filed for bankruptcy, when Enron fired Andersen after disclosure that the audit firm's employees were involved in shredding of key Enron documents. Even though Andersen was to blame in Enron's fall, the auditors did find some irregularities in Enron's reporting of losses, or lack thereof.

Andersen's main concern was Enron's dealings with SPEs. In 1999, Enron's board of directors was told by Andersen that the company's fund manipulations done thorough SPEs was suspicious. David Duncan, lead Andersen auditor, warned the board that "…many [of the SPEs] push limits and have a high-risk profile." Despite that, Duncan did not point that out as being a main concern of his. The legality of the SPEs was up to interpretation, based on the information made available to auditors. Later, when testifying in court, Duncan stated that the Andersen auditors did not have enough information to properly interpret and assess if rules had been broken by Enron. Even if the auditors did not have access to all the information, Andersen had advised Duncan against some of Enron's deals.

Members of Andersen's Professional Standards Group (PSG) commented and wrote memos on the clear conflicts of interest and sheer lack of sense in some of Enron CFO's decisions about SPEs. Benjamin Neuhausen wrote "…Why would any director in his or her right mind ever approve such a scheme?". Despite the concerns shown by Andersen's PSG, Duncan chose to stick with Enron and assured partners of that decision at one of their annual risk assessment meetings. Some questioned Duncan's ability to manage the Enron account due to his young age and lack of strength even though he appeared to have developed a great deal of confidence while working with Enron.

Red-flags started appearing when Sherron Watkins, a former Andersen employee who was suspicious about Enron's financial schemes was assigned to work on "off-the-books" Enron SPE deals. As soon as Watkins realized what was going on, she wrote a letter to Enron's CEO Ken Lay explaining what was happening as well as her concerns. Watkins wrote "I am incredibly nervous that we [Enron] will implode in a wave of accounting scandals" due to the "funny accounting" she saw in one of Enron's SPEs.

Paper Shredding

In October 23rd, 2001, Duncan met with senior members of his team about Enron's books. At that time, Enron' s stock was in freefall, the SEC had started an investigation and both Andersen and Enron had to act quickly. Enron was, indeed, collapsing. Duncan called an emergency meeting with his audit team located at Enron's Houston headquarters. The staff was told to comply with Andersen's new policy on audit document handling. This new policy Duncan pointed out had been created just a year before with the aim of preventing Andersen's documents from being used in court cases. Even though some documents could not be shredded, other secondary ones could be destroyed. And that is exactly what Duncan had his entire workforce do. No questions asked, as they were simply complying with a firm policy. The mass shredding did not occur solely in Houston.

Both Andersen's and Enron's offices in Portland, Chicago and London joined in on the shredding taking part in HQ Houston. The "document purge" was on. Enron and Andersen staff even joined forces to speed up the shredding process. Even when Andersen's fraud investigator David Stulb entered the Houston building, the papers shredders were actively working non-stop. In the other room, Duncan was deleting emails and other files in his office. Stulb warned Duncan he could not destroy those documents since they would very likely need them later.

As Duncan failed to comply, Stulb called Andersen's New York office to let them know how wrong everything had gone at Enron. It took a subpoena issued on November 8th to stop the shredding. Andersen staff went as far as writing "No more shredding" on top of the shredding machines. Despite the subpoena issued by the SEC, an incredibly large number of files had already been destroyed along with tens of thousands of emails and other files. This meant Andersen was responsible for destroying evidence needed for a SEC investigation. Andersen's lawyers later claimed that shredding was business as usual, part of the company's need to destroy unnecessary files. On May 13th, 2002, Duncan admitted in court that he obstructed justice by starting the shredding at Andersen and Enron offices.

Not All Bad

Even though Andersen was in very hot water over the situation with Enron, the fact that the auditor helped revise Enron's statements in November 2001 played in Duncan's favour in court. Andersen revised Enron's previous five years of financial statements. Those revised files included reductions in net income and accurately reported debt. The review of that five-year period alone placed close to increased Enron's reported debt by $2.6Bn. As one may expect, companies tend to not like restatements of earnings nor debt since those often reveals unfortunate financial situations. Contrary to the typical practices of both Andersen and Enron, the audit firm advised Enron to restate earnings. In the end, both companies came out looking incompetent since the restated earnings revealed serious shortfalls. One month later, in early December, Enron filed for bankruptcy.

Apparent Cover-Up

While tens of thousands of physical and online documents had been destroyed, not all of Andersen's documents were, as some audit records were still used by the court. Those reports showed that Enron had accumulated losses of $618 million by the year 2000 and that a write-off of $1Bn was necessary. Enron wanted that write-off to be categorized as "non-recurring" and needed Andersen's approval. A memo sent by Duncan proved that he disagreed with that decision since that would be inaccurate. In addition to that Duncan memo, the federal attorney brought up an email written by Nancy Temple, an attorney at Andersen. In the email, Temple wanted the word "misleading" to be changed in a document describing Enron's accounting practices.

Temple wanted this change so that it would seem Andersen clearly stated its concerns regarding the "non-recurring" categorization Enron wanted since it would have been any auditor's duty to report so. Temple also asked for her name to be removed from the email. The jury interpreted this as a cover-up and convicted Andersen on that memo rather than because of the shredding and deleted emails. David Duncan and the entire Andersen Houston office displayed clearly poor judgement, made quite questionable decisions that affected how they worked on Enron's financials. In the end, Andersen's choice of keeping risky Enron as a client can be cut down to pure greed. Greed that was strong enough to compromised Andersen's values and decades-long rock-solid reputation.

3.3 - Worldcom

Context & History

Worldcom started out in 1983 by the hands of Murray Waldron and William Rector, who wanted to "create a Long-Distance Discount Service known as LDDS. In 1995, Bernard Ebbers an early investor in the company, took the role of CEO. By 1989, LLDS had gone public through the acquisition of Advantage Companies Inc. and eventually merged with Advanced Telecommunications Corp. in 1992. The latter was a competitor in the discount long-distance service industry. Ebbers' strategic acquisitions included other long-distance providers Resurgens Communications Group, Metromedia Communications in a mixed stock and cash buy out, resulting in LDDS being the fourth largest long-distance network in the United States by 1993. In the following year, LDDS went out and acquired IDB Communications Group Inc. through an all-stock deal[5]. This purchase allowed the company increased both its domestic and international serviced areas.

By 1995, LDDS acquired another competitor, Williams Telecommunications Group for around $2.5 billion in a cash deal. It was then that LDDS changed names to now be called Worldcom. Following past years' trend, now Worldcom entered the digital fibre optic and optic cable network facilities by acquiring MFS Communications, which owned those local network facilities. In addition, Worldcom also acquired UUNet Technologies, which allowed the company to increase its presence in both Europe and United States as an internet service provider (commonly referred to as ISP) for businesses.

As the company had grown immensely over the mid-to-late nineties, it was in 1998 that Worldcom completed three mergers, with one of them being the largest in history at that time. The latter was the merger with MCI Communications, in which $40 billion were transacted. Alongside that transaction, Brooks Fibre Properties and CompuServe were acquired and merger for $1.2 billion and $1.3 billion, respectively. It was after the MCI merger that Worldcom changed its name to MCI Worldcom. As the now global giant was aiming to grow further worldwide, Sprint and Worldcom were looking to merge in 1999. Even though the mega merger was close to happening, regulatory bodies in both the United States and Europe put their respective objections forward,

[5] For further detail on WorldCom's story, rise and fall, please refer to: (Pandey & Verma, 2004)

which resulted in the merge not seeing the light of day. Despite that business failure, Worldcom ended up acquiring another large Telco company, SkyTel Communications in 1999. Two years later, on June 7th, 2001, WorldCom's shareholders agreed on a recapitalization given that two separate entities world then be publicly traded as a result of the operation. The two new publicly traded stocks were WCOM, which reflected upon the performance of the company's "data, internet, international and commercial voice services" and MCIT, which reflected upon the performance of WorldCom's small, consumer businesses, wholesale long-distance voice and data, wireless texting and dial-up internet access.

Worldcom was a global telecommunications company, placed at an honourable fourth place in Fortune's 500 telecom sector companies in April of 2002. At the time, Worldcom was operating in over sixty-five countries. The company had earned its place as a solid player Europe as a both local and network facilities-based competitor spread throughout twenty-one countries throughout Europe, the United States of America, South America and the APAC (Asia-Pacific) region. At that time, the global market for telecommunications was worth around $800 billion, a number that caught the attention of global companies in the sector.

Worldcom truly was a force to be reckoned with due to its sheer size and global reach. The countries Worldcom was operating in at the time accounted for around two thirds of the $800 billion previously mentioned. Looking into absolute figures, the telecom giant's network had over 95,000 route miles installed in over 70,000 buildings. According to Pandey & Verma (2004), the company's core business operations were divided into two major segments, namely data services including IP (Internet Protocol) networks, internet services such as VPNs (Virtual Private Networks), website management, voice services on a commercial level, customer communications systems with respective design, management and implementation and overall international communication services.

All of WorldCom's assets included the company's buildings, investments, cash, furniture, equipment and an assortment of intangible assets. In addition, some long-term and current assents, along with goodwill, were also included in the calculations. As MCI Group was acquired by Worldcom, their assets had to be calculated as well. Adding up to WorldCom's already sizeable network based, intangible assets, MCI group carried a wide range of "retail and wholesale communication services". Those included services such as long-distance communications over voice and data, local consumer-based voice communications, dial-up internet services and an assortment of small businesses in the United States. MCI group's assets also included voice switches, internet modems (dial-up), a nationally renowned brand, customer relationships, just under 20 call centres with high-performing salespeople and an innovative culture, ingrained in the company's *modus operandi*. WorldCom's businesses were responsible for close to 61 per cent (60.7 per cent) of the total revenues, while MCI group's revenues accounted for just under 40 percent (39.3 per cent) of the combined total revenues. As of the year 2001, WorldCom´s assets accounted for as much as 88.4 per cent of the group's total assets, with MCI group´s assets taking up 13.5 per cent of the combined assets of both groups.

Corporate Culture

As WorldCom had been growing at an extremely fast pace, fuelled by growth acquisitions, fragmentation started to hit company culture (Kaplan & Kiron, 2004). A former Worldcom accountant recalled them having fellow accountants in offices they did not know even existed, getting calls from people they had never even heard of beforehand. WorldCom's Mississippi headquarters kept and checked the corporate books, all while trying to consolidate information from as many as 60 incompatible accounting systems from all the companies WorldCom had acquired. Regarding network operations, WorldCom's headquarters were in Texas. Human resources were in Florida and the legal department was in Washington, D.C. Despite having the finance HQ there, none of WorldCom's senior lawyers was in Jackson, Mississippi. Ebbers seemed to purposely exclude lawyers from his inner circle, having dealt with them solely when needed. Ebbers even told his lawyer how displeased he was with their advices, regardless of them being often justified. This played a role in creating a corporate culture where legal professionals were not welcome.

A former WorldCom manager stated that "each department had its own rules and management style. Nobody was on the same page". Even when he had started, there were no written policies. When Ebbers was made aware of this lack of a proper corporate code of conduct, he called the idea a "colossal waste of time." WorldCom seemed to encourage a culture of blind obedience from the top down in which subordinates would not question their superiors and simply did as they were told. Those who dared to question their superior would be met with criticism and even threats. A specific situation stands out regarding this systemic attitude within WorldCom: In 1999, the director of WorldCom General Accounting warned a senior manager working at the Internet division that if he were to show some numbers to the "f******g auditors"[6] he would throw him out the window.

In addition, both Ebbers and Sullivan usually approved compensation beyond what had been contractually agreed. They used motivators such as bonuses, promotions to reward selected loyal employees working in the finance, accounting and investor relations. Despite it being out of the ordinary, the human resources department never objected to those unique awards (Zekany et al., 2004). Some employees were unaware of the existence of an internal audit department. Those who knew about it had a hard time trusting it since they knew the department reported straight to Sullivan.

What Happened – Expense-To-Revenue Ratio

As Worldcom rapidly expanded during the 1990s, the company was determined to build up revenues and gathering enough capital to sustain additional growth. Ebbers' quote clearly states WorldCom's goal at the time "Our goal is not to capture market share or be global. Our goal is to be the No. 1 stock on Wall Street." (Charan et al., 2002). Growing revenues were means to achieving an end: Stock price growth and market value. As a result of a strong push for revenue growth, managers were incentivized to prioritize long-term results over short-term gains. Following that strategy, WorldCom bet on selling long-term fixed rate leases in anticipation of a growth in customer demand. The drawback of those leases was that they included tough termination provisions. Even if the company noticed their capacity was not being used to its full potential and wanted to cut the lease, they would have to pay considerable fees. In practice, this meant that, even if customer demand was lower than WorldCom expected, the company would still have to pay for the unused capacity.

In the early 2000s, as competition in the telecommunications sector became more fragmented, WorldCom was forced to lower price to remain competitive. The impact of the dot-com bubble bursting also affected the industry due to the economic recession that ensued. This overly competitive pricing situation meant WorldCom's Expense-to-Revenue ratio (E/R) was under strong pressure. This indicator is key to financial analysts and other industry players, and WorldCom's E/R was worsening. In the beginning of 2000, WorldCom's E/R ratio was 42%, and

[6] Gene Morse's personal correspondence.

the strong pricing and revenue pressures made it difficult for the company to even keep it at that level. In a desperate move, Ebbers made an emotional speech explaining the he and other decision makers at WorldCom would lose everything they had if company performance did not improve. As the market seemed to not listen to the emotional speech and business kept on declining, WorldCom's management, specially CFO Sullivan, had to resort to two key accounting tactics to improve WorldCom's apparent performance: Accrual releases (1999, 2000) and capitalization of line costs (2001, 2002). In addition, WorldCom also resorted to aggressive revenue-recognition methods to get closer to Ebbers' revenue forecasts.

Accrual Releases

WorldCom typically estimated its line costs on a monthly basis. Even though bills or neither received nor paid until months after the transaction occurred, the generally accepted accounting principles (GAAP) required companies to set those amounts aside anyway by matching expenses with revenues in the income statement. Knowing that the cash was still to be paid, the accounting entry would be an accrual to liability account that would later be deducted once payment to the line owner occurred. If the bills were under the expected amount, the difference would then be reflected in the income statement as a reduction in line expenses.

In 1999 and 2000, Sullivan warned WorldCom staff that release accruals were artificially high due to the merger with MCI, which supposedly resulted in overaccruals. Sullivan delegated the task of enforcing these changes to David Myers, a financial controller, to handle any complaints from senior managers and pressure them to change the books. Over many threats to subordinates or even blackmail, WorldCom released a total of $3.3Bn worth of accruals, most of which were directly ordered by Sullivan and/or Myers. This eventually resulted in many business units being left with cash reserves under the amounts necessary to pay the incoming bills.

Expense Capitalization

In early 2001, the aggressive accrual release meant done in both 1999 and 2000 meant that tactic was no longer an option to improve WorldCom's E/R ratio. Since revenues kept on declining, Sullivan wanted WorldCom's R/E ratio to remain at 42%. While that may have seemed reasonable to Sullivan himself, others described it as being overly optimistic, unrealistic and even impossible. A senior at WorldCom said the pressure was unbearable, worse than all the previous pressure the man had felt throughout his decade-and-a-half of experience. Sullivan had to come up with an innovative solution, pushing the boundaries of his creativity.

Aware that WorldCom was stuck to the long-term contract in which the company paid for excess capacity, Sullivan thought WorldCom could register the excess capacity as capital expenditure rather than an operating cost. The reasoning behind this idea was that paying for excess capacity prepared WorldCom to enter the market quickly when new demand eventually increased. In April of 2001, the CFO stopped recognizing expenses for unused line capacity. Sullivan then tasked Myers and Yates with ordering WorldCom's accounting department to recognize $771 million of unused line expenses as a capitalization of an asset account named "construction in progress." Later than month, WorldCom filed a 10-Q report to the SEC in which the company reported $4.1Bn of line costs and capital expenditures including close to $550 million of the capitalized line costs. This allowed WorldCom to maintain its 42% R/E ratio, with the company having reported revenues of $9.8Bn. Had WorldCom not used these aggressive accounting tactics, the R/E would have escalated to 50%.

Internal Auditors

The head of WorldCom's internal audit department, Cynthia Cooper had been in the company for nine years. Gene Morse, a senior manager at the same Internal Audit department, was transferred over from his previous position at WorldCom after being threatened by Yates after he suggested speaking to external auditors in 1999. The Internal Audit Department reported directly to Sullivan, WorldCom's CFO. The department's main objective was to perform operational audit used to measure the performance of certain business units and to enforce the company's spending control. The external auditor in responsible for WorldCom's account was Arthur Andersen. Andersen assessed the reliability. Truthfulness and integrity of the information publicly reported by WorldCom. The external auditor would then report its findings to the directors of WorldCom's audit committee.

In August of 2001, Cynthia Cooper was doing an operational audit regarding the company's capital expenditures. Her audit revealed Corporate at WorldCom had $2.3Bn of capital expenditures. This number, when compared to WorldCom's operations and tech group's $2.9Bn worth of capital expenditure, concerns are to be raised. Cooper did exactly that by requesting an explanation of the $2.3Bn attributed to Corporate. Internal Audit then received an updated figure, Corporate's capital expenditures had decreased to $174 million. A footnote in that document explained that the remaining $2.3Bn included a "metro lease buyout, line costs, and some corporate-level accruals." Months later, in early 2002, Cooper received a complaint issued by the head of WorldCom's wireless business unit regarding $400 million in future cash payments and expenses that were transferred away to boost WorldCom's earnings. Cooper then asked an Arthur Andersen auditor to explain the strange transfer. The answer she got was that the auditors only answered to Sullivan. This was a clear red-flag, and Cooper started investigating. Cooper made WorldCom's audit committee aware of the situation, which resulted in Sullivan telling her to stay away from that business unit as she was screamed at. Still in March of 2002, WorldCom received an expected request for information from the SEC. The Commission was curious to know how WorldCom was able to remain profitable while other telecommunications companies reported major losses.

Cooper decided to conduct a full-fledged financial audit without Sullivan's permission. Morse helped Cooper by accessing WorldCom's online journal entries due to his IT expertise. While access to those records was only accessible to Sullivan, Morse managed to get access from one of the software engineers for testing new software. This allowed Morse and Cooper to look through every single record, expense or any other transaction. Since Morse had previously crashed the system while checking records during the day, he chose to go through the records at night. Morse then downloaded all the material he examined to a CD-ROM so that WorldCom could not destroy the files.

External Auditor – Arthur Andersen

Arthur Andersen independently audited WorldCom from 1990 up until 2002. Andersen placed WorldCom as its most valuable client, and both firms were interested in maintaining a long-term business relationship. An evidence of Andersen's commitment to be a part of WorldCom's expansion was after the merger with MCI. Andersen underbilled its staff hours and justified the cuts as being an investment in a sound relationship with WorldCom. In addition, Andersen had a full-time 10-person team dedicated to WorldCom exclusively.

Andersen started out by operating as it usually did, the traditional way of auditing, by testing thousands of details of a large pool of transactions. To keep up with WorldCom's growth and operations' expansion, Andersen had to modernize its methods by adopting more efficient and sophisticated auditing procedures based on data analytics and risk assessment. Andersen's role was to identify potential risks and check if WorldCom had the necessary internal controls for said risks.

Practically speaking, Andersen reviewed WorldCom's processes, systems and evaluated how well business units exchanged information with the field. All this work was done under the assumption that the information passed on to Andersen by the General Accounting department was accurate. The typical requests made to General Accounting were around thirty high-level summaries sent to Andersen each quarter. Besides assessing these internal risks, Andersen also evaluated the risk of expenditures related to capital projects and whether information was being accurately exchanged. This applied to line cost transactions as well. The auditor also assessed the risk of liabilities related to line costs being understated or overstated by WorldCom and did this by verifying the reliability of the information received from the field. Despite these efforts to assess the risk of the national line costs, Andersen failed to apply the same tests to WorldCom's international line costs even though a $34 million corporate reversal in those costs was reported in the UK in early 2000. Andersen was mostly focused on the eventual scenario of accidental errors rather than on intentional misstatements.

Despite some apparent lacks of suspicion, Arthur Andersen's risk management software placed WorldCom as a high-risk level for potentially committing fraud. This rating was later escalated to a "maximum" level by the auditors since they were taking WorldCom's merger and acquisition plans, focus on high stock prices for those acquisitions, as well the telecommunications industry's volatility. Even though WorldCom's rating was at an extremely risky level, Andersen kept its former auditing practices, which meant WorldCom was being audited as a medium-risk client. Andersen could have identified WorldCom's tactics for boosting revenues and lowering liabilities (capitalizing line costs, and accrual reversals) had WorldCom not barred access to its general ledgers. Andersen was denied access to WorldCom's computerized accounting ledgers on multiple occasions.

In addition, WorldCom's ability to maintain the desired 42% R/E ratio should have raises some eyebrows at Andersen. Instead, Andersen chose to go with WorldCom's word and skipped on doing any follow-up work on that matter. WorldCom's employees were informed of what information could be given (or not) to Andersen's auditors. When the auditor requested meetings with the senior VP of WorldCom's financial operations those requests were refused. WorldCom also hid information, altered data on documents and transferred millions in dummy operations to mislead Arthur Andersen. WorldCom even prepared special revenue reports for Andersen in which problematic items were removed or buried somewhere else in the financial statements. Arthur Andersen claimed WorldCom's compliance was fair and chose not to inform the audit committee about the restrictions imposed to them by WorldCom when trying to access people and information.

3.4 - Parmalat

Background

Parmalat started out as a preserved-meat business in the early decades on the 20th century. In 1961, Calisto Tanzi took charge of his father's business and launched it under the Parmalat name. Decades later, in 1990, Parmalat went public and expanded greatly over the years. At that time, the company was the eighth largest in Italy.

Risk of Fraud and Subsequent Scandal

Parmalat resorted to the bond market to get some of its financing. Over eight years (1995 to 2003), $5Bn in liabilities were added to Parmalat's books after 35 trips to the bond market. At the time, Parmalat employed 36,000 employees worldwide. In late 2003, a 4Bn€ hole was discovered in the company's accounts after an accounting scandal involving Tanzi himself was made public. Consequently, Parmalat was close to going bankrupt and accusations of financial wrongdoing were being thrown around, mostly targeting Tanzi. It turned out that a copious amount of bank confirmations was falsified and then submitted to auditors by internal Parmalat employees.

Knowing the auditors relied on such information, the fraudulent records included a close to $5Bn cash balance bank confirmation. According to Roberts et al (2004), the forgery was perpetrated by a Parmalat employee who resorted to techniques as basic as scanning the bank's logos, an employee's signature and assembling a fake document, which was ultimately given to the auditors as legitimate. Later, the bank confirmed such records never existed nor occurred.

3.5 - Bernard Madoff's Ponzi Scheme

Background

Bernard Madoff's Ponzi scheme is considered one of the worst financial scandals of the 21st century. Madoff ran the largest Ponzi scheme in history, fooling mostly wealthy investors from all around the globe by promising steady returns that constantly beat the market at a 1% monthly growth rate. In the sixties, Bernard Madoff Investment Securities (BMIS) was founded using Madoff's own saving from his lifeguarding years along with his relatives' help (Azzim & Azam, 2016). For the following decades, Madoff built his solid reputation on Wall Street as a visionary that helped create the NASDAQ, eventually leading to Madoff taking over as chairman of the exchange.

Madoff used his reputation and spotless Wall Street credentials to set up the largest Ponzi scheme in history. By promising steady returns of around 12% per year regardless of market volatility, Madoff's fund was perceived by many as a safe investment vehicle. When compared to hedge funds that were, at the time, doubling and tripling investors' money, Madoff's monthly 1% guaranteed gains seemed reasonable even to risk averse investors. As the fund worked on an invite-only basis, those approached by friends and relatives to invest with Bernard Madoff felt privileged to have been chosen to such an exclusive club. This worked specially well since the stock market had been booming in the early 21st century and there was a fear of missing out on incredible gains provided by such an economic expansion that seemed to keep on going. As Madoff surrounded himself with wealthy, influential individuals, the word-of-mouth about investing with Madoff quickly spread to the upper echelons of society, driving billions in investor cash to Bernard Madoff's fund.

Role of Auditors

Major players in the accounting and audit industry suggested Madoff's asset-management firm was safe to invest in large sums of money into (Azzim & Azam, 2016). Companies such as BDO Seidman, KPMG and other large firms agreed on Madoff's legitimacy. Contrary to the due diligence inherence to assurance professionals, auditors responsible for checking Madoff's accounts and financials simply checked the statements produced by Madoff himself. Ultimately, Madoff's auditing firm was solely made up of three people, including a partner, an accountant and one secretary. It turned out this external auditor was nothing other than a mere front, as Madoff was the only truly in charge of the supposed auditing task, he was the only decision-maker in his fund (Drew, 2010). While major audit firms suggested Madoff's fund was secure to invest with (Gandel, 2008), those same companies did not seem to do the necessary research to assess the correctness of Madoff's investors' decisions.

Experts suggest the accountable audit firms simply checked the financial statements Bernard Madoff fabricated himself (Gandel, 2008). Rye Select, one of the funds invested with Madoff at the time even notified investors that the financial statements would not be independently verified, wrongfully assuming Madoff's numbers were accurate and fair. Despite Madoff being a reputable character in the financial scene, it is the auditor's role to apply reasonable professional scepticism, as things should never be taken at face value (Gay & Simnett, 2012). It is the auditor's role to ensure all numbers add up, with corresponding evidence of such numbers and corresponding transactions, invoices, among other financial documents. To ensure fair and sensible fraud detection and prevention, auditors should have a thorough understanding of their clients' businesses, foster an open communication channel with the client and be familiarized with the firm's typical behaviours and practices. The auditor's final output is typically represented by an audit opinion, in which the audit firm provided an informed opinion regarding the audited firm's financial statements and/or internal controls truth and fairness.

In Madoff's case, red flags were quick to appear. First, it was of on Madoff's part not to ask for any help from the major audit firms. Instead of hiring the big-name firms, Madoff chose to go with a small accounting firm named Friehling & Horowitz (Gandel, 2008). Despite Bernard's reputation and idolization in Wall Street, auditors were still required to check the fund's numbers and various financials for both truth and fairness, as any auditor should. While doing their due diligence, auditors must be aware of possible misstatements, some of which may indicate the occurrence of fraud. Material misstatements may appear under the radar, which is why auditors need to pay extra attention to any client's financial reports.

According to Apostolou & Crumbley (2008), auditors should have paid more attention and have given additional scrutiny when auditing Madoff since fear of a global recession were already scaring financial markets. Another red flag was the lack of effective internal controls. Since Madoff was seemingly running the whole scheme, duties were far from segregated, which made internal controls that much more complicated. The third red flag was having some Madoff investors stating major accounting firms signed off on Bernard's billions of dollars in fund's assets. In addition, the sheer fact that Madoff's investments were constantly beating the market while presenting an amazing, year-long track record of positive returns should have been enough to raise eyebrows among experts.

David Friehling, the only practitioner responsible for auditing BMIS admitted having never performed an audit on Madoff's fund since the audit firm "had sold their licence to Madoff more than 17 ago", according to SEC's New York Regional Office director James Clarkson (Azzim & Azam, 2016). On top of that, the auditor falsely stamped documents attesting to their supposed BMIS audit, stating the financials were complying with US GAAP and that the fund's internal control were in good shape. All this was done being fully aware that BMIS' investors would be relying solely on those pieces of information, wrongfully deceiving those who invested with Madoff and negatively affecting their decision-making processes.

To make matters worse, both Friehling and his relatives invested over ten million dollars with BMIS, violating AICPA's (American Institute of Certified Public Accountants) 2015 policy of forbidding accountants to audit companies with whom they invested. Friehling & Horowitz's arguable lack of ethics, failure to properly conduct the job they were hired for, clear conflicts of interest and lack of regulatory accountability leaves significant room for improvement, as well as a major lesson to be learned by auditors and the overall accounting profession.

3.6 – Lehman Brothers

Background

Lehman Brothers was established in the late 19^{th} century in 1850. As the investment bank's business grew, it became the US' largest underwriter of mortgage bonds (Onaran, 2008). Besides Lehman's investment banking activities and services, the company also played an important role in both buying and selling United States treasuries, acting as a primary dealer.

Ernst & Young and Lehman's Use of Repo 105

World-renowned accounting giant Ernst & Young independently audited Lehman Brothers from the turn of the century up to Lehman's bankruptcy in 2008. As the entity responsible for reviewing Lehman's financial statements, Ernst & Young's duties included complying with all professional and regulatory standards, ensuring Lehman's reporting complied with US GAAP, test internal controls and attest to the veracity of the information presented to stakeholders via the company's statements. While doing so, Ernst & Young would have had to apply the already discussed professional scepticism inherent to the audit and accounting profession. Auditors must pay extra attention to potential signs if fraud or material misstatements, ultimately providing an audit opinion and assurance to financial markets. According to Wiggins et al. (2014), the audit giant signed off on all of Lehman's financial statements up to the investment firm's demise in 2008. In an effort beyond Ernst & Young's job description as an auditor, the company also served as Lehman's trusted advisor in dealings beyond the firm's financial statements and compliance with accounting standards since they were aware of Lehman's complex and sophisticated businesses.

Repurchase agreements, commonly referred to as "Repos", are used by investment banks such as Lehman. Repos are used so that firms can meet short-term financing needs, ensuring short-term borrowing activities go smoothly and can be used to borrow funds against assets given as collateral. A few days after the transaction (funds in exchange of collateral assets), Lehman would repay the funds, reacquiring the assets given as collateral. These business transactions are typically registered as "financing". Even when assets are handed over to another entity as collateral, such assets still show up in Lehman's balance sheet due to it being registered as a "financing" activity (as opposed to a sale, in which the asset would be alienated). Assets and liabilities merely go under a few select changes, ultimately remaining the same as before. An obligation to repay the loan and repurchase the collateral is booked as part of the financing transaction.

By resorting to registering the transaction as a sale, the accounting treatment differs. In September 2000, the Statement of Financial Accounting Standards 140, referred to as SFAS 140, allow some repos to be registered as sales rather than financings when it came to the applicable accounting treatment. After SFAS 140 was approved, Lehman started studying and developing a way to benefit from the newly approved change in how repos could be reported from an accounting point of view. The solution found by Lehman was the infamous Repo 105, which earned its name due to it consisting of Lehman over-collateralizing repos at 105%, 5% over its obligation. Doing so allowed Lehman to register the repos as sales as opposed to financing. This allowed the investment firm to strategically use Repo 105 to conceal potentially undesirable assets from its balance sheet days before investor snapshots were taken.

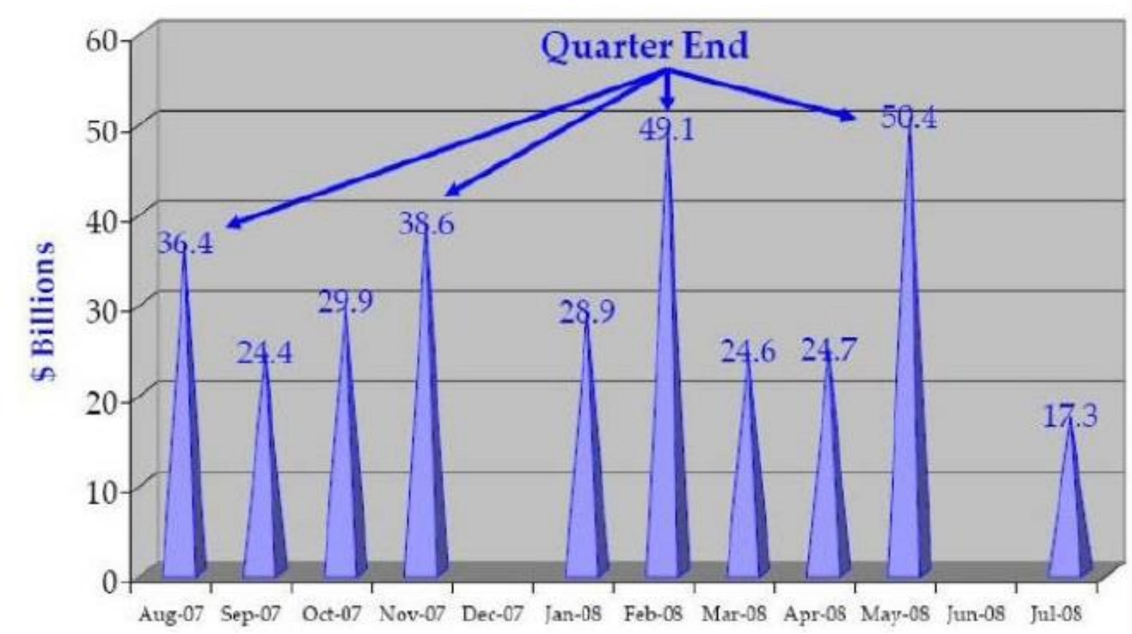
Repo 105 peak times of usage coincided with the period just before Lehman had to report its quarterly financials, as seen on Figure 5. By doing so, Lehman could deceive its stakeholders by temporarily hiding certain assets, which were repurchased days later due to it being a repurchase agreement. Lehman could then retract those securities given as collateral from its financial statements. In addition, the cash Lehman got from the repo after handing over the collateral assets was not registered as borrowings, neither was the increase in liabilities due to obligation generated by the repurchase agreement. Ultimately, Lehman was able to reduce its leverage using the aforementioned accounting tactics, which seemed to be insufficient to save the company from bankruptcy, which was filed in 2008 and arguably started the 2008 financial crisis and global recession.

There are still ongoing disputed regarding Ernst & Young's role in helping Lehman Brothers develop the Repo 105 mechanism, as the company specialized on those matters, hence it the being one of the Big 4 accounting firms worldwide. Ernst & Young claims to have had no role in advising Lehman during the development of Repo 105, which contrasts to claims made by former Lehman employees. Some of those people recall discussing Repo 105 with Ernst & Young's accountants. Despite those rumours, it is known Ernst & Young eventually became aware of Lehman's use of Repo 105 and engaged in various discussions with the investment firm on that matter. Nevertheless, it is only fair to question the audit giant's way of handling the Lehman case, as some red flags came about when investigating Repo 105 transactions.

To start, Repo 105 transactions were oddly expensive since they required a UK law firm's approval letter due to no US companies being willing to approve Lehman's use of Repo 105. Ernst & Young also defended that its professional obligation was to verify the correctness of reporting of Repo 105 transaction, not its purpose nor agreement with the practice. The audit firm claimed its obligations did not include investigating the timing nor volume of those transaction, which Lehman strategically performed just before quarterly reports. Lehman's use of Repo 105 escalated in both 2007 and 2008 due to the firm's inability to liquidate toxic mortgage-backed securities to anything near their original book value.

As Figure 5 shows, Lehman's use of Repo 105 during both 2007 and 2008 escalated to the astounding value of $50Bn, enabling the investment firm to temporarily hide those securities from the market. Ultimately, Ernst & Young audited Lehman's Repo 105 documents and transaction, met with Lehman personnel on various occasions, but failed to further inquire the company on how it decided on treating Repo 105 transactions under SFAS 140. In addition, Ernst & Young also failed to apply the typical auditors' "professional scepticism" when analysing Lehman's use of Repo 105 on certain periods and in unusual volumes.

Figure 5 - Lehman Brothers' Strategic Use of Repo 105, Aug. 2007 – Jul. 2008



Source: Examiner's Report, Vol. 3, pp. 875.

3.7 - Satyam

Background

Satyam Computer Services Limited was started by Ramalinga Raju in 1987 and headquartered in Hyderabad (India). Having started with only twenty employees, the firm quickly grew into a global business (Bhasin, 2013). Core activities included IT process outsourcing catering to various industries. Satyam's success was a national pride in India, proving the county's economy was in a growing state.

By 2003, Satyam employed over 13,000 associate that served hundreds of clients worldwide. The booming IT industry helped Satyam as the industry was estimated to be worth $400Bn and was growing at a compound rate of 6.4%. To ensure the company kept growing, a variety of growth strategies was though out so that Satyam would remain competitive. From 2003 up until 2008 Satyam grew immensely and satisfied investors in practically every financial metric they could be concerned about. By early 2008, Satyam had grown to an astounding $2.1Bn. Annual compound growth was at 35%, operating profits were up 21%. Earnings Per Share (EPS) followed suit, having grown from \$0.12 to an incredible \$0.62, showing a compound growth rate in the order of 40%. In the beginning of 2003, Satyam's stock peaked after experiencing a 300% growth over the past five years. The IT giant was a super-star company, which pleased investors and other stakeholders as it constantly beat expectations. Satyam went on to win numerous awards regarding its innovation, corporate governance and accountability. In 2007, the founder of Satyam, Ramalinga Raju was awarded the "Entrepreneur of the Year" award by audit firm Ernst & Young. Other awards included MZ Consult's "Leader in India in Corporate Governance and Accountability" in 2008. Still in 2008, Satyam was awarded with the "Global Peacock Award" by the World Council for Corporate Governance. However, things were too good to be true. Five months later, "India's Enron" was revealed and rocked the IT giant's entire functioning due to the sheer size of the accounting fraud that took place.

Accounting Scandal

In January of 2009, Ramalinga Raju sent a letter to Satyam's Board of Directors informing them of the manipulation he had been responsible for several years up to that time. Raju admitted to having overstated assets on the company's books by close \$1.5Bn. Around \$1Bn in loans and cash reserves were completely made up. In addition, the company also understated liabilities in its statements. Pressured to meet stock analyst expectation, Satyam artificially increased stated income for years on end. An example was October 2009´s statements which showed overstated revenues by 75% and profits by close to 100%. Raju and the firm's audit team used a variety of techniques to cook the books. Raju himself fabricated bank statements, faked bank accounts all in order to boost Satyam's balance sheet with balances that did not exist. Those fake accounts were also fraudulently used to justify additional interest income in the income statement. In what came as a surprise, Raju admitted to also creating thousands of fake salary accounts which he used to take possession of the money deposited in those phoney accounts. Satyam's head of the internal audit department assisted Raju by creating thousands of fake client identities and respective invoices used in inflating revenue. After a series of complications and potentially shady business deals in which Satyam was close to buying companies in which Raju and his family members had a stake in, investment bank Merrill Lynch blew the whistle after finding financial irregularities. This resulted in Raju resigning in January 2009 and fully admitting the company had falsified financial statements and notifying India's financial equivalent of the SEC, the Security and Exchanges Board of India (SEBI).

Role of Auditors

Satyam's external auditor was heavily criticized for failing to detect the fraud at Satyam. The audit firm audited Satyam from June 2000 up until the fraud was discovered in 2009. The company signed off on Satyam's financial statements, which meant they were also responsible for what was reported according to the Indian legislation. An item that raised concerns was the $1.04Bn Satyam reported having and categorized as bank deposits that generated no interest. As some accounting experts have argued, any company with such cash reserves would either invest it or return it to shareholders. The fact that Satyam apparently chose to keep things the way they were should have raised alarms over at the audit firm, which would then start a further investigation and testing on that matter. In addition, it appears the auditors did not check with any banks whether Satyam's deposits existed. Satyam was able to perpetrate fraud over many years without the auditors finding out.

Every time the company wanted to manipulate its balance sheet and income statement, it would simply create fictitious entities without any eyebrows raised by the auditors. The fact that Satyam paid the audit firm twice as much as all other audit companies were charging gave room for speculation regarding the firm's possible awareness of the fraud and lack of action nonetheless. The audit firm audited Satyam for nine years and failed to discover any evidence of fraud while Merrill Lynch discovered some red flags in a mere ten days when doing its due diligence on Satyam. This would suggest the auditors may have been in collusion with Satyam, which would explain the lack of rigorous audits and failure to detect fraud, as well as the suspiciously high payments made by Satyam.

3.8 - Toshiba

Accounting Fraud and Subsequent Backlash

Japanese company created in 1875. Became a "real company" in June of 1904. Manufacture and sell electronics and energy products. Around 200,000 employees worldwide (2017) Ranked #9 for good corporate governance (2013).

The global financial crisis of 2008 reduced Toshiba's profitability. This pushed employees to inflate and boost profits, even if artificially or fraudulently. These methods included booking future profits early, pushing back losses and other charges/expenses and misevaluation of inventory. Overall, Toshiba overstated profits by $1.2Bn from fiscal year 2008 to the first three quarters of fiscal year 2014. Another report states that profits may have been overestimated by around $2Bn. Three different CEOs involved in fraud. Atsutoshi Nishida, who served the company from 2005 to 2009, succeeded by Norio Sasaki, who served for the following five years up until 2013. It was then that Hisao Tanaka served the company as CEO up until 2016, when Tanaka resigned after the accounting scandal unfolded before the public eye. All three were accused of over pressuring managers to achieve results impossible to get without committing fraud. They were accused of promoting a corporate culture that accepted and promoted fraud.

Toshiba's case serves as a good example of application of the Fraud Triangle Theory since it allows for the categorization of the three pillars of the theory. Starting with the Opportunity pillar, the lack of internal controls incentivized employees to engage in fraudulent acts. Regarding corporate governance, the CEO's tone most likely made it easy for fraud to occur since the ends seemed to justify the means. This connect to the second pillar, Pressure. The corporate culture fostered at Toshiba at the time meant that employees were expected to achieve extremely ambitious and complicated profits, truly difficult to obtain without resorting to fraud. In addition, Toshiba's leaders created challenges aimed at motivating employees to overachieve to the point where the objectives were unrealistic. The pressure to succeed and impress the superiors lead employees to engage in fraudulent practices, their goals would be achieved through any means necessary. The last and third pillar, Rationalization was explained by the reputation hit Toshiba would suffer if disastrous results were presented to the public. This may have served as a rationalization for committing accounting fraud – it was being done for the greater good, the company's wellbeing and sustainability.

As a result of the accounting fraud, stakeholder trust was negatively impacted, resulting in a 40% drop in Toshiba's stock following the public release of the fraud. Lawsuits started filling the company's offices along with around $3M in damages from the falling stock prices. As Toshiba's financials were far from ideal, around 35,000 employees were let go after the scandal and Toshiba had to withdraw from the Japanese stock index as a result. The company had to cut 30% of their Consumer Electronics jobs and had to sell their Indonesia plant. Overall, stakeholders ranging from investors to consumers lost trust in Toshiba, impacting the company's bottom line and decade-long reputation in Japan and worldwide. In response to the scandal, Toshiba strengthened its internal controls, implemented tighter budgeting rules, reviewed its financial reporting mechanisms and processes, and created both an Audit Division and Audit Committee.

4. – Audit Reforms

4.1 – US Sarbanes-Oxley Act of 2002

Following large financial accounting scandals, such as the Enron and Worldcom scandals, the United States congress passed the Public Company Accounting Reform and Investor Protection Act of 2002, also referred to as Sarbanes-Oxley (SOX) Act on July 25, 2002. By that time, a fall of 40% had rocked stock indices of major public companies on the preceding 30 months (Coates, 2007). The public was tired of headlines covering prominent companies getting involved in financial scandals, bankruptcies and other wrongdoings. Prime examples of such headline makers are household names including Enron, Sunbeam, Tyco, Worldcom and Xerox.

The increase of accounting restatements - in which companies would correct past financial statements – were taking a greater toll on the market and in its overall size. This raised alarms with the United States government, as mostly all Americans owned stocks whether it be through pension and retirement funds or directly investing in such financial instruments. This tailor-made legislation aimed to improve audit quality, increase market trust in the audit industry -which was severely hindered by the early 2000s scandals- and make C-level executives accountable by making them sign off financial statements. Such did not happen prior to the Sarbanes-Oxley Act, as Jeffrey Skilling, Enron's CEO at the time of the scandal, testified before the United States congress excusing himself from any accounting wrongdoings. At the time, CEOs were able to avoid prosecution since they were not required to personally sign and approve financial statements, they would just manage and run the company.

As stated by Coates (2007), the Sarbanes-Oxley Act "was designed to fix auditing of U.S. public companies". These events were triggered by the notion, at the time, that "auditing had been working poorly". Both Wall Street investors and investors agreed on passing the legislation to create an entity that would supervise, monitor and regulate the auditing market. From that agreement and passing of the Sarbanes-Oxley Act, the Public Company Accounting Oversight

Board, commonly referred to as PCAOB), was created as a watchdog, the audit market version of the SEC (which kept overseeing public companies).

The Public Company Accounting Oversight Board (PCAOB) is the audit firms' watchdog. Before the PCAOB was created, audit firms were basically self-regulated. The PCAOB is responsible for handling Registration, Monitoring, Standard-Setting and Enforcement. If an auditor has, at least, one publicly traded client, they must register with the PCAOB, which will then monitor them by periodically reviewing samples of their audits to make sure everything is legitimate and transparent.

The PCAOB started out by calling on auditors to enforce existing laws fighting theft and fraud by corporations. On top of that, the way auditors conducted business with their clients, their relationships and hiring of non-audit services were rethought. Audit rotation was a Sarbanes-Oxley practice that forced companies to rethink their partnerships, since some firms had worked with the same auditor for decades. Firm were mandated to switch auditors after five years to avoid potential wrongdoings due to eventual illegal deals between auditor and customer. The conflict of interest of doing non-audit work for audit clients was also targeted by the Sarbanes-Oxley Act, which banned audit firms from selling customers such services. As audit firms were being paid, let's say, $10 million from their Advisory services, maybe they would turn a blind eye when auditing a client to keep that account and profit from the lucrative Consulting deals, while keeping Audit as their bread-and-butter.

Section 404

In a nutshell, companies were upset with Section 404 since it meant they would have to invest lots of money in monitoring its internal controls both internally and by having to hire an external, independent auditor. From the audit firms' side, this brought them more business and increased fees charged to their clients. Due to section 404, companies were also mandated to assess the effectiveness of their internal controls and report on its findings. Having the internal controls was not sufficient. If any issue is found, the company must report it.

Auditors must implement quality control. If the company is editing a publicly traded client, they will be subject to additional scrutiny. In addition, a second partner must review and approve audit reports when working for a publicly traded company. Those two partners must mandatorily rotate every 5 years to avoid developing too close of a relationship with the client's management, which could result in favours or conflicts of interest. Audit firms also must audit the client's internal control and issue a report on its findings, which check the client's internal control checking. In a nutshell, Section 404 has earned its infamous reputation among companies due to increased costs and time spent on the additional control checking imposed by the Section. With management being required to assess and report on the effectiveness of their firm's internal controls and compliance systems on an annual basis, costs are likely to increase. Adding insult to injury, external auditors must be present when these assessments and reports are being conducted and produced to ensure proper assurance.

4.2 - Global Ripple Effect of SOX

The Sarbanes-Oxley Act of 2002 served as an inspiration to major regulatory reforms on a global scale, ranging from Europe to Asia in the forms of the European Audit Reform, the UK's Companies Act 2004 & 2006 and China's Basic Standard for Enterprise Internal Control.

The European Audit Reform (EAR) is commonly referred to as the European version of the Sarbanes-Oxley Act of 2002. As thoroughly explained by Afterman (2016), in April 2014 the European Union (EU) approved legislation aimed at reforming the statutory audit market. Statutory audit is mandatory by law, mostly affecting publicly listed companies since those are under higher stakeholder and regulatory scrutiny. These audits must be conducted by an external auditor. The European Audit reform is composed of both a regulation and a directive, affecting around thirty-thousand public-interest entities (PIE) in the EU. The main provisions of the EAR include increasing the responsibilities of the audit committee regarding oversight of statutory audits, introducing new auditor reporting requirements, imposing mandatory auditor rotation after a set period and limiting the fees charged for permitted non-audit services. The concept of a "joint audit" is also mentioned in the EAR when discussing possible extensions of the standard ten-year audit firm rotation to longer periods, up to 24 year in the case of the aforementioned joint audits.

The restriction of non-audit services comes as a response to the major public accounting scandals in which auditors were driven to upsell consulting and other services to their audit clients due to the increased profitability of those non-audit services. Services that can no longer be performed by auditors to PIEs include tax and tax compliance, corporate finance and corporate valuation, financial statement preparation and design of internal controls or risk management mechanisms. The latter also applies to IT systems.

Financial Times' Tim Sutton (2019) suggested that, had the UK implemented a piece of regulation like the Sarbanes-Oxley Act of 2002, the known Patisserie Valerie accounting scandal, in which the company fabricated thousands of ledger entries, would have been spotted earlier on that when it was. Cases such as Patisserie Valerie's continue to rock the UK audit market, which is seeking inspiration from regulations such as the US Sarbanes-Oxley Act, namely the infamous Section 404.

In China, the Basic Standard for Enterprise Internal Control (Basic Standard), referred to by some as "China SOX" (Lu & Ma, 2017) is China's version of the US Sarbanes-Oxley Act of 2002, issued in 2008 and with supporting guidelines in 2010. The Basic Standard mimics the US's regulation in various aspects, hence the nickname "China SOX." Its aim was to improve financial reporting quality and effectiveness of internal controls checking, ultimately reducing risks for stakeholders and other companies. Even though China is known for being years behind the United States when it comes to internal control checking and financial reporting, Basic Standard is a step forward and contributes to the development of Chinese accounting and audit practices. China SOX is seen as an important step in the further development of China's enterprises' internal controls and corporate governance.

5. Discussion & Conclusion

5.1 - Reactive SEC

It is known that most accounting and overall financial scandals have taken place in the United States, under the SEC's supervision and regulation. Known to be a fierce financial watchdog, the Securities and Exchange Commission has gained a global reputation due to thoroughly investigating companies operating in the US. Having carried out major investigations, some of them resulting in incarceration of the masterminds behind significant scandals, such as Bernard Madoff, who was sentenced to 125 years in prison. Even to this day, the Madoff Victim Fund is working towards recovering as much capital to Madoff's victims. This raises the question of whether the SEC is truly effective in detecting, investigating and punishing offenders or if the

Commission's reactiveness (as opposed to a preventive behaviour) keeps them stuck in a vicious cycle of scandal after scandal happening in the US. Taking Enron's case, for example, the SEC was permissive to the point where they allowed Enron to apply mark-to-market accounting to an unprecedented asset class – energy futures contracts. It can be said that the SEC's greenlight regarding the use of mark-to-market accounting in Enron's case was a catalyst towards the demise of both Enron and Arthur Andersen.

The capitalist nature of the United States promotes innovation, pushes boundaries, especially in the financial era. Take Enron's use of mark-to-market accounting for energy futures. The SEC approved it despite it being totally unheard of. In WorldCom's case, only when strong evidence of fraud was revealed did the SEC demand a restatement of financial from the company. Both these companies were able to sustain fraudulent practices for years before the SEC got involved. While insiders knew, some of them even shared their concerns with the upper management of their company, it all happened under the SEC's watch. Take the introduction of the Sarbanes-Oxley Act. A case can be made for those claiming the US Government and the SEC were reactive to the scandals than preventive. SOX was approved after two of the biggest bankruptcies in the United States rocked the financial world, causing billions of dollars in losses to shareholders and those caught in the crossfire.

This act made clear that both the CEO and CFO had to sign-off and verify the veracity of their company's financial statements. This would make them accountable and would prevent executives from using Enron's Skilling and Ken Lay's excuse of "just managing the company, not the numbers and accounting parts." In addition, those caught in accounting scandals would get enhanced criminal penalties since both the CEO and CFO signed-off on the statements. The "I'm not an accountant" line did not work anymore. Criminal charges are worsened if they are caught destroying documents and other important evidence – this applies to audit firms too.

The crisis theory in regulation helps explain the set of factors that prevent authorities and regulators such as the SEC from acting before major scandals take place. These entities' lack of information compared to the information held by companies prevents regulators from being proactive. In countries where this happens, regulatory systems do not seem to develop as time goes by. It ultimately comes down to a game of cat and mouse, where fraudsters play the mice and authorities in the likes of the SEC play the cat in a never-ending cycle. As time goes by, ways of committing fraud evolve, perpetrators innovate, and authorities are then tasked with investigating these often-complex organizational fraud networks.

5.2 - Groupthinking

Corporate culture seems to be one of the common denominators between some of the world's largest corporate frauds and consequent bankruptcy, namely Enron and Worldcom. Whether it be Enron's macho-man culture that idolized the managers and board, who famously went on extreme sports vacations, intimidated those who tried to stand in their way and disregarded commonly accepted and respected rules, or WorldCom's managers who threatened to throw subordinates out the window, corporate culture played an important role in how these scandals went down. The type of behaviour displayed by WorldCom executives towards auditors set the tone for how the company resisted cooperating with Arthur Andersen when questioned about its finances and suspicious transactions. Groupthink is known to affect corporations both positively and negatively. On Andersen's case, the company's "Think straight and talk straight" served a symbol of pride to those working for the reputable and, at the time, most prestigious of the Big 5 accounting firms.

Andersen's corporate culture lead them to expand internationally and consolidate the firm's global prestige amongst rivals and potential clients. As the company expanded internationally and acquired clients such as Enron and Worldcom, the stakes were high and Andersen staff were incentivised to turn a blind eye to some suspicious activity due to the sheer size of these customers. Andersen themselves knew the pair was in the high-risk profile as the groups' internal risk assessment department performed such an analysis. Despite those efforts, seemingly toxic corporate cultures often featuring intimidation tactics and macho-men, idolizing the C-Suite executives' practices, even prestigious Arthur Andersen's decade-long reputation was thrown to the ground, leading the company to bankruptcy and the fall of one of the "Big 5."

5.3 - The "Big 4" Accounting Firms

Accounting scandals have resulted in efforts towards "taming" the big auditing firms, namely the Big 4. Those efforts include approved regulation such as the Sarbanes-Oxley act of 2002, the European Audit Reform, which forces companies to switch auditors every set number of years (depending on the country) to prevent companies and auditors from getting too comfortable. Allowing them to do so could increase the chance of fraud occurring due to the opportunity provided by the year-long (and maybe even decade-long) relationship both firms would develop throughout the years. Just as it happened with Arthur Andersen, being too friendly or simply turn a blind eye to what one's clients are doing, despite it maybe being against the law, can bring terrible consequences to those who develop such firm-client relationships. All Big 4 accounting firms - Deloitte, EY, KPMG and PwC- have been involved in scandals over the last decade, even after stricter regulation was approved and implemented. Accounting giant KPMG was recently fined $50 million in the US for taking advantage of stolen regulator documents that described what they would be searching for when auditing the accounting firm.

In the UK, politicians at the House of Commons have been pushing for a so-called "break-up" of the Big 4 to prevent further scandals and wrongdoing (Marriage, 2019). The audit market has suffered due to conflicts of interest, poor audit quality and regulators lacking resources and/or will to investigate those matters. The future seems to be headed towards an operational split of the Big 4, in which the Big 4 would split their audit businesses into separate legal entities. Going through with this operational split would remove the incentive audit firms currently have of potentially overlooking some client wrongdoing so that they can keep selling their consulting services to that same client. Another added benefit of this break-up would be cultural, as auditors tend to be more sceptical and consultants tend to be more client focused. Measures such as these would ideally increase auditor independence, transparency and overall audit quality. While these firms remain as the top contenders in the industry, it is most likely going to be a complex task on the regulators' end to effectively break-up the Big 4 oligopoly currently dominating the audit and assurance industry.

United Kingdom's Competition and Markets Authority (CMA) proposed in late 2018 that the Big 4 should leave some room for rival audit firms to operate in the listed companies audit market, namely the FTSE 250. The Financial Reporting Council reported that, in 2017, the Big 4 dominated just under 100% of the FTSE 250 audit market, leaving little to no room for competitors such as BDO to gain market share. As of 2017, only 7 of the 250 FTSE 250 audits were performed by non-Big 4 firms. In response to the CMA's proposal of an operational split, both EY and PwC shared sceptical opinions, stating that such a spilt would be radical and should not happen simply due to a market study that was conducted. Audit giant PwC defended such a "intrusive and disproportionate" set of measure would be unprecedented. While the Big 4 seem to dislike the idea of a split-up, audit rival BDO seems to be in favour of creating separate legal entities for auditors.

Even when firms must switch auditors, a CMA report shows around 90% switch to another Big 4. And for those firms switching from a non-Big 4, they are very likely to switch to a Big 4. These firms should set the standard for the entire market by acting with integrity, transparency and fairness.

5.4 - Greed over Ethics

Greedy, money-hungry individuals and corporations are the common denominator among all accounting scandals analysed in this thesis. As both companies and regulators are pushing for further transparency in business, avoiding conflicts of interest via measures such as the Sarbanes-Oxley act of 2002, human greed never ceases to push the boundaries of creativity. This creativity is used by corrupt executives and other professionals to design the world's most innovative and often complex schemes to achieve their goals of fooling investors and regulators with fabricated books. While some of these "creative tactics" may be legal, most are a hair away from crossing into the realm of unlawfulness. Not to mention the lack of morals and ethics associated with the wide range of scandals presented in this thesis. Greed sees no culture, no nationality nor age.

Despite efforts being made on the part of regulators worldwide and public statements issued by companies supposedly tackling corruption and lacks of transparency, greed seems to usually take the upper hand. The *Big Four* have gradually been adapting to the ever-changing corporate regulatory environment and increased scrutiny by the general public since those same audit firms are now frequently features on news headlines worldwide. Having measures set in place such as the mandatory audit rotation after a set number of years (depending on each country) may have a deterring effect on overly comfortable auditor-client relationships, which can only benefit the industry.

It is now up to corporate executives at both the audit firms and their clients to stand for what is right and manage their companies accordingly. Otherwise, most of the progress achieved and sacrifices made throughout the last twenty-years (since the collapse of Enron and Worldcom) will have been for nothing other than smoke and mirrors to bait the general public and all other stakeholders who rely on audit firms' outputs to make sound financial decisions.

5.5 - Role of Auditors & Why Companies Hire Them

Often companies have an in-house accounting and auditing department which is responsible for preparing and monitoring financial reports (Squires et al., 2003). In addition to these internal auditors, companies resort to hiring external auditors. These are independent entities appointed by the company's board of directors, which is typically advised by the CFO (Chief Financial Officer), hired to double-check the work done by the internal financial staff, including fellow accountants.

Since US federal regulations were introduced in the early thirties that all public companies trading in are required to have a yearly external audit done to check their financials. This allows shareholders and even the management to be shielded from mismanagement of company funds and even fraud. These regulations were implemented as a reaction to what happened in the so-called "Roaring Twenties", during which speculation was rampant and managers were incentivized to inflate stock prices to finance speculative investments.

What followed those years was the 1929 financial markets crash, which triggered a ten-year depression. To avoid such an unfortunate set of events, companies were mandated to hire external auditors to ensure transparent and sound financial practices, as auditors would be checking the accuracy of the work of internal accountants. Having yearly external audit allows stakeholders, mainly stockholders, receiving annual reports on the company's financial situation as part of the annual report. Audit reports allow interested stakeholders to know the auditor's opinion regarding the accuracy of the internal documents prepared by internal auditors and accountants, in particularly financial reports.

External auditors check whether the company's financial statement comply with the Generally Accepted Accounting Standards (GAAS) and the Generally Accepted Accounting Practices (GAAP). In the audit reports, stakeholders can find critical statements made about the firm's financials, which helps investors assess financial conditions and improves their decision-making process. Although audit reports contain critical information about the financials of a company, it is important to keep in mind that auditors are not hired for their criminal investigation skills, which they possess none of.

According to ISA 240, the International Standard of Auditing with relates to auditors' responsibilities when dealing with fraud occurring within a financial statement audit, the objectives of audits are the following. First, identify and assess the risk of material misstatement of the financial statements due to fraud. Second, to obtain enough appropriate audit evidence regarding the assessed risk of material misstatement due to fraud, through designing and implementing appropriate responses. Third, to respond appropriately to fraud or suspected fraud identified during the audit. When investigating possible fraud and throughout the career of an auditor, internal controls are key to obtain reasonable assurance. Internal controls include having a senior sign off on expense reports, challenge abnormal expenses, have specific budget categories, segregate responsibilities, choose to perform random checks, foster a feedback culture. Other examples of internal controls may include a predefined number of signatures on a check before the payment is approved. Only a select number of people in the company would be able to sign-off checks over certain amounts, for example.

Despite an auditor's work being very extensive and thorough, most of it is quite routine. Auditors do not go into a client's office expecting to detect criminal activity as if they were in a crime scene. An auditor's work mainly revolves around checking key accounts such as Payables and Receivables and to assess whether the transactions corresponding to those accounts are being properly recorded and accounted for regarding consistency and appropriate. And, as common sense would have one think, auditors are not actively looking to find incriminating evidence on those who hired their services. They do not perform spying activities such as bugging phones, listening to private conversation nor investigate beyond their job description. Even during an auditor's daily tasks of checking transactions, some company's sheer size prevents accountants from individually checking each account.

As an alternative to that, auditors sample transactions and check if the processes applied to register and account for those samples is according to standards. If that appears to be the case, then the auditor can assume the company's accounting is okay. As an ex-Arthur Andersen said, auditors analyse a company's financial system to check whether it is secure or not. While these processes can be quite standardized and seemingly "black on white", there is still plenty of room for subjectivity and naturally occurring differences of opinion.

Accountants may disagree with a colleague's method of financial reporting, their opinions may differ when discussing how to calculate and report a company's financials. As one would expect, the number of different perspectives and option increases along with the growing complexity of a company's financial structure. For example, there are over 100,000 pages of rules on the Financial

Accounting Standards Board guidelines. Practically speaking, that means sometimes finding a rule to match a specific accounting problem can take quite some time due to it being such a lengthy process, subject to interpretation. While these apparently overcomplicated rules seemed to slow down the audit process and gave room to subjectivity, which complicates the accountant's profession, companies such as Arthur Andersen lobbied to keep things as they were. Andersen did so because their customers valued the flexibility given to them by those same lengthy and often confusing accounting rules and guidelines.

The audit work is evolving along with technological innovation, which may contribute to a more transparent, less prone to tampering working methods. Auditors are known to be more sceptical than management consultants, as they tend to have to play more a suspecting, detective-like role when working with clients. To ensure transparency and integrity, auditors should avoid getting comfortable with clients. Audit reforms implemented in the last decade, including mandatory auditor rotation for listed firms contributes towards achieving these goals of a fair, independent and transparent market, free of constraints such as conflicts of interest. The sheer size of fraud worldwide and the occurrence of such fraud on a global scale, as shown by the cases described in this thesis, ranging from the US to India and Japan, goes to show how important the role of an auditor truly is.

Fraud methods are constantly evolving, some may be boosted by the technological revolution the world is currently going through. As shown in this thesis, these methods can take any form and the fraudsters' creativity is the limit of how fraud can be perpetrated. Auditors and mainly regulators will always suffer from an information deficit on companies, which will always leave them a step behind criminals. Audit firms could further invest in improving how internal controls and financial statements are reviewed, improving the overall flow of information and transparency throughout the entire external audit process. Allied to strict regulators such as the SEC and PCAOB, the audit profession can help regain all trust lost in financial markets after the 21st century's largest financial scandals rocked the global economy while constantly reinventing its role in providing assurance to all stakeholders.

5.6 - Further Work

For those interested in subjects surrounding financial scandals, auditing, regulation and all the possible ramification of these topics, the following topics would benefit from further research. For example, the role of artificial intelligence and other technological innovations in the audit profession, and how it can be used to improve early detection of financial fraud. The effects of Sarbanes-Oxley Act of 2002 and other regulatory interventions on audit quality. Along these lines, it is also important to study the effects of audit reforms in the audit profession and the requirements imposed to audit professionals. Finally, understanding the benefits and costs of implementing legislation and regulation to prevent fraud and misreporting is another important field of research.

Regarding fraud and financial accounting scandals, one could investigate the effects of such scandals on foreign investment across-countries. In addition, the legal consequences for fraud perpetrators and accomplices before and after the introduction of the US Sarbanes-Oxley Act of 2002 should interest those working in the field. Knowing how national and organizational culture affect the possibility and occurrence of fraud is relevant to understand the factors triggering unethical behaviors.

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