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An examination of the fraudulent factors associated with corporate fraud

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AN EXAMINATION OF THE FRAUDULENT FACTORS ASSOCIATED WITH CORPORATE FRAUD

by

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ABSTRACT

Between the years 1998 and 2002, the United States suffered a time in which several large companies engaged in fraudulent behavior which eroded investor confidence in the stock market and to some extent destabilized the economy. Audits, which were conducted to assess the validity and reliability of a company's financial statements, were not detecting the material misstatements in the statements. As a result, both the US Government and the accounting profession needed to come up with a way to prevent these immense frauds from occurring in the future. As a response to these large frauds, in 2002, the US Government passed the Sarbanes – Oxley Act of 2002 (SOX) and the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards No. 99(SAS No. 99) to improve investor confidence and the auditing function's ability to detect material frauds.

The intent of this thesis was to look at the fraudulent factors associated with several recent corporate frauds and compare them to the standards set by SAS No. 99. Through the analysis conducted, this thesis looks at the relationships between pressures, opportunities, and rationalizations made during the act of fraud.

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INTRODUCTION

Between the years 1998 and 2002, the United States suffered a time in which several large companies engaged in fraudulent behavior which eroded investor confidence in the stock market and to some extent destabilized the economy. Audits, which were conducted to assess the validity and reliability of a company's financial statements, were not detecting the material misstatements in the statements. As a result, both the US Government and the accounting profession needed to come up with a way to prevent these immense frauds from occurring in the future. As a response to these large frauds, in 2002, the US Government passed the Sarbanes – Oxley Act of 2002 (SOX) and the American Institute of Certified Public Accountants (AICPA) issued Statement on Auditing Standards No. 99 (SAS No. 99) to improve investor confidence and the auditing function's ability to detect material frauds.

Sarbanes – Oxley Act of 2002 (SOX)

Enacted on July 30, 2002, SOX was a gubernatorial reaction to the then recent accounting frauds taking place at some of the nation's largest public companies; such as Enron, Adelphia, and WorldCom. SOX contains 11 titles that mandate specific financial reporting. A complete list of the sections within each title can be found in appendix A (Law).

Title I: Public Company Accounting Oversight Board (PCAOB)

As SOX only pertains to publicly held companies, the PCAOB was established to provide independent oversight of public accounting firms that provide public auditing services to companies. In addition, Title I creates a central oversight board in charge of regulating auditors by registering auditors, defining specific procedures for audits, quality control, and enforcing SOX on the auditors.

Title II: Auditor Independence

In order to limit conflicts of interest, Title II establishes standards for external auditor independence by preventing auditing companies from providing non auditing services such as tax and consulting to the same client.

Title III: Corporate Responsibility

Title III mandates the senior executives of publicly held corporations to take individual responsibility for the accuracy and completeness of their corporate financial reports, therefore circumventing a part of the *limited liability* associated with corporate ownership. This is done by the company's CEO personally certifying and signing that to the best of his/her knowledge there is integrity in the company's financial reports.

Title IV: Enhanced Financial Disclosures

Title IV of SOX escalates the requirements for reporting both on and off balance sheet transactions as well as stock transactions of corporate officers to prevent insider trading. Title IV also requires timely reporting of an entity's financial position.

Title V: Analyst Conflicts of Interest

In order to restore market confidence in analysts Title V establishes codes of conduct for securities analysts and also mandates full disclosure of any conflicts of interest that may arise.

Title VI: Commission Resources and Authority

Title VI gives the Securities and Exchange Commission (SEC) the power and authority to bar professionals such as dealers and brokers from their practice

Title VII: Studies and Reports

Title VII requires the SEC to perform studies on the securities violations and enforcement actions as to whether others have manipulated either their earnings or their current financial position.

Title VIII: Corporate and Criminal Fraud Accountability

Also known as the "Corporate and Criminal Fraud Accountability Act," Title VIII enumerates the specific punishments and penalties associated with fraudulent behaviors or behaviors that interfere with federal investigations. Title VIII also provides certain protection for whistleblowers within a corporation.

Title IX: White Collar Crime Penalty Enhancement

This title increases the criminal punishments for white collar crimes and conspiracies. With this title, failures to certify corporate financial reports are now a criminal offense.

Title X: Corporate Tax Returns

Title X mandates that the Chief Executive Officer sign the corporate tax return.

Title XI: Corporate Fraud Accountability

Title XI classifies fraud as a criminal action and assigns harsher punishments to particular actions included in corporate fraud and record tampering.

Statement of Auditing Standards Number 99 (SAS No. 99)

In 1997, SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, was adopted in order to clarify the auditors' responsibility to detect fraudulent behavior. In October of 2002, SAS No. 82 was revised by the Auditing Standards Board of the American Institute of Public Accountants (AICPA) to form SAS No. 99, which became effective for all audits as of December 15, 2002. SAS No. 99 was, similarly to SOX, issued in part due to the then recent accounting scandals at several major publically traded companies such as Enron, Adelphia, WorldCom, etc (Romney, Marshall; Steinbart, Paul). SAS No. 99 requires auditors to:

- Understand fraud in order to effectively perform a thorough audit.
- Discuss the risks of material fraudulent misstatements.
- Obtain information. The auditors must gather evidence about the existence of fraud by looking for fraud risk factors, testing company records, and interviewing management about any potential past or current fraud.
- Identify, assess, and respond to risks using the information obtained from management.
- Evaluate the results of their audit tests and if there are any discrepancies, determine the impact of this on the financial statements and the audit.

- Document and communicate findings to management and the audit board in order to seek remedies.

- Incorporate a technology focus. SAS No. 99 recognizes the impact technology has on fraud risks and provides commentary and examples specifically recognizing this impact. It also notes the opportunities the auditors themselves have to use technology to detect fraud.

SAS No. 99 requires that auditors consider two types of misstatements—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets—while assessing the risk of fraud (AICPA 2002). Additionally SAS No. 99 requires the auditors to consider the risk of fraudulent financial reporting and misappropriation of assets in context of the pressures, opportunities and rationalizations experienced by the management of a company as a whole. The following sections will give a more detailed explanation of the fraud risk factors and different types of frauds mentioned by SAS No. 99 (American Institute of Certified Public Accountants).

Parts of the Fraud Triangle

Pressure

A pressure is a person's incentive to commit a fraud. Frauds can be committed by either an individual against the greater corporation or the corporation can themselves commit the frauds.

From a personal standpoint the first type of pressure is financial in nature and can be caused by an increase in expenses through lifestyle changes, having heavy losses, or being engulfed in debt. The perpetrator often feels that such pressures cannot be shared with others and believes that to commit the fraud is the only way to get out of their difficult situation.

Also, many people who commit these frauds are disgruntled employees who have a strong feeling of resentment towards their employer. These employees feel that they are owed something more for their work and are pressured into getting what they think is rightfully theirs.

SAS No. 99 defines four common corporate fraud pressures (Appendix to SAS No. 99).

1) Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Significant declines in customer demand and increasing business failures in either the industry or overall economy
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
- Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
- New accounting, statutory, or regulatory requirements

2) Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages

- Need to obtain additional debt or equity financing to stay competitive-including financing of major research and development or capital expenditures

- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements

- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

3) Information available indicates that management or the board of directors' personal financial situation is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity

- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow (1).

- Personal guarantees of debts of the entity

4) There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.

Opportunity

Once some sort of pressure, or need, exists an opportunity must arise for the person to commit the fraud or else it will likely never occur. Some examples of an opportunity include nonexistent or ineffective control systems in place to check financials, a person's ability to override any controls that are in place, being the last in line to check the figures, or having great managerial power that supersedes any other person in ones direct chain of command. Opportunity is the condition or situation that allows a person or organization to do three things:

- Commit the fraud
- Conceal the fraud
- Convert the theft or misrepresentation into personal gain

As alluded to above, someone will not commit the fraud if they think they cannot get away with it (Romney, Marshall; Steinbart, Paul).

From a corporate standpoint SAS No. 99 provides four deficiencies within a company that can provide an opportunity for fraud to occur (Appendix to SAS No. 99).

1) The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm

- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions

- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate

- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions

- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist

- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification

2) There is ineffective monitoring of management as a result of the following:

- Domination of management by a single person or small group (in a nonowner-managed business) without compensating controls

- Ineffective board of directors or audit committee oversight over the financial reporting process and internal control

3) There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity

- Overly complex organizational structure involving unusual legal entities or managerial lines of authority

- High turnover of senior management, counsel, or board members

4) Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)

- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff

- Ineffective accounting and information systems, including situations involving reportable conditions

Rationalization

Once an opportunity exists for the fraud to be perpetrated one would need to rationalize to oneself that what they are doing is not wrong. While there are obviously some individuals out there that have a certain ethical values that enable themselves to intentionally commit these acts, more often than not this is not the case. Assuming that for the majority of employees Douglas McGregor's theory Y is true, the theory that states that employees are inherently good in nature and exist in a climate of trust, a person will not commit a fraud even if they have a pressure and the opportunity to do so if they believe that what they are doing is wrong in nature (McGregor). The larger the pressure that exists on someone, the larger the likelihood that the otherwise honest person will be able to rationalize the social acceptability of the event. Common rationalizations made include:

"I'll pay the money back"

"It's only a loan"

"I'm due this from before"

"Others are doing it"

“What I’m doing is not that bad”

“It was for a good cause”

“I'm above the rules”

Types of Fraud

Fraudulent Financial Reporting

As defined by SAS No. 99, there are two types of misstatements that constitute fraud. The first of which is those arising from fraudulent financial reporting (FFR). These are intentional omissions of a material amount that are designed to deceive the users of the financial statements, included are the owners and investors or potential investors in the company as well as a government authority. However, often times the occurrence of FFR is not intended to be a grand scheme to avoid taxes, but rather to cover up some sort of prior event misstatement that would be viewed negatively on the financial statements. The perpetrator of this offense generally reasonably expects to correct this misstatement when business improves. As illustrated by SAS No. 99, FFR can be accomplished through:

- Manipulation, falsification, or alteration of accounting records
- Misrepresentation or intentional omission from the financial statement events or transactions
- Intentional misapplication of accounting principles not in adherence to GAAP.

Misappropriation of Assets

The second type of fraud as defined by SAS No. 99 is misappropriation of asset (MOA) cases.

MOA involves theft of assets that creates a valuation difference on the financial statements.

The most common forms of MOA include:

- Stealing assets from a company
- Falsifying purchase orders and receiving orders
- Embezzling

INSTANCES OF FRAUD

SAS No. 99 defines two types of frauds that can be committed, fraudulent financial reporting (FFR), which is the intentional omissions of a material amount that are designed to deceive the users of the financial statements, and misappropriation of assets (MOA), the theft of assets that creates a valuation difference on the financial statements. Secondly, SAS No. 99 identifies the three points in the fraud triangle needed for a person to commit a fraud: pressure, opportunity, and rationalization. In the below section, several instances of fraud will be studied in order to examine how the two types of frauds mentioned by SAS No. 99 and the fraud risk factors manifest themselves in actual instances of major frauds.

Enron Corporation

History of the Corporation

Enron Corporation (Enron) was incorporated in 1985 after the merger of Northern Natural Gas Company and Houston Natural Gas, at which time the headquarters were moved to Houston Texas from Omaha Nebraska at the urging of new CEO, and former Houston Natural Gas CEO, Kenneth Lay. Originally a natural gas pipeline company, management saw trends in the industry that often had a lot of uncertainty as to the future, causing prices to peak and valley. Enron became an intermediary between the pipeline companies and the gas suppliers to help stabilize gas prices. This eventually became what Enron did as a business, becoming a trading and financial services company instead of a traditional pipeline company. From 1996 to 2001, Enron was named “America’s Most Innovative Company” by Fortune Magazine as well as one of the “100 Best Companies to Work for in America.”

In 1990, Andrew Fastow was hired as the Chief Financial Officer. During his tenure Fastow set to work establishing several Limited Liability Special Purpose Entities, enabling Enron to place its own liability on these subsidiaries so that they would not appear on its own account, allowing Enron to maintain a good credit rating and high stock prices. At its highest, Enron’s stock prices reached roughly $90 per share with a net worth of about $60 billion.

However, after years of creating these faux Special Purpose Entities, the public opinion of Enron collapsed in late 2001. Arthur Anderson, then a member of the “Big Five” accounting firms, reported a non GAAP net income of $393 million, while their GAAP net income showed an actual loss of $644 million. Within weeks the values of their shares were down to a mere 25 cents and Enron filed for bankruptcy.

<u>Explanation of the Fraud</u>

Fraudulent Financial Reporting

During Fastows tenure as Enron’s CFO, many Special Purpose Entities were created. The purpose of these entities is meant to help subsidize the parent company if a particular service is not reasonably provided in their market. Enron did not use them for this purpose, however. Enron would make deals with its Special Purpose Entities that would actually transfer a greater amount of liabilities to the subsidiaries than assets as would be expected in this kind of activity, resulting in the Special Purpose Entity's financials to suffer while improving Enron's.

In 1999, Enron launched EnronOnline, an internet-based trading operation, which was used by virtually every energy company in the United States. Enron President and Chief Operating Officer Jeffrey Skilling began advocating a novel idea: the company didn't really need any "assets." By pushing the company's aggressive investment strategy, he helped make Enron the biggest wholesaler of gas and electricity, trading over $27 billion per quarter. The firm's figures, however, had to be accepted at face value. Under Skilling, Enron adopted mark-to-market accounting, in which anticipated future profits from any deal were tabulated as if real today. Thus, Enron could record gains from what over time might turn out to be losses, as the company's fiscal health became secondary to manipulating its stock price based on estimates rather than hard data.

The result of these two instances of FFR being that many of Enron's debts and the losses that it suffered were not reported in its financials, as well as its gains exaggerated. Therefore, top management was knowingly deceiving their stakeholders by reporting vastly inflated numbers when compared to the actual income.

Pressure, Opportunity, and Rationalization

Enron grew to become one of the largest companies in American history and had received numerous awards for their success and business practices. In their roughly 16 years of existence, Enron went from the small product of two mid market energy and natural gas companies to a business whose net worth exceeded $60 billion. So needless to say, both internal and external expectations were high. Enough so was this that at around $90 per share before its collapse, Enron was widely considered a “Blue Chip” stock, or rather one that was deemed to be unable to fail. Even as the price per share was plummeting in late 2001, investors saw this as an opportunity to buy rather than sell. The expectations were that investor profitability was at highs for so long; excessive pressures existed for management to meet the requirements set by outside third parties.

Opportunity existed because much of what management was doing was considered a common loophole in a way to avoid taxes. Tax evasion is illegal, tax avoidance is not. The nature of the industry provided opportunity to engage in fraudulent financial reporting through the use of significant related party transactions. Also, balance sheet accounts were based on significant estimates that involve subjective judgments and complicated transactions. Another opportunity existed because of Arthur Anderson basically turned a blind eye to this fraud when they should have been the first to notice and report it.

Enron truly was able to rationalize their actions because they were engaging in what they believed were commonly used loopholes in the law. While not exactly ethical, they believed that these transactions were fully legal.

Adelphia Communications Corporation

History of the Corporation

Adelphia Communications Corporation (Adelphia) was, at its prime in the mid 1990's, the sixth largest communications provider in the United States. Riding on the Internet and Technology 'bubble' of the era, the cable industry was one that had a high economic entrance barrier due to immense fixed installation costs. However, once overcome, these industries typically outperformed the stock market.

Adelphia was no exception. Since its beginnings in 1952, Adelphia was largely based on debt financing, remaining one of the largest privately owned ventures until its Initial Public Offering (IPO) in 1986. As the company grew, so did its operations; creating subsidiaries in the telephone business, internet, a sports television channel, and a sports radio channel.

Although Adelphia was a publically traded firm, the company remained largely a family run business. Of Adelphia's financing through equity, only about forty percent of the company's voting shares were filed as 'Class A shares' which were available to the public. The remainder, 'Class B shares' retained the right of having ten votes apiece and were held entirely by the Rigas Family. In addition to being the majority shareholders, the Rigas family held five of the firm's nine seats on the board of directors. John Rigas was the Chairman and CEO, his sons Tim, Michael, and James were CFO, VP of Operations, and VP of Strategic Planning, respectively. In addition, Peter Venetis, John Rigas's son in law, was also on the board.

The vast amount of leverage, both financial and operating, lead many analysts to question the company, but when put together with huge operational success in the late 1990's, the leverage aided to a vast increase in stock price. But when the dot-com bubble burst as competition increased, the market came to a crashing halt underlined by the September 11, 2001 attacks, causing Adelphia's stock to plummet. From a high of $84 in May of 1999, the stock had fallen to below $16 by 2002. In order to show support to investors, the Rigas family regularly purchased the company's stock as it declined. However, in doing so, the family used a company slush fund to purchase these but did not record the shares as treasury stock; instead keeping the shares in their private portfolios.

In May of 2002, with the strong urging of the minority shareholders, John Rigas, followed by his three sons, resigned from their positions, leaving the company in financial distress. On June 25, 2002, Adelphia filed for chapter 11 bankruptcy.

Explanation of the Fraud

Fraudulent Financial Reporting

By the end of 1999, it had become clear that Adelphia was on the downside. Of the six largest telecommunications firms in the nation (Adelphia being the sixth largest), Adelphia's debt to equity ratio of 2.81 was over four times greater than the next largest, Cable Vision, with a .69 debt to equity ratio. Also, out of the industry norm, Adelphi was also the only major company to have a ratio of greater than one, forcing it to spend over twice the percentage on debt services when compared to competitors. This created a managerial pressure to raise enough capital to finance this debt while still remaining profitable.

In order to raise the capital, Adelphia questionably manipulated the financials. Although the parent company made the vast majority of the decisions, the subsidiaries were held liable for about two thirds of Adelphia's debt. While the subsidiaries were heavily burdened by the debt of the parent, the parent was individually protected from the risk of bankruptcy.

By the time of its collapse, Adelphia had about $3.5 billion worth of outstanding debt, and when coupled with the debt dealt to the subsidiaries, the total debt of the company amounted to $12.5 billion.

Misappropriation of Assets

In addition to financial statement fraud, the Rigas Family also committed acts of self dealing on several occasions. Although the official compensation for the executives were below the industry average, John Rigas was permitted to have $1 million wired to his personal account per month without question; a benefit he took full advantage of. Also, as documented above, the Rigas Family used a company slush fund to purchase shares of Adelphia's stock as the price declined in order to show the market insider confidence in the company. Although the motivations and pressures might have been good at heart, the fact that these stocks were not reported as treasury shares renders the act as a fraud.

Pressure, Opportunity, and Rationalization

Pressures on the Rigas family to keep their financial status were evident as information available indicates that the personal financial situations of the family members were threatened by the entity's performance issues. As Adelphia was clearly on the downside, management took advantage of the company policy that allowed them to take large loans at low interest rates.

Adelphia's downfall is an example of the opportunity created when poor corporate guidelines and governance is paired with a great deal of financial and operating leverage. The problems at Adelphia such as the lack of transparent financials and managerial self dealing were allowed to continue without being caught either internally or through external audits until the company was forced into bankruptcy.

Also, by owning over sixty percent of the company's voting rights, and by having five out of the nine seats on the board of directors, the Rigas family felt that they could do anything that they wanted, as any way you looked at it, they owned over half of the company.

Clearly, because of the ownership rights of the family, each of the guilty members were able to rationalize their actions as they were 'above the rules.

AOL Time Warner, Inc.

History of the Corporation

On January 11, 2001, AOL Time Warner, Inc. was officially formed when AOL purchased Time Warner for $164 billion after nearly a year to gain the final approval by the Federal Trade Commission. This merger was to combine the assets of two of the largest communication giants in the United States, each of which were centered in different markets, to streamline the industry through "bundling" different services into one consumer package. When the deal was originally announced, it seemed as if the company would be able to extend its use of *Product Differentiation*, a corporate strategy implemented by creating a product or service that is unique in some important way and the perception of which allows the price of the product to be higher. By tapping into AOL, Time Warner would reach deep into the homes of tens of millions of new customers. And conversely, AOL would use Time Warner's high-speed cable lines and infrastructure to deliver to its subscribers Time Warner's branded magazines, books, music, and movies. This would have created 130 million subscription relationships (Li).

However, this plan never was able to come to fruition as the dot-com bubble burst followed by the September 11th attacks sent the new company into a tailspin. AOLs value dropped from $226 billion to $20 billion leading to the subsequent goodwill write off loss of $99 billion.

Many expected synergies between AOL and the other Time Warner divisions never materialized, as most Time Warner divisions were considered independent fiefs that rarely cooperated prior to the merger. A new incentive program that granted options based on the performance of AOL Time Warner, replacing the cash bonuses for the results of their own division, caused resentment among Time Warner division heads who blamed the AOL division for failing to meet expectations and dragging down the combined company. AOL Time Warner COO Pittman, who expected to have the divisions working closely towards convergence, instead found heavy resistance from many division executives who also criticized Pittman for adhering to optimistic growth targets for AOL Time Warner that were never met. Some of the attacks on Pittman were reported to come from the print media in the Time, Inc. division under Don Logan (Viacom).

<u>Explanation of the Fraud</u>

Fraudulent Financial Reporting

According to the SEC Report, two notable FFR frauds took place in the early 2000's. First, fraudulent "round trip transactions" were used to inflate AOL's advertising revenues, and secondly bulk sales were misrepresented in order to inflate the total number of subscribers. From the SEC Report:

> *Beginning in mid-2000, stock prices of Internet-related businesses declined precipitously as, among other things, sales of online advertising declined and the rate of growth of new online subscriptions started to flatten. Beginning at this time, and extending through 2002, the company employed fraudulent round-trip transactions that boosted its online advertising revenue to mask the fact that it also experienced a business slow-down. The round-trip transactions ranged in*

complexity and sophistication, but in each instance the company effectively funded its own online advertising revenue by giving the counterparties the means to pay for advertising that they would not otherwise have purchased. To conceal the true nature of the transactions, the company typically structured and documented round-trips as if they were two or more separate, bona fide transactions, conducted at arm's length and reflecting each party's independent business purpose. The company delivered mostly untargeted, less desirable, remnant online advertising to the round-trip advertisers, and the round-trip advertisers often had little or no ability to control the quantity, quality, and sometimes even the content of the online advertising they received. Because the round-trip customers effectively were paying for the online advertising with the company's funds, the customers seldom, if ever, complained.

The company artificially inflated the number of AOL subscribers in the second, third, and fourth quarters of 2001 so it could report to the investment community that it had met its new subscriber targets, an important metric the market used to evaluate AOL (both before and after its merger with Time Warner). Specifically, the company counted members from "bulk subscription sales" to corporate customers (for distribution to their employees) when the company knew that the memberships had not, and mostly would not, be activated. In at least one instance, the company entered into round-trip arrangements to fund *the corporate customers' purchases of bulk subscriptions. Additionally, in last-minute efforts to meet the quarterly targets, the company on at least four occasions shipped non-conforming bulk subscription membership kits to the customers prior to quarter-end with the understanding that it would turn around and replace them at a later date with conforming kits, but it nonetheless counted new subscribers from these sales as of the quarter-end (SEC, SEC CHARGES TIME WARNER WITH FRAUD).*

Pressure, Opportunity, and Rationalization

In the time leading up to the fraud, there was great pressure on top management to live up to the merger of AOL and Time Warner, how it will lead to great innovation and, more importantly, a very profitable venture. Around the time of the merger, the world economy was beginning to show signs of turmoil because of the dot-com bubble bursting. The pressure to conceal the troubles that AOL was in came from many sides. If the world knew the problems of the internet giant, there would be a loss in creditor confidence which would lead to a decrease in stock price. More importantly, if the word got out the merger between the two companies might not come to life.

The opportunity exists in most FFR cases that upper management are usually those who have the power to make changes, and therefore are the ones to commit the infraction as they are the ones who stand the most to gain or lose.

Bristol-Myers Squibb Company

History of the Corporation

With the merger of Bristol-Myers and Squibb in 1989, the newly formed Bristol-Myers Squibb Company joined to become the second largest pharmaceutical enterprise and a leader in pre cancer and cancer prescriptions as well as manufacturing pharmaceuticals in HIV/Aids, arthritis, hepatitis, cardiovascular disease, diabetes, and psychiatric disorders. Since the merger, it has been Bristol-Myers Squibb's mission to "discover, develop, and deliver innovative medicines that help patients prevail over serious diseases." Some of the key products in the biopharmaceutical corporation include *Plavix, Abilify, Reyataz, Avapro, Sustiva,* and *Baraclude* which combine to gross the corporation $19.5 billion in fiscal 2010.

Explanation of Fraud

Fraudulent Financial Reporting

In 2002, Bristol-Myers Squibb was investigated for an accounting scandal that was the result of the restatement of their revenues between the periods 1999 through 2001. During this period, the corporation inflated its sales and earnings through the means of *Channel Stuffing* in order to create the façade that the company had either met or exceeded all of its internal goals and in turn would lead to higher prices on the marker. In doing this, Bristol-Myers Squibb recognized

$1.5 billion in revenues to its two largest wholesalers upon shipment, and contrary to GAAP (SEC, Bristol-Myers Squibb Company Agrees to Pay $150 Million to Settle Fraud Charges).

In addition, according to the Federal Trade Commission, the company engaged in a series of anticompetitive acts over the previous decade to obstruct the entry of low-price generic competition for three of Bristol-Myers Squibb's widely-used pharmaceutical products: two anti-cancer drugs, Taxol and Platinol, and the anti-anxiety agent BuSpar. Bristol-Myers Squibb avoided competition by abusing federal regulations to block generic entry; deceived the U.S. Patent and Trademark Office (PTO) to obtain unwarranted patent protection; paid a would-be generic rival over $70 million not to bring any competing products to market; and filed baseless patent infringement lawsuits to deter entry by generics (Commission).

Pressure, Opportunity, and Rationalization

The major problem with channel stuffing comes in the form of, like many pressures for fraud, once you start doing it, it’s impossible to stop without getting caught. The initial pressure came in the form of unrealistic internal corporate goals. Even if the goals are unrealistic, once they are set, the market does not care as to why they were not met and your stock price begins to fall. Therefore, what was once internal pressure evolves into external pressures that are unrealistic, and sometimes impossible.

By committing this fraud, Bristol-Myers Squibb was able to artificially inflate its revenues in order to keep its share holders happy. The channel stuffing began to contribute to excess inventory levels in the market that posed a material risk to the company's future sales and earnings. To compensate, Bristol-Myers Squibb would in turn materially understate its accruals, leading to the necessity to keep several sets of financials.

As stated above, opportunity is the condition or situation that allows one to commit, conceal, and convert the fraud into personal gain. Although top management never was publically found guilty in the case of Bristol-Myers Squibb, the leeway for top management to commit, conceal, and convert were in place. Like other FFR cases, the end of the road comes at the top where there is no one left to check their work. If something gets changed here, it will likely go undiscovered, especially if it is concealed well.

The rationalization for Bristol-Myers Squibb may have been purely as a last resort to keep ahead in the market. With the economy just coming out of two recessions around the turn of the century, things had to be done to stay afloat, and in the case of many, fraud was the answer. The FFR committed helped Bristol-Myers Squibb meet its goals, which in turn led to positive results in the market. Although the façade created does not quantifiably hurt anyone, what it does do is create an anticompetitive market that the perpetrator can turn a blind eye to.

Global Crossing Limited

History of the Corporation

Global Crossing Limited is an international telecommunication company that provides computer networking services to more than 700 cities throughout 70 countries. Founded in 1997 by four associates of Pacific Capital Group, Global Crossing raised $35 million in capital from various investors in order to start the endeavor. By mid 2000, Global Crossing had gone from a midsized firm with about 150 employees, to an international firm with over 14,000 employees. In June, 2001, Global Crossing completed its core communications network, spanning four continents, 27 countries and 200 major cities. However, many investors were losing their confidence in the firm as it continued to rack up large amounts of debt, at which time the stock quote of Global Crossing fell from over sixty dollars to roughly twenty five by midsummer, and would continue to fall, hitting five dollars per share by November 2001.

In January 2002, as many of its subsidiaries were defaulting on their loans, Global Crossing filed for chapter 11 bankruptcy protection; a issue that would take nearly two years to recover from.

Explanation of the Fraud

Misappropriation of Assets

Global Crossing's short time in the spotlight garnered a large amount of public attention and it was quickly revealed that the company, particularly its executives, lavishly spent the company's money on a frivolous scale. Four of Global Crossing's CEOs received at least $23 million in personal loans from the company, some of which were forgiven entirely even when bankruptcy was becoming a greater possibility. These same executives also received over $13.5 million in after-tax signing bonuses along with lucrative stock options during the same period in which their debt was forgiven. Also, evidence of insider trading exists as executives with the company sold $1.3 billion in shares as the stock first showed signs of a downturn.

Additionally, according to an article by the LA Times, a group of banks sued Global Crossing executives for $1.7 billion, claiming the company engaged in a "massive scam" to conceal Global Crossing's decline so it could borrow $2.25 billion two months before its collapse in 2002 (Global Crossing Fraud Lawsuit Can Proceed).

Pressure, Opportunity, and Rationalization

Information available shows that the opportunity was present to commit a fraud due to management's personal financial position which was threatened as the entity's financial performance was suffering. Company executives, for the most part, were associated with the company while the company was, in fact, doing well. Despite a large portion of the income coming from outside the realm of normal operating income, during the first years of the company's existence, the company was able to raise billions in capital. Not far removed, these executives were looking for a way to maintain an outwardly profitable business, at seemingly any means necessary.

Also, being that this was a young firm, the lavish lifestyle lived by the executives had become the norm. They rationalized that it was a right of some sort that comes with the title, enabling them to continue to spend on themselves despite the company operating in the red.

K-Mart

History of the Corporation

The first K-Mart store was opened on March 1, 1962, in Garden City, Michigan as a subsidiary discount store to the S.S. Kresge Corporations stores which had existed since 1899. Opening just months before the first Wal-Mart store, K-Mart became the leader in its own market; having over 1,000 locations worldwide by 1980, offering recognizable brands at bargain prices. But as the 1980s went on, the company's fortunes began to change. Many locations were run down and not properly maintained as corporate began to focus most of its attention to other subsidiary companies that it owned such as Sports Authority and Walden Books.

It took until the mid 1990s before K-Mart made an effort to change its image by revamping its stores and marketing, however many believe it to be too little too late, as market share fell well below rivals Wal-Mart and Target.

On January 22, 2002, K-Mart filed for chapter 11 bankruptcy. Then Chairman Chuck Conaway accepted full blame for the financial disaster; and as K-Mart emerged from chapter 11, Conaway stepped down from his position.

The public perception of K-Mart has yet to recover, but in 2009 K-Mart reported its first annual sales increase since 2001. Despite it only being a .5% increase over 2008, it has become proof to management that the merger with Sears Roebuck and Company in 2004 had generated an upside for the all but dead discount store.

<u>Explanation of the Fraud</u>

Fraudulent Financial Reporting

As reported by the Securities and Exchange Commission (SEC) on August 23, 2005, the SEC filed charges against two former K-Mart executives for misleading investors about K-Marts financial condition in the months preceding the company's bankruptcy. According to the Commission's complaint, former Chief Executive Officer Charles C. Conaway and former Chief Financial Officer John T. McDonald are responsible for materially false and misleading disclosure about the company's liquidity and related matters in the Management's Discussion and Analysis (MD&A) section of K-Mart's Form 10-Q for the third quarter and nine months ended October 31, 2001, and in an earnings conference call with analysts and investors.

Peter H. Bresnan, an Associate Director in the Division of Enforcement, stated, "Investors are entitled to both accurate financial data and an accurate description of the story behind the numbers. K-Mart's senior management failed to honestly inform investors that K-Mart faced a liquidity crisis in the third quarter of 2001, how the company's own ill-advised action had caused the problem and what steps management took to respond to it."

The Commission alleges that, in the MD&A section, Conaway and McDonald failed to disclose the reasons for a massive inventory overbuy in the summer of 2001 and the impact it had on the company's liquidity. For example, the MD&A disclosure attributed increases in inventory to "seasonal inventory fluctuations and actions taken to improve our overall in-stock position." The Commission alleges that this disclosure was materially misleading because, in reality, a significant portion of the inventory buildup was caused by a K-Mart officer's reckless and unilateral purchase of $850 million of excess inventory. According to the complaint, the defendants dealt with K-Mart's liquidity problems by slowing down payments owed vendors, thereby withholding $570 million from them by the end of the third quarter. According to the complaint, Conaway and McDonald lied about why vendors were not being paid on time and misrepresented the impact that K-Mart's liquidity problems had on the company's relationship with its vendors, many of whom stopped shipping product to K-Mart during the fall of 2001. K-Mart filed for bankruptcy on Jan. 22, 2002 (SEC, SEC CHARGES KMART'S FORMER CEO AND CFO WITH FINANCIAL FRAUD).

Misappropriation of Assets

On January 22, 2002, K-Mart filed for Chapter 11 bankruptcy protection under the leadership of its then-Chairman Chuck Conaway and President Mark Schwartz. Conaway, who had had success building up the CVS Corporation, had accepted an offer to take the helm at K-Mart along with a loan of some $5 million. In a scandal similar to that involving Enron, Conaway and

Schwartz were accused of misleading shareholders and other company officials about the company's financial crisis while making millions and allegedly spending the company's money on airplanes, houses, boats and other luxuries. At a conference for K-Mart employees in January 2002, Conaway accepted "full blame" for the financial disaster. As K-Mart emerged from bankruptcy, Conaway was forced to step down and was asked to pay back all the loans he had taken (Davies).

Pressure, Opportunity, and Rationalization

K-Mart had once been considered to be a blue chip stock, although overtime this confidence had dwindled, the company's investors still expected a hefty profit from the superstore. As competition stiffened, leading to operating losses and the inability to generate cash, financial stability became threatened. As investor demands remaining high, K-Mart was pressured into finding a way to make its bottom line appear to be better than it actually was. By showing false hype in the company's outlook, investor confidence for the long term remained relatively high and the company still maintained the status quo.

SOX has a provision that denies a company from loaning large amounts of money to their management. However, the fraud at K-Mart occurred before the passage of the Act in 2002. Faulty internal control components lead to management trying to pass off the money they were taking from the company simply as being a loan, with every outward belief to refund the money.

Tyco International, Ltd.

History of the Corporation

Founded in 1960, Tyco International, Ltd. (Tyco) was originally an investment and holding company focusing primarily on governmental experiments in the private sector. But in 1962, after relocating to Massachusetts, Tyco's focus shifted more to the high tech industry, which remains the main focus today.

Throughout the next 40 years, Tyco aggressively acquired well over 1,000 subsidiaries throughout the high tech market. This includes companies such as ADT, Tectron, United States Surgical, and Wells Fargo, just to name a few. In the late 1980's Tyco reorganized its subsidiaries into four segments: Electrical and Electronic Components, Healthcare and Specialty Products, Fire and Security Services, and Flow Control.

With the growing complexity between Tyco's subsidiaries and trying to manage them all, in January 2002, Tyco announced a plan to make the four segments of its business each its own company. But due to the previous two years recessions severely damaging Tyco's stock price, this plan was put on hold and never came to fruition. 2002 marked the first fiscal year in over three decades where Tyco suffered a operating loss. In effort to ease the burden, Tyco tried to divest some of their subsidiaries, but to no avail, stock prices continued to plummet as the rest of the world was recovering economically.

To add to the financial woes of the company, midway through the fiscal 2002 year, Tyco became embroiled in a massive scandal involving its former Chairman and CEO, L. Dennis Kozlowski, and his senior management team. Kozlowski resigned and former Tyco CEO John F. Fort became interim CEO until the board of directors completed a search for a permanent replacement. As a consequence, on June 17, 2002, Tyco filed federal suit against Mark H. Swartz, Tyco's former executive Vice President and Chief Corporate Counsel, and Frank E. Walsh, a former Director.

Not until mid 2004, after a complete gutting of the top management and liquidating several subsidiaries, did Tyco get back on the black side of break even. By the end of 2004, Tyco employed about 260,000 people worldwide and reported revenue of $40 billion.

<u>Explanation of the Fraud</u>

Misappropriation of Assets

Following below is the report filed by the SEC regarding what was going on behind the scenes by Tyco’s top management while the corporation was undergoing turmoil in 2002.

The Securities and Exchange Commission today filed civil fraud charges against three former top executives of Tyco International Ltd., including former CEO L. Dennis Kozlowski, alleging that they failed to disclose multi-million dollar low interest and interest-free loans they took from the company, and in some cases, never repaid. The SEC complaint, which also charges former Tyco CFO Mark H. Swartz and Chief Legal Officer Mark A. Belnick, alleges that the three former executives also sold shares of Tyco stock valued at millions of dollars while their self-dealing remained undisclosed.

According to the SEC complaint, Kozlowski and Swartz granted themselves hundreds of millions of dollars in secret low interest and interest-free loans from the company that they used for personal expenses. They later caused Tyco to forgive tens of millions of dollars they owed the company, again without disclosure to investors as required by the federal securities laws. Belnick, according to the complaint, failed to disclose that he received more than $14 million in interest-free loans from the company to acquire two residences in New York City and Park City, Utah.

"Messrs. Kozlowski, Swartz and Belnick treated Tyco as their private bank, taking out hundreds of millions of dollars of loans and compensation without ever telling investors," said Stephen M. Cutler, the SEC's Director of Enforcement. "Defendants put their own interests above those of Tyco's shareholders. Those shareholders deserved better than to be betrayed by the management of the company they owned."

Thomas C. Newkirk, Associate SEC Enforcement Director, stated: "Filing this case today simultaneously with the related criminal charges brought by the Manhattan District Attorney is the result of the effective working relationship we have with the Manhattan District Attorney and the New York City Police Department. We will continue with this investigation" (SEC, SEC Sues Former Tyco CEO Kozlowski, Two Others for Fraud).

Pressure, Opportunity, and Rationalization

Tyco was one of the fastest growing companies as it continually acquired competitor after competitor as well as venturing into new markets. When the fraud begun, there was no true pressure outlined by SAS No. 99 on the people who committed the act. With the lack of institutional controls, the opportunity to engage in these zero interest loans was incredibly high. Eventually, with their lavish lifestyle, theses loans became a necessary source of income.

To the accused, however, what they were borrowing was not substantial if you look at the big picture, especially since they were convinced that all they were doing was taking a loan from the company. This, to them, was money that would be paid back eventually, possibly even with interest.

WorldCom

History of the Corporation

Under the direction of CEO Bernard Ebbers, the Long Distance Discount Services (LDDS) provider began as a small privately owned regional company in Hattiesburg, Mississippi in 1983. Through a merger with Advantage Companies Inc., in 1989 the company decided to go public under the name LDDS WorldCom, and later just WorldCom.

With the company's IPO WorldCom raised billions, in which it primarily used to aggressively grow through the acquisitions of several other large communication providers throughout the decade. With the acquisition of MCI in 1998, WorldCom was the second largest long distance communications provider in the United States, behind AT&T. An attempt to merge with Sprint Corporation in October 1999 failed due to concerns of the formation of a monopoly. Nonetheless, reported revenue went from $154 million in 1990 to $39.2 billion in 2001 as a result of numerous mergers and acquisitions.

According to the Library of Congress Congressional Research Service, the fundamental economic problem confronting WorldCom was the vast oversupply in telecommunications capacity that emerged in the 1990s, as the industry rushed to build fiber optic networks and other infrastructure based on overly optimistic projections of internet growth. WorldCom and other telecommunications firms had faced reduced demand as the dot-com boom ended and the economy entered recession. Their revenues have fallen short of expectations, while debt taken on to finance mergers and infrastructure investment remains (Lyke).

At the beginning of the second quarter of 2001, WorldCom admitted that it had fraudulently misclassified $3.8 billion of debt as no longer outstanding. In addition, about $14.7 billion of additional debt due in 2001 was misclassified as current in 2002.

On July 21, 2002, WorldCom filed for Chapter 11 Bankruptcy protection and wouldn't emerge until 2004 under the name MCI, which was later acquired by Verizon Communications in February of 2005.

Explanation of the Fraud

Fraudulent Financial Reporting

As indicated above, WorldCom success was largely due to its ability to sustain grandiose acquisitions supported by the dot-com boom of the 1990s. Culminating with failure when the Justice Department forced WorldCom and Sprint to stop its proposed merger, stock declined and Ebbers was asked to step down as CEO in April 2002.

With his removal, a night audit team was able to find that beginning back in 1999, the company had used fraudulent accounting methods to mask its declining earnings by underreporting its costs through capitalizing costs rather than properly expensing them, and also by inflating revenues with the fictitious entry “Corporate unallocated revenue account.” By the end of 2003, the SEC investigation estimated that the company’s inflated assets totaled over $11 billion.

<u>Pressures, Opportunities, and Rationalization</u>

With the failed merger with Sprint in 1999, WorldCom no longer had enough liquid assets to stay afloat during the dot-com bubble burst and was beginning to fall victim to declining stock prices. During the three year period between 1999 and year end of 2001, stock prices had fallen by about $60 per share and something had to be done. Under the direction of CEO Ebbers and some of his top executives, WorldCom underreported its liabilities and over reported its revenues, both ultimately resulting in an improved financial position for the company. These improved numbers on the financials would in turn boost investor confidence in the company and would consequentially improve the waning stock price.

A second issue could be considered a misappropriation of assets fraud, months before his release from the company as CEO, Ebbers persuaded the company to loan him $400 million so that he could pay off his own personal debts. The company agreed only because Ebbers had convinced them that if not for the loan, he would be forced to sell off his shares of the company, which would substantially hurt the price of the shares. Ebbers strategy ultimately failed, as he was ousted from the company, never paying off his debts to WorldCom.

Opportunity presented itself as this was a top down fraud. Unlike speculations brought up during the Enron case, Andersen likely did not have any idea that the fraud was occurring as it reported that WorldCom's financials were sound in its 2001 opinion of the company. No one knew what was going on; or rather what was really going on, until a link in the fraud chain, Ebbers, was removed.

A common belief as to how this was rationalized by the company, and even initially the auditors who initially suspected a fraud, was that Ebbers had persuaded the involved parties that this was only a temporary thing while the company got back on its feet. As WorldCom was located in a relatively small city, the company had become the life blood of the economy as it employed a large percentage of the population. If WorldCom was allowed to fail, then Mississippi's only Fortune 500 Company would be destroyed, sending thousands out of a job and damaging the entire state's economy. No one involved wanted to be the cause of this.

HealthSouth Corporation

History of the Corporation

HealthSouth Corporation (HealthSouth), formerly Amcare, Inc., was incorporated in Birmingham, Alabama on February 22, 1984. With over 150 hospitals and clinics opened since its incorporation, Healthsouth has become the nation's largest system of inpatient rehabilitative hospitals.

HealthSouth grew through the means of acquiring many different firms within the health care industry which in turn broadened its market throughout the 1990's. Its largest project to date was a planned cooperative effort with Oracle Corporation to build the world's first all digital hospital.

During construction, HealthSouth became under scrutiny of the SEC when then CEO Richard Scrushy sold off $75 million of his stock just days before the company reported a massive $1.4 billion loss. Although Scrushy was never found guilty of insider trading, it did prompt further, more detailed, audits to be conducted on the company which revealed that income had been overstated by about 4700%.

Despite its stocks plummeting, HealthSouth was able to reorganize its assets in order to avoid chapter 11 bankruptcy.

In this restructuring, the company sold off its underperforming medical center division in order to help with profitability. Also, the surgery, outpatient, and diagnostic divisions were each sold off to become more specialized in the rehabilitative market, in effect reverse the movements made in the 1990's.

Explanation of the Fraud

Misappropriation of Assets

HealthSouth's first accounting problems occurred during 2002 when then CEO Richard Scrushy sold $75 million of his shares just a few days before the company released a large loss. After a long investigation, in June 2005, the SEC acquitted Scrushy of all 36 of the accounting fraud charges against him, most notably one count in violation of the SOX, which casts doubt on the enforceability of the law. But in June 2006, when his CFO agreed to wear a wire to help the investigation into Scrushy, he was convicted on a bribery charge unrelated to the original investigation. Scrushy was found guilty of arranging $500,000 in campaign donations in exchange for a seat on a state hospital regulatory board (Scrushy, former Alabama governor found guilty).

Fraudulent Financial Reporting

The second fraud only became evident to the SEC during their investigation of HealthSouth's CEO potentially engaging in insider trading. The SEC found Scrushy had falsely reported grossly exaggerated company earnings in order to meet stockholder expectations. Of the $4.5 billion in revenue reported in 2003, $1.4 billion was considered to be falsely inflated, leading to a roughly 4700% increase in total net income.

Pressure, Opportunity, and Rationalization

According to the report filed by the SEC, HealthSouth was artificially inflating its earnings since shortly after it became a publically traded company. Therefore, there was excessive pressure for management to meet the requirements and expectations of the financial markets. Between 1999 and the second quarter of 2002, the period initially under scrutiny, HealthSouth intentionally overstated its earnings, identified as "Income Before Income Taxes And Minority Interests," by at least $1.4 billion in reports filed with the Commission.

Also, pressure existed on CEO Scrushy to continue inflating earnings in order to maintain his lavish lifestyle. Scrushy sold at least 7,782,130 shares of HealthSouth stock since 1999, when share prices were affected by the artificially inflated earnings. Moreover, Scrushy received salary and bonus payments based on HealthSouth artificially inflated earnings.

Opportunity existed to commit these frauds through means of ineffective monitoring of the company's management. On a quarterly basis, HealthSouth’s senior officers would present Scrushy with an analysis of HealthSouth's actual, unreported, earnings for the quarter as compared to Wall Street's expected earnings for the company. If HealthSouth's actual results fell short of expectations, Scrushy would tell management to "fix it" by recording false earnings on HealthSouth's accounting records to make up the shortfall. These orders would then be passed down to the accounting department and false accounting entries were made.

Scrushy was able to rationalize his actions as being for the good of the company. During the time the fraud was going on, SOX was just starting to form and regulations were not nearly as highly regarded in the workplace. Because the act could not directly hurt anyone and only help investors, what was going on was rationalized away as not being a bad thing to do (SEC, SEC Charges HealthSouth Corp., CEO Richard Scrushy).

CONCLUSION

Due to the then recent frauds in some of the nation's largest public companies, the AICPA issued SAS No. 99 in order to address the apparent holes in SAS No. 82 by further clarifying the auditor's responsibilities in order to detect fraud. According to SAS No. 99 large public companies are likely to be exposed to two major types of frauds: frauds arising from fraudulent financial reporting and frauds arising from misappropriation of assets. Also, according to SAS No. 99 there are three major categories of factors that could induce fraud; namely, pressures, opportunities and rationalizations. The primary motive of this paper was to examine how the two types of frauds and three different fraud risk factors occur in a sample of frauds detected at some large corporations.

Based on the analysis of various frauds we can infer that frauds related to both FFR and MOA have resulted in significant losses at various corporations. The more common of the two types of fraud in larger companies, FFR is generally the resultant of a company altering their financials to make the ratios appear to be better to the users. One way to do this, as demonstrated by Enron and Adelphia, is to create special purpose entities or subsidiary companies whose sole purpose was to buy off the parent company's debt, which in turn making the parent appear to be much more profitable than it actually is. Another, less grandiose means to commit FFR is to not adhere to Generally Accepted Accounting Principles (GAAP) standards. As evidenced by WorldCom, a company can improve their financials by altering their revenues and expenses in order to inflate their assets.

The second type of fraud, misappropriation of assets, involves theft of assets by a person within the corporation. Although this has since been legally corrected when SOX included a section that no longer allowed management to accept substantial loans from their company, of the companies looked at in the previous chapter, four of the five who showed evidence of MOA were guilty of an executive lavishly taking company money to spend on themselves.

SAS No. 99 also identifies the importance of the factors of the fraud triangle in motivating and facilitating frauds at large corporations. In nearly all instances, in order for a fraud to occur, the person committing the fraud needs an external factor to pressure them into committing the fraud, an opportunity to commit the fraud must present itself, and they must be able to rationalize their actions.

Some of the common findings of the research conducted are that in FFR cases, the common pressures involved in the frauds were results of management trying to cover up some sort of deficiency within the company, whether it was to improve the company's holdings or more so to try to save their declining stock prices. On the other hand, in MOA cases, it was found that many managers who committed these frauds did so because of a need to either create, or later keep up with the lavish lifestyle they created trough stealing from their company. In almost all cases, weak internal controls enables these fraudsters the opportunity to commit these frauds. Many times, the fraud occurs at a point where one person has the authority to both authorize and accept payments, and often, the fraud is only discovered because of some inhibiting factor that prevents the fraud from continuing to occur, and the change is noticed. Finally, with rationalization, the cases above present many different ways someone can rationalize to themselves that this action was worth doing. Whether it was the only way to save a dying company, or money that was believed to be rightfully belonging to them, in nearly all cases the fraudster believed that this was the right thing to do.

Therefore, to prevent the occurrence of frauds in the future corporations should be aware of the presence of frauds risk factors, and they should have adequate governance mechanisms to control these factors. The accounting profession should ensure that the auditors are aware of these fraud risk factors while conducting an audit so that they can design adequate procedures to control for these factors.

Appendix: SOX Titles and Sections List

TITLE I — PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
Sec. 101. Establishment; administrative provisions.
Sec. 102. Registration with the Board.
Sec. 103. Auditing, quality control, and independence standards and rules.
Sec. 104. Inspections of registered public accounting firms.
Sec. 105. Investigations and disciplinary proceedings.
Sec. 106. Foreign public accounting firms.
Sec. 107. Commission oversight of the Board.
Sec. 108. Accounting standards.
Sec. 109. Funding.

TITLE II — AUDITOR INDEPENDENCE
Sec. 201. Services outside the scope of practice of auditors.
Sec. 202. Preapproval requirements.
Sec. 203. Audit partner rotation.
Sec. 204. Auditor reports to audit committees.
Sec. 205. Conforming amendments.
Sec. 206. Conflicts of interest.
Sec. 207. Study of mandatory rotation of registered public accounting firms.
Sec. 208. Commission authority.
Sec. 209. Considerations by appropriate State regulatory authorities.

TITLE III — CORPORATE RESPONSIBILITY
Sec. 301. Public company audit committees.
Sec. 302. Corporate responsibility for financial reports.
Sec. 303. Improper influence on conduct of audits.
Sec. 304. Forfeiture of certain bonuses and profits.
Sec. 305. Officer and director bars and penalties.
Sec. 306. Insider trades during pension fund blackout periods.
Sec. 307. Rules of professional responsibility for attorneys.
Sec. 308. Fair funds for investors.

TITLE IV — ENHANCED FINANCIAL DISCLOSURES
Sec. 401. Disclosures in periodic reports.
Sec. 402. Enhanced conflict of interest provisions.
Sec. 403. Disclosures of transactions involving management and principal stockholders.
Sec. 404. Management assessment of internal controls.
Sec. 405. Exemption.
Sec. 406. Code of ethics for senior financial officers.

Sec. 407. Disclosure of audit committee financial expert.
Sec. 408. Enhanced review of periodic disclosures by issuers.
Sec. 409. Real time issuer disclosures.

TITLE V — ANALYST CONFLICTS OF INTEREST
Sec. 501. Treatment of securities analysts by registered securities associations and national securities exchanges.

TITLE VI — COMMISSION RESOURCES AND AUTHORITY
Sec. 601. Authorization of appropriations.
Sec. 602. Appearance and practice before the Commission.
Sec. 603. Federal court authority to impose penny stock bars.
Sec. 604. Qualifications of associated persons of brokers and dealers.

TITLE VII — STUDIES AND REPORTS
Sec. 701. GAO study and report regarding consolidation of public accounting firms.
Sec. 702. Commission study and report regarding credit rating agencies.
Sec. 703. Study and report on violators and violations
Sec. 704. Study of enforcement actions.
Sec. 705. Study of investment banks.

TITLE VIII — CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY
Sec. 801. Short title.
Sec. 802. Criminal penalties for altering documents.
Sec. 803. Debts nondischargeable if incurred in violation of securities fraud laws.
Sec. 804. Statute of limitations for securities fraud.
Sec. 805. Review of Federal Sentencing Guidelines for obstruction of justice and extensive criminal fraud.
Sec. 806. Protection for employees of publicly traded companies who provide evidence of fraud.
Sec. 807. Criminal penalties for defrauding shareholders of publicly traded companies.

TITLE IX — WHITE-COLLAR CRIME PENALTY ENHANCEMENTS
Sec. 901. Short title.
Sec. 902. Attempts and conspiracies to commit criminal fraud offenses.
Sec. 903. Criminal penalties for mail and wire fraud.
Sec. 904. Criminal penalties for violations of the Employee Retirement Income Security Act of 1974.
Sec. 905. Amendment to sentencing guidelines relating to certain white-collar offenses.
Sec. 906. Corporate responsibility for financial reports.

TITLE X — CORPORATE TAX RETURNS
Sec. 1001. Sense of the Senate regarding the signing of corporate tax returns by chief executive officers.

TITLE XI — CORPORATE FRAUD AND ACCOUNTABILITY
Sec. 1101. Short title.
Sec. 1102. Tampering with a record or otherwise impeding an official proceeding.
Sec. 1103. Temporary freeze authority for the Securities and Exchange Commission.
Sec. 1104. Amendment to the Federal Sentencing Guidelines.
Sec. 1105. Authority of the Commission to prohibit persons from serving as officers or directors.
Sec. 1106. Increased criminal penalties under Securities Exchange Act of 1934.
Sec. 1107. Retaliation against informants.

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