Presented at the 17th Annual Convention of the Global Awareness Society International, May 2008, San Francisco, CA, USA

PREVENTIVE MEASURES OF CORPORATE ACCOUNTING FRAUDS

Ibrahim M. Badawi
Department of Accounting & Taxation
Tobin College of Business
St. John's University
Jamaica, N.Y. 11439 USA
Email: Badawii@stjohns.edu

INTRODUCTION

In reaction to the widespread and diverse corporate accounting frauds during the 1980s and 1990s, the U.S. government promulgated and implemented a diversity of corrective actions in order to protect public interest and to restore public and corporate stakeholders' confidence in corporate financial reporting, as well as the external auditing function and the capital market. In 2002, the U.S. lawmakers, in a compromise by the House and Senate, passed the Sarbanes-Oxley Act 2002 (S-O or the Act), which was signed by President Bush into Public Law 107-204 on July 30, 2002.

The S-O Act has greatly impacted the publicly held companies and their external auditors. The Act has (1) imposed strict reforms of corporate governance responsibility and accountability on publicly-held companies; and (2) mandated the Securities and Exchange Commission (SEC), a government regulatory watchdog of corporate financial reporting, to oversight the accounting profession by, for example, imposing tougher regulatory ethical standards and exercising vigorous enforcement.

One of the principal outcomes of the S-O Act has also been the creation of the five-member Publicly Company Accounting Oversight Board (PCAOB), which is established to oversight the public accounting profession. Notably, the Act is applicable not only to U.S. publicly traded companies, but is also applicable to any non-U.S. company registered on U.S. exchanges, regardless of country of incorporation. Moreover, external auditors of such registrants, regardless of their nationality or place of business, are subject to the oversight of the PCAOB and to the statutory requirements of the Act.

These newly passed statutes of the Act and the SEC's new rules are considered the most significant legislation and regulation affecting the U.S. corporate community and the accounting profession since 1933. Nevertheless, there have long been other U.S.

regulatory bodies such as NYSE, NASDAQ, the American Institute of CPAs, and State Societies of CPAs, and the Financial Accounting Standards Board (FASB). These entities have passed new regulations which impose additional burdens on publicly traded companies and their external auditors.

The primary focus of the study is threefold. The first focus is on the Integrated Framework on Internal Control, developed by the Committee of Sponsoring Organizations (COSO) in the second half of the 1980s. The second focus is on the corporate and accounting reforms embodied in the Sarbanes-Oxley Act. The third focus is on the newly created entity, i.e., the PCAOB, a derivative of the Act. For so doing, the paper consists of four brief parts. Part I highlights the corporate incidences of fraudulent financial reporting in corporate America. Part II deals with the Treadway Commission Report and response of the Auditing Standards Board. Part III deals with the 2002 SOA mandatory requirements to reform the financial reporting process and the public accounting profession. Notably, the Act is applicable to (1) all corporations (U.S. and foreign) whose stocks are traded on the U.S. capital markets; (2) all public accounting firms which provide accounting services to publicly traded companies; and all certified public accountants who are employees of publicly traded companies. Part IV provides concluding remarks.

I. FRAUDULENT FINANCIAL REPORTING, 1980s-2005

The capital markets in the United States have long been considered to be among the most efficient in the economically developed world. One reason for the efficient operation of these markets has been the public availability of creditable financial statements by those using them as a basis for their investment and credit decisions. A potential threat to the efficient functioning of these markets is the incidence of fraudulent financial reporting.

Fraudulent financial reporting is intentional or reckless conduct, acts, or omissions, that result in materially misleading financial statements. Confidence in the operation of capital markets is compromised when the system of public disclosure is eroded by reported instances of fraudulent reporting. Public revelation of corporate fraudulent financial reporting has caused a variety of adverse consequences to corporate stakeholders, such as corporate bankruptcies, financial market plunge, depleted private

and public retirement funds, lost jobs, and loss of governmental tax revenues. The list of corporate accounting scandals in the U.S. is extensive, and the nature of accounting irregularities is creative. Methods of financial statement schemes range, for example, from fictitious or fabricated revenues, timing differences of recognizing revenues and expenses, improper asset and liability estimation or valuation and reporting, concealed expenses and liabilities, to improper full disclosures.

In the mid 1980's, there were significant failures of tremendous number of banks and other financial institutions that eventually led various groups to identify possible causes, including the extent of fraudulent financial reporting involved in the failures. Between late 1990s and early 2000s, a series of business failures and financial scandals in almost all sectors of the economy, became public, especially since the 2001 collapse of the Enron Corporation, which eventually caused a serious decline in investor confidence in the capital markets and mistrust of the public accounting profession.

II. COSO AND THE TREADWAY COMMISSION REPORT: 1986-1999

In response to the mid 1980s failure of many giant banks and financial institutions, several politicians and groups initiated efforts to identify possible causes of failures, including the extent of fraudulent financial reporting. In August 1986, Congressman John Dingell and other members of the Subcommittee on Oversight and Investigations of the U.S. House of Representative's Committee on Energy and Commerce proposed legislation to amend the Securities and Exchange Act of 1934 to require independent public accountants to include procedures for material financial fraud detection, to require reporting on internal control systems, and to require the reporting of fraudulent activities to appropriate enforcement and regulatory authorities.

These legislative proposals were not accepted. They were persisted on the belief that the public accounting profession could respond successfully without further intervention by the legislative branch of the federal government. Accordingly, a private-sector response to these legislative proposals was led by the Committee of Sponsoring Organizations (COSO), which oversaw the National Commission on Fraudulent Financial Reporting (Treadway Commission). This commission, jointly sponsored and funded by the American Institute of Certified Public Accountants (AICPA), the American

Accounting Association (AAA), the Financial Executives Institute (FEI), the Institute of Internal Auditors (IIA), and the National Association of Accountants (now the Institute of Management Accountants "IMA"), was formed to identify factors contributing to fraudulent financial reporting and to develop recommendations to reduce its future incidences.

The Treadway Commission, which issued its report in October 1987, concluded that the responsibility for fraudulent financial reporting was not vested in one group. While the commission conceded that financial statements are the responsibility of a company's management, it issued a series of recommendations for publicly traded companies, their independent public accountants, the Securities and Exchange Commission (SEC), and the educational community.

The report identified a number of factors that might contribute to fraudulent financial reporting, which include a number of environmental, institutional, and individual personal incentives to engage in fraudulent financial reporting. Institutional incentives include falsely improving financial appearances in financial statements for the purpose of maintaining market stock prices or to meet investor expectations as well as delaying the reporting of financial difficulties in order to avoid failure to comply with covenants in debt agreements. Individual incentives include falsely reporting results in order to achieve targeted results for bonus or incentive compensation purposes, as well as to avoid penalties for poor performance in achieving targeted profit objectives.

The Treadway Commission indicated that the oversight bodies that establish auditing standards and those that monitor compliance have a continuing responsibility to uphold the integrity of the disclosure system. The commission also concluded that many of the Securities and Exchange Commission's fraudulent financial reporting cases against auditors were for alleged failures to conduct the audits in accordance with generally accepted auditing standards (GAAS).

In response to the Treadway Commission report, the Auditing Standards Board (ASB) of the AICPA issued ten new auditing standards in 1988. These ten Statements on Auditing Standards (SAS's) often referred to as "Expectation Gap" standards which included requirements affecting the auditor's responsibility to detect and report errors

and irregularities, consideration of internal control structure in a financial statement audit, and communication with a company's audit committee.

In 1992, COSO issued Internal Control: An Integrated Framework for companies, their managements and their auditors. The framework is a conceptual paradigm that provides subjective concepts of effective internal control. COSO defines internal control as a process designed by a company's management designed to provide reasonable assurance that the company achieve its objectives in the following areas:

- Reliability of financial reporting
- Compliance with applicable laws and regulations
- Effectiveness and efficiency of operations

The COSO framework identified five interrelated components of internal control:

- The control environment that sets the tone of an organization.
- Risk assessment that identifies and analyzes potential risks.
- Control activities that are policies and procedures to assure that management objectives are carried out.
- Information and communication that identify and process information that enable people to carryout responsibilities
- Monitoring that assesses compliance with control procedures.

The framework provides only reasonable assurance because there are inherent limitations in any system of internal control. Prior to the SOA 2002, internal controls were evaluated in the context of planning an audit of financial statements but the results of the assessment of internal controls was not reported publicly.

Continuing attempts have also been made to gain an understanding of fraudulent financial reporting in the 1990's. In 1999 COSO issued the results of a study of SEC Accounting and Enforcement Releases between 1987 and 1997. This study attempted to gain an understanding of the participants, extent and duration of fraudulent behavior. At the request of the SEC chairman, the New York Stock Exchange, and the National Association of Securities Dealers formed the Blue Ribbon Committee that was charged with recommending ways to enhance the effectiveness of audit committees. The Blue Ribbon Committee recommended stronger audit committee oversight responsibilities relating to financial reporting.

III. THE SABANES–OXLEY ACT 2002, THE SEC, AND THE PCAOB

Between late 1990s and early 2000s, there was a series of business failures and financial scandals, the mostly prominent is the case of Enron Corporation, all of which have caused a serious decline of investor confidence in corporate financial reporting, the public accounting profession, and consequently in the capital markets.

In an attempt to restore public investor confidence, U.S. Congress passed the Sarbanes–Oxley Act of 2002 that amended the SEC Act of 1934 and expanded rules concerning corporate governance, improving the oversight of external auditors, focusing the attention of companies and auditors on internal control and increasing penalties for non-compliance. The intent of these elements of the SOA is to reduce the likelihood that material fraud will go undetected.

The SOA includes the following major provisions.

- The creation of the Public Companies Accounting Oversight Board (PCAOB)
- Rules designed to increase auditor independence
- New responsibilities for corporate directors, chief executive officers and chief financial officers
- Enhanced financial disclosures

The PCAOB is a five-member board of financially literate members. The board has the authority to establish auditing standards, quality control standards, and independence standards for audits of public companies. In addition, the PCAOB has the authority to inspect the work of public company auditors. The PCAOB deliberations result in the adoption of rules that are submitted to the SEC for approval. Prior to the Sarbanes-Oxley Act, the AICPA Auditing Standards Board was responsible for these functions on a self regulatory basis.

The SOA has strengthened auditor independence by making it unlawful for an auditor to perform audit services for a public company and also to perform non-attest services such as bookkeeping services and other consultative services for the same audit client.

The SOA has increased penalties imposed on the managements of public companies found to be responsible for false and misleading financial statements.

Included in the act is a provision requiring a public company's chief executive officer and chief financial officer to certify the appropriateness of the financial statements and disclosures contained in the company's annual report.

Section 404 of the SOA and Auditing Standard Number 2 issued by the PCAOB require corporate management and the company's independent auditor to issue two reports that must be included in the company's annual report filed with the Securities and Exchange Commission. These two reports require management and the independent auditor of public companies to evaluate and report on the effectiveness of the company's internal control over financial reporting.

Management will state in its report its responsibility for maintaining adequate internal control over financial reporting and give its assessment of whether or not internal control over financial reporting is effective or not.

The independent auditor will evaluate and report on the fairness of management's assessment. The auditor will also perform an independent audit of internal control over financial reporting and will issue an opinion on whether internal control is operating as of the assessment date. If one or more material weaknesses exist at the company's fiscal year-end, the auditor cannot conclude that internal control over financial reporting is effective.

The purpose of these reporting requirements is to increase the likelihood that material weaknesses in internal control over financial reporting will be identified and remediated.

Despite these requirements, it is still possible for fraudulent financial reporting to occur. Although the intended results of internal control reporting is to reduce the likelihood that material fraud will go undetected, no system of internal control provides absolute assurance from manipulation, collusion or management override.

Only public accounting firms and individual Certified Public Accountants (CPAs) associated with publicly-held companies are subject to the new rules of the SEC and PCAOB's new standards. The Act impacts (1) large accounting firms, (2) individual CPAs actively working as an auditor for a publicly held company, and (3) a CPA working in the financial management area of a public company.

The newly established five-member PCAOB has the authority to (1) set and enforce auditing, attestation, quality control and ethics (including independence) standards for auditors of publicly traded companies; (2) inspect the auditing operations of public accounting firms that audit public companies; and (3) impose disciplinary and remedial sanctions for violations of the board's rules, securities laws and professional and accounting standards.

The Act requires the rotation of the lead audit partner and review audit partner every five years. The Act extends the statute of limitations for the discovery of fraud to two years from the date of discovery and five years after the Act (previously one year and three, respectively). The Act restricts the consulting work public accounting auditors can perform for their publicly-held audit clients. The Act establishes harsh penalties for securities law violations, corporate fraud, and document shredding.

In line with the April 26, 2003 deadline under the S-O Act 2002, the SEC determined that the PCAOB is ready to fulfill its mandate. In separate two actions, the SEC affirmed the status of the PCAOB and the Financial Accounting Standards Board (FASB) regarding issuers, i.e., publicly-held companies. The SEC reaffirmed that it will continue to recognize pronouncements of the FASB as being generally accepted for purposes of filings with the SEC [AICPA e-mail News Update, May 2, 2003]. At its April 16, 2003 meeting, the PCAOB initiated the first step in establishing a process to develop auditing standards for publicly held companies (and to be followed by public company auditors) and to engage in a comprehensive review of the existing standards [AICPA e-mail News Update, April 18, 2003].

VI. CONCLUDING REMARKS

Deceptive (creative or aggressive) accounting is a process whereby corporate accountants and executives, as well as accounting practitioners, utilize their experience and knowledge of accounting rules to manipulate the accounting numbers to be reported in the entity's accounts and consequently on the financial statements for special purposes. There are three groups of business people who commit financial statement frauds. They range from senior management (CEO and CFO), mid- and lower-level management, to organizational criminals. CEO and CFO commit accounting frauds to conceal true business performance, to preserve personal status and control,

and to maintain personal income and wealth. Mid- and lower-level employees falsify financial statements for their area of responsibility (subsidiary, division, or other unit) to conceal poor performance and/or to earn performance-based bonuses. Organizational criminals falsify financial statements to obtain loans or to hype a stock they plan to sell in a “pump-and-dump” scheme.

Despite the continuing and evolutionary corporate and accounting reformatory efforts in the U.S., Europe, and by international organizations, the number of incidences of corporate frauds is increasing and they are hard to detect. According to a new Big Four survey, reported on the AccountingWeb on December 5, 2005, the number of companies around the world that reported incidents of fraud increased 22 percent in the last two years.

While layers of new controls have been implemented to improve corporate governance, fraud is still widespread, difficult to prevent, and detected many times by chance, according to the biennial survey by PriceWaterhouseCoopers (PWC), which interviewed more than 3,000 corporate officers in 34 countries. Fraud was detected by 45 percent of the companies polled, which is up from 37 percent in 2003, Reuters reported. In North America, 60 percent of the fraudsters were company employees. Almost 25 percent were senior managers. PWC found that “accidental” ways of detecting fraud, such as calls to hotlines or tips from whistleblowers, account for more than a third of the cases. Internal audit was responsible for detecting fraud about 26 percent of the time. Companies have been required to invest in internal controls by the SOA. The study also found that companies with a larger number of controls could better determine the full impact of the fraud, uncovering three times as many losses as companies with fewer controls, the Ottawa Business Journal reported. Despite the increase in frauds reported, almost 80 percent of companies did not consider it likely that they would suffer from financial fraud over the years to come.

REFERENCES

AccountingWEB.com. 2005. Corporate Fraud Still Widespread, Difficult to Detect. December 2005.
http://www.accountingweb.com/cgi-bin/item.cgi?id=101540&d=815&h=817&f=816&dateformat=%B%20%e,%20%Y

Badawi, Ibrahim M. 2005. "Global Corporate Accounting Frauds and Action for Reforms."
Review of Business, 26, 2 (Spring), pp. 8-14.

------------------------. 2004. "SEC Rules to Reform the Mutual Fund Industry." Globalization and
Sustainable Development, edited by Shyam S. Lodha, Xiahong He, and Anita Jackson.
Southwestern Connecticut State University, New Haven, Connecticut, May 14-15, pp. 142-
144.

------------------------. 2003. "An Inventory of Cases of Corporate Fraudulent Financial
Reporting." Responsible Business in a Global Economy, edited by Shyam S. Lodha, Xiahong
He, and Anita Jackson. Southwestern Connecticut State University, New Haven, May 29-30,
10-12.

------------------------, and Adrian P. Fitzsimons. 2002. Sarbanes-Oxley Act and SEC Proposals
Address Corporate Responsibility. Bank Accounting & Finance, 15, 6, pp. 30-35.

Committee of Sponsoring Organizations of the Treadway Commission. Report of the National
Commission on Fraudulent Financial Reporting. n.d.
http://www.coso.org/publications/NCFFR_Part-1.htm.

Committee of Sponsoring Organizations of the Treadway Commission. Internal Control-
Integrated Framework. n.d.
http://www.coso.org/publications/executive summary_integrated_framework.htm.

Crumbley, D. L., L. E. Heitger, and G.S. Smith. 2003. Forensic and Investigative Accounting.
Chicago: CCH Incorporated.

Green, S. 2004. Manager's Guide to the Sarbanes-Oxley Act: Improving Internal Controls to
Prevent Fraud. N.Y.: John Wiley & Sons, Inc.

Public Company Accounting Oversight Board. An Audit of Internal Control Over Financial
Reporting Performed in Conjunction with an Audit of Financial Statements. n.d.

http://www.pcaob.org/Standards/Standards_andRelated_Rules/Auditing_Standard_No.2.aspx.

Public Company Accounting Oversight Board, PCAOB Release No.2005-002. Proposed
Auditing Standard-Reporting on the Elimination of a Material Weakness.
http://www.pcaob.org/Docket_018/2005-03-31_Release_No._2005-002.pdf.

Wells, J. T. 2005. Principles of Fraud Examination. N.Y.: John Wiley & Sons, Inc.