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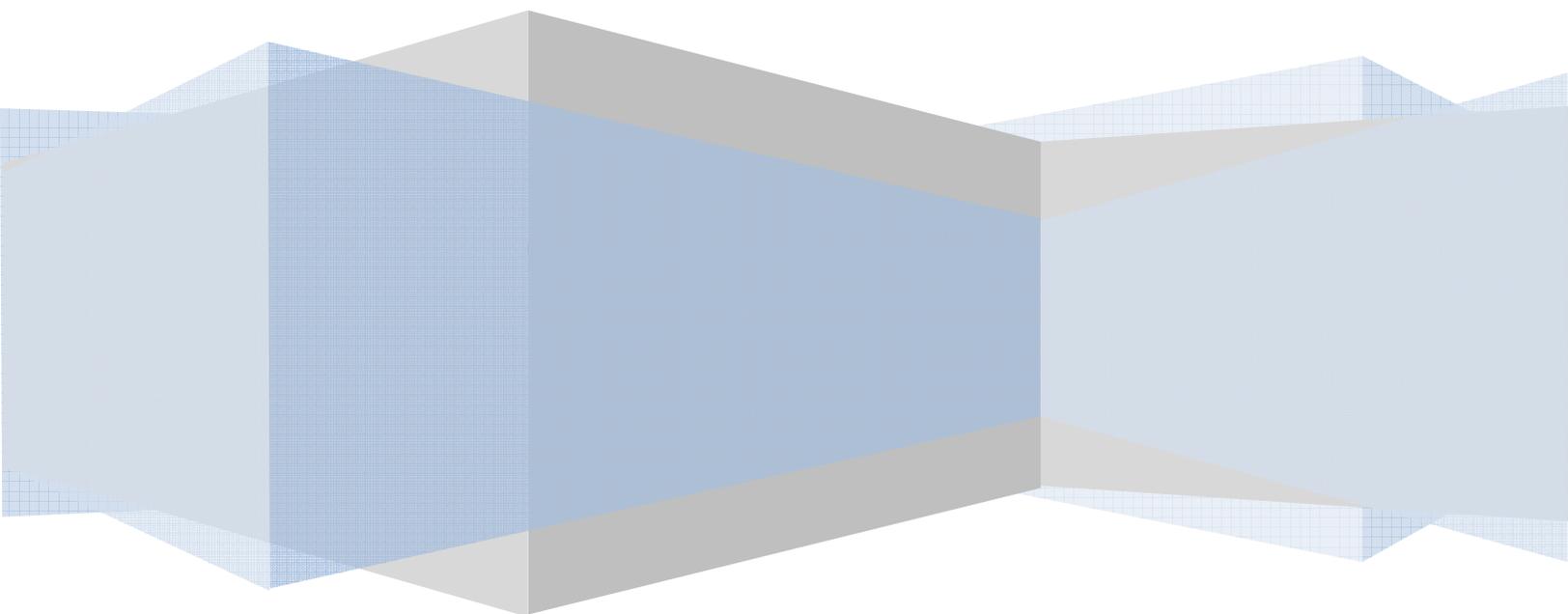
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Sigmund Freud, the Austrian psychologist, believed that every human being is mentally born with a “clean slate”, known as *Tabula rasa*, where personality traits and character are built through experience and family morale. Other psychologists and neurologists believe individuals have an innate destiny to be either “good” or “bad” – a more fatalistic view on human life. Psychological theories are controversial, as it seems almost impossible to prove which theory is reality, but we find ourselves visiting these ideas when trust, ethics, reputation, and integrity are violated.

The Sarbanes-Oxley Act is still a relatively new federal law set forth by the Securities Exchange Commission in 2002. Since its implementation, individuals have been wondering if Sarbanes-Oxley is effective enough and doing what it is meant to do – catch and prevent future accounting frauds and scandals. With the use of closer and stricter rules, the SOA is trying to prevent frauds with the use of a created Public Company Accounting Oversight Board. Most importantly, however, it was created to protect the investors from self-interested managers, so as to not have repeats of the Enron, WorldCom and Tyco International scandals. Lack of ethics and honesty seem to have been the primary issues within corporate and accounting scandals. Can the SOA identify companies that are being unethical even though its primary purpose is to prevent fraudulent acts? Can upper management still find a way around these extra rules and regulations newly implemented by law? In this thesis, I will discuss many concerns that public companies, auditors and individuals have about the effectiveness of the law over the past nine years of its existence.

Enron and WorldCom – What’s Going On?

Enron Corporation was formed in 1985, with CEO Kenneth Lay. In 1990, Lay hired Jeff Skilling, who later became CEO of the company. When changes in government regulations of electrical power

markets occurred, Enron transformed into a market maker for different energy-related commodities. In the late 90's, Enron's stock prices soared as the confidence of investors grew. The corporation became the seventh largest company in the United States. Meanwhile, the CFO, Andrew Fastow, was creating false, separate investment companies (encouraged by Skilling and Lay), called "Special Purpose Entities", leading investors to believe the energy company was in better financial condition than they actually were. In fact, Enron was hiding losses in controversial and often off-balance-sheet fraudulent accounts. Not having losses on the financial statements (especially long-term losses) greatly increases the net income but provides inaccurate information to the shareholders. These losses occurred due to Enron's attempt to innovate with projects that ended up falling through, pushing Enron further into financial distress. However, the problem was that losses generated from the cancelled projects were actually recorded as assets within the company's financial statements.

Since net income is negatively impacted by a company's losses directly, recording the losses as assets gave Enron's balance sheet an embellished appearance to investors, but completely eliminated any sign of financial decline (losses) within net income in the shareholder's eyes. Therefore, we see the immense earnings management manipulation that occurred among corporate management, and all for personal gain. In August 2000, the peak shares were 90 dollars, but after corporate scandals, shares dropped to 30 cents in 2001. In the end of 2001, Enron filed for Chapter 11 bankruptcy, after admitting their \$586 million overstatement in profits a month before.

The public accounting firm, Arthur Andersen, was Enron's auditors. Andersen could have stopped the scandal, but instead aggravated the accounting fraud by literally destroying one ton of auditing documents in shredders from the Enron audit. Andersen was convicted of "obstruction of justice", having to pay a maximum possible fee of \$500,000 for the unlawful act. In June of 2002, Andersen, a firm founded in 1913 by the youngest CPA of his time, was found guilty of multiple criminal charges and surrendered their license as a public CPA firm. An auditor's only asset is their reputation, and when that is destroyed, the firm is morally and ethically destroyed. According to Bethany McLean, a journalist of

Fortune magazine, who prompted a more effective look at Enron's financial statements, mentions in regards to accounting, "you want to know why something is the way it is", but "there is no reason why...no fundamental truth underlying it. It's just based on rules." For the Arthur Andersen public accounting firm, Skilling, Lay and Fastow, accounting rules were something to bypass and get around, not follow.

Because of Andersen's unprofessional behavior and Enron's unethical activities, millions of investors' retirement money and other funds collapsed with Enron. Arthur Andersen employed over 80,000 workers, and Enron, 22,000 employees. All because of this scandal in 2001, over 100,000 corporate workers suddenly became unemployed.

What is Sarbanes-Oxley? – The Good & the Bad:

After the scandal with Enron, as well as fraudulent activities that occurred within WorldCom and Tyco, it was obvious that corporations had to modify their accounting methods with some sort of regulation. This is when Senator Paul Sarbanes and Representative Michael Oxley stepped in to put together an Act to regulate auditors as well as the upper management (CEO, CFO and Chairman) of public companies to protect investors and keep them confident in publically traded corporations - a law known as the Sarbanes-Oxley Act of 2002. A most prominent portion of the act lies within the responsibility of the Public Company Accounting Oversight Board, which is a board whose duty is to issue Auditing Standards, as well as independence, quality control and ethics standards. Taken directly from the SOX act, the PCAOB's responsibility is "to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." The PCAOB is overseen by the SEC, and without either of the regulatory boards, Sarbanes-Oxley would cease to exist because no one would be enforcing the rules under the Act.

More Costly Than Beneficial? After passing the Sarbanes-Oxley Law followed a loss of \$1.4 trillion in shareholder wealth. But can we say the costs trump all benefits? Not necessarily. Steve Schwarzman, CEO of private-equity juggernaut Blackstone, recently said that Sarbanes-Oxley "is probably the best thing that's happened to our business and one of the worst things that has happened to America." One reason may be that many public corporations find SOX so costly that they are trying to go private.

From Public to Private to Avoid the Act. After its implementation, many companies have realized how timely and costly the SOX Act is. Public companies' (those entities that have active investors) first inclination to the Act was to "go private". Why not avoid all the costs and stress of adjusting to Sarbanes-Oxley and the PCAOB oversight board, and just be a private firm, being accountable only to the AICPA? According to the paper *Was the Sarbanes-Oxley Act of 2002 really this costly?*, by Christian Leuz, going-private transactions are determined by the entities themselves along with internal management, who decide to take less than three hundred shareholders for their company. This allows the companies to deregister from the Securities Exchange Commission (SEC). Going private is commonly known as "going dark" because privatizing entities takes away their ability to finance investments and innovations for the companies, as it changes the entire organizational form. It involves a recapitalization or concentration of ownership. However, remaining a public firm with fully invested shareholders allows companies to continue their growth through means of financing. The difficult decision to stay Public while increasing the level of regulation within the companies, or go private and losing most investors is far from being simple, especially when it comes to compliance with Sarbanes-Oxley.

Major factors in determining whether to go private include not only expenses of implementation, but the tendency to overspend on attempting to strengthen internal control. It is stated that firms that have strong formal internal controls find it easier to adjust with the additional SOX requirements than firms that have fewer and less formal controls; no doubt this is due to the fact that companies with more efficient internal controls are spending less money on strengthening internal controls themselves

since they are already seen as effective. Of course, the companies with weak internal controls may consider going-private more than companies who are healthier control-wise. However, as long as companies are still staying competitive in the market, whether they are private or public, they are still actively contributing to the economy. It can be inferred that it is better to change your company's position (public to private) than to have the stress and expenses of complying with SOX.

True Benefits. "We cannot forget that the costs of implementing the law are worth the benefits", as stated by Paul Sarbanes. He mentions that we have to remember the thousands of people that lost their pension and retirement savings because of the 2002 Enron and WorldCom scandals. With SOX, the costs that come with ensuring that public companies have a legitimate system of internal financial controls is more important than sitting back and taking no action. The only problem is both ethical and unethical public companies are complaining about the costs of the law and the law itself. Ethical companies do not want to dish out thousands or millions of dollars for a law they personally do not need if their financial statements are accurate and honest. Unethical companies are, on the other hand, worrying about the law and the future, depending on what external auditors may find. So far, with the Act, there have been numerous costs of implementation, but there have been benefits as well. With that mentioned, let us take a deeper look at the specifics of SOX.

Sarbanes-Oxley covers a range of rules for public accounting firms and publicly traded companies to comply with; some are broad topics and others are more specific and narrow. The most note-worthy and often controversial section of the Act includes Section 404: Assessment of internal control. More broad topics include, but are not limited to, Auditor Independence (avoiding client-auditor conflict of interest), Corporate Responsibility (management take individual responsibility for the completeness and accuracy of the corporation's financial statements) and Corporate and Criminal Fraud Accountability. Although the Act provides numerous guidelines and standards to follow, many have argued that the costs outweigh the benefits, and vice-versa.

SOX Section 404:

Section 404 on “Management Assessment of Internal Control” may be the biggest concern, which requires management and the external auditor to report on the accuracy of the company's internal control over financial reporting (signing off on or verifying the reports). Since the purpose of SOX is to reduce the potential for corporate fraud, Sarbanes-Oxley has made it a requirement that all publically-traded companies have their internal controls audited. Internal controls are implemented by companies to ensure appropriate capturing and recording of individual transactions, which are then collected into ending account balances. By auditing internal controls, auditors determine if controls have weaknesses which would make it more possible for errors and fraud to occur. According to the book, *How to Comply with SOX Section 404*, auditors use a top-down approach, which is mentioned in the Auditing Standards 5 and 2 (AS5, AS2), when it comes to the risk-based audit approach. Under “top-down”, the auditor obtains an understanding of the client’s business objectives and strategies, identifies the business and audit risks (what could go wrong in preparation of financial statements), documents an understanding of internal control, and gathers sufficient, appropriate audit evidence. AS2 and AS5 are types of guidance for the PCAOB and management (AS2) and auditors (AS5) when audits are being performed.

According to the CPA Journal, “Two conclusions are evident from the data on auditor changes. First, there is greater auditor-switching among companies with material weaknesses. This may be due to disagreements with auditors over ICFR reporting, higher audit fees, or auditors resigning from higher-risk engagements. Second, the frequency of auditor-switching is increasing overall.” “Specifically, 13% of Big Four sample clients reported material weaknesses in 2004, compared with 31% of mid-tier firm clients and 16% of small-firm clients.” “Nonetheless, the data reported here and in other recent academic research suggest that there are considerable benefits of improving ICFR that accrue to the companies themselves.”

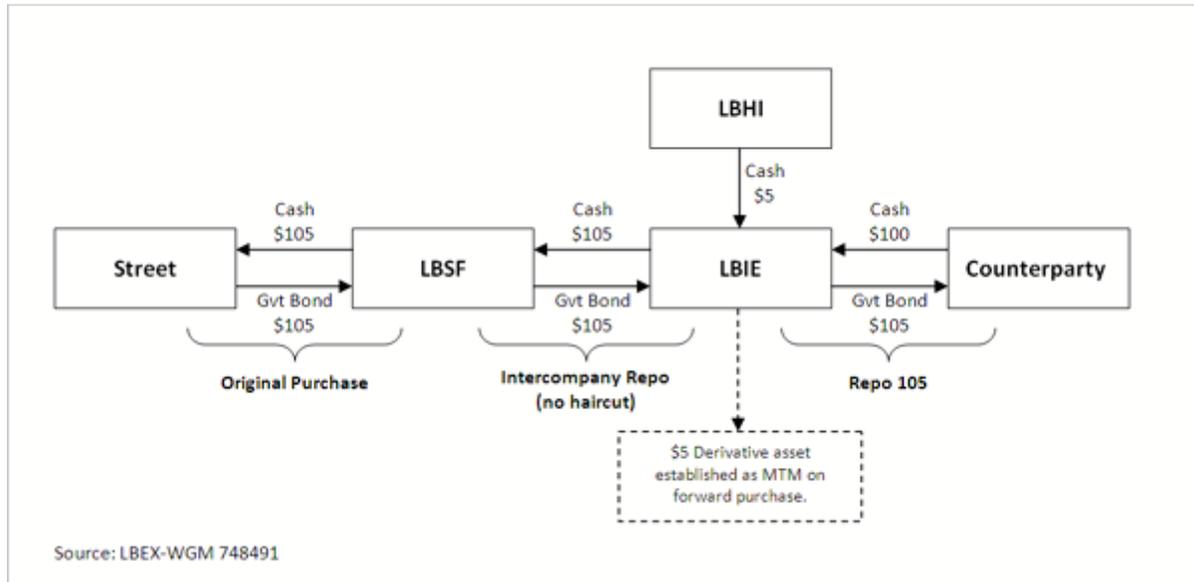
Has Sarbanes-Oxley strengthened the backbone of public accounting by providing better guidelines and more effective approaches to auditing? Maybe, but here is the clincher- if the Big 4 are reporting

the lowest statistics of clients who have weak internal controls (as opposed to mid-sized and smaller firms' clients), why have there been significantly large scandals within companies who are audited by the Big 4?

Sarbanes-Oxley should never be viewed solely as a compliance and disclosure law to satisfy the SEC and investors. It should be a compliance and *analysis* law of the public company. Section 404 requires disclosure by management of internal controls. The report under Section 404 must provide "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting", as stated in 15 U.S.C. § 7262(a), and "contain an assessment, as of the end of the most recent fiscal year of the company, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting" (SOX, Section 404).

SOX requires the separation of CEO from Chairman of the company's board as to limit the power they have in the company (Corruption in Corporate America, 36). The committees of public companies serve to oversee the management who are making the decisions relating to finances, corporate strategy and profitability. According to Corruption in Corporate America, "the board is there to spot problems early and to get management's attention directed to their solution" (p. 38) and to replace management who fail to bring out an effective solution. However, with many corporate frauds, it has not just been a manager who was the culprit. Is it possible for the CEO, CFO and Chairman of the board to be involved in a fraud? Of course it is. During an interview with Stephen Pedneault, the forensic accountant stated a concerning fact; he said that despite the Section 404 sign-off within the SOX act, 84% of the frauds within the past 10 years have involved the CEO and/or CFO, and therefore, has had little impact on decreasing the level of fraud and financial statement restatements. If we have not been concerned about the effectiveness of Sarbanes-Oxley in the past, this statement should change our perception.

Sarbanes-Oxley's Unfortunate Failure – Lehman:



<http://dealbook.nytimes.com/2010/03/12/the-british-origins-of-lehmans-accounting-gimmick/>

Above is an illustration of a Repo 105 transaction.

The Lehman Brothers scandal unfolded in 2008, with auditors Ernst & Young in trouble in 2010 for failure to disclose Repo 105 transactions to investors, also known as repurchase agreements. Repos “involve raising cash to fund operations by lending out high-quality assets (usually Treasury bills) for a short period of time. As part of the deals, the banks agree to repurchase their collateral within days or weeks” (Lehman’s Repo 105: More Than You Ever Wanted to Know). Lehman Brothers exchanged securities worth 105% of the cash it received (Repo “105”) according to an examiner’s report. Since Lehman Brothers had limited cash flow and was in greater debt than its balance sheet showed (\$50 billion, to be exact), the company was desperate for cash. So, Richard Fuld (CEO and Chairman of Lehman) began engaging in Repo 105, to obtain quicker cash. The report stated that Lehman would get the Repos off its books, report earnings, showing lower leverage ratios, and then buy the assets back. Of course, in the end, this technique and strategy was supposed to make Lehman appear more liquid than the company actually was.

Instead of describing them as loans, however, they were viewed as “sales” on their financial

statements, never mentioning that these securities should be paid back (returned) to the lender, such as Citigroup and JPMorgan. When Lehman first designed Repo 105 in 2001, the firm was unable to get any U.S. law firms to sign off on the aggressive accounting, “namely that these transactions were true sales instead of what amounted to the parking of assets”. In addition, “Repos generally cannot be treated as sales in the United States because lawyers cannot provide a *true sale opinion* under U.S. law”.

This is the illegality of Repo; a type of window-dressing, where it makes the investment bank look more liquid and financially healthy. Therefore, this temporarily lowered their risk, while in reality, their debt and financial leverage was growing each quarter. In the last quarter of 2007, their debt was \$39 billion, in the first quarter of 2008, their debt was \$49 billion, and in the second quarter of 2008, their debt grew to \$50 billion. In the following quarter, JPMorgan and Citigroup called Lehman and asked them to pay their borrowed money back, which is when Lehman knew they were in trouble since they didn’t have the cash. They filed for bankruptcy in September of 2008.

Former NY Governor, Eliot Spitzer, states that Lehman’s primary motive behind these sale-like transactions was to “mislead the market” and there was no economic reason for it. Hand cuffs, Spitzer claims, are the only solution to stop the fraudulent acts - criminal acts are not allowed and this cannot be emphasized enough. Richard Fuld paid himself \$500 million over 15 years by using the illegal transactions of Repo 105. A criminal act that cannot be shamed enough.

Ernst and Young did nothing to challenge or question the missing disclosure of the \$50 billion debt. In Fact, Andrew M. Cuomo (New York Attorney General) sued Ernst & Young in December of 2010. The Attorney General accused the public accounting firm of helping Lehman Brothers “engage in a massive accounting fraud” by misleading investors about the investment bank’s financial health. A few months before the company filed for bankruptcy, executives had been told that their financial statements did not add up. Still Ernst & Young did nothing to prevent further damage. Clearly, they broke the law.

Matthew Lee, then a senior vice president overseeing Lehman’s global balance sheet, wrote a detailed and complex letter addressed to Ernst & Young demonstrating his concern about Lehman

Brothers. He suggested that the internal auditors do not seem to have the “professional expertise to properly exercise the audit functions they are entrusted to manage.” With that said, a primary issue is that under Sarbanes Oxley (Section 404), the CEO and CFO (higher-up management) are required to certify the published financial statements that must comply with Securities and Exchange Commission standards. Management must attest to their methods of establishing and maintaining an adequate internal control structure and procedures for financial reporting. So where was Ernst & Young’s professional skepticism in this audit? Where was the SEC and why did Sarbanes-Oxley fail to diagnose this scandal?

Sarbanes-Oxley and Its Best Moments:

The SOX act was not an easily comprehensive 66-page law when it was implemented in 2002 because of its vagueness. In fact, nearly 9 years later, corporations and public accounting firms are still trying to devise some of the meanings behind the law. Therefore, it is obvious that the law is not as simple as following the road rules of a stop sign or traffic light. However, since audit teams are becoming more familiar with the Act and understand its greater purpose, they will still spend time on the specific, narrow aspects of the law, but can focus more on the larger, broader picture. “This is because audit committees have made it over the steepest part of the learning curve, altering its practices, information systems and policies to meet the demands of Sarbanes-Oxley” (Audit Committee’s New Agenda).

Many the problems with SOX in some scandals since 2002 were due to the fact, to a degree, that audit committees did not fully understand the law. Nonetheless, there’s always a loophole that, it seems, no law could predict or anticipate; hence the implementation of SOX. Because Enron, WorldCom and Tyco scandals could not have been anticipated, no law was in place to check the firm’s true level of ethics within the financial statements. Will committees and boards have to add to the SOX law in the future as new fraudulent acts unravel (i.e. Lehman). Most likely, but we can only continue hoping SOX

will continue to protect shareholders as best it can for the current time. But what has SOX done so far and has the Act successfully caught frauds in mid-scandal?

HealthSouth Corporation was established in 1984 by Richard M. Scrushy with four partners. By 2000, the corporation provided sports medicine to the National Football League's New England Patriots and Washington Redskins, as well as the New England Revolution, a Major League Soccer Team. A corporation that had nearly 1,700 facilities and employed 51,000 employees in every state and abroad, a HealthSouth investigation was launched in September of 2002 (not even 2 months after the Act was enacted). It was identified that Scrushy had committed accounting fraud and overstated earnings by \$1.4 billion, starting in 1999. Shortly thereafter, Scrushy was fired, and the financial officer, Emery Harris, was guilty of fraud as well as pleading guilty to possible insider trading. The SEC charged two former executives (one was the former CFO) guilty with insider trading and securities fraud and false certification of financial records. The list of executives involved in the scandal went on. It turns out that HealthSouth executives faked a total of \$2.5 billion in earnings, not the prior suspected amount of \$1.4. It was later discovered that Scrushy, the chairman and CEO, alleged he used the money gained by the company fraud to buy assets including diamond jewelry, a plane, a yacht, Cadillacs, cuff links, works of art by famous painters, land and an armor-plated sport-utility vehicle (*Corporate Scandals- The Many Faces of Greed*). Auditors Ernst & Young admitted that they had relied on too few people for information about how HealthSouth was managed and did not properly check and test certain accounts – a big deal.

The HealthSouth case was the first scandal caught and identified so quickly, and all because of Sarbanes-Oxley. Top U.S. officials asserted that with the enactment of SOX, corporate-fraud prosecutions would intensify and the scandals would be identified in effective and efficient time. With the scandal of HealthSouth, the Federal Bureau of Investigation, Department of Justice and local U.S. attorneys, along with the SEC, all got involved to prosecute executives. According to Deputy Attorney General Larry Thompson, The SOA “focused the responsibility of some of these executives squarely on the fact that if you make fraudulent or false statements, you are going to be held criminally

responsible.”

If it wasn't for SOA, HealthSouth may still be committing corporate fraud and overstating earnings, taking advantage of their investors. The common concern, however, is how many scandals equivalent to HealthSouth has Sarbanes-Oxley not identified yet? Are there more? Analysts say that more precise financial statements are now being prepared for public companies, showing that aspects of Sarbanes Oxley are successful thus far. This is also leading to a greater confidence in the shareholders of these companies. The SEC emphasizes, however, that it is crucial that requirements of the Act are strategically and universally followed, and that exceptions are not permitted (*Sarbanes Oxley: Success or Failure?*). It may take several more years to completely understand the law itself and if it is having a powerful and effective impact on corporations.

Sometimes we get frustrated with what we see so far with Sarbanes-Oxley. We may see it as a crucial law that, putting capitalism aside, may be essential for future corporate America, yet what many of us forget is that SOX is not even a decade old. It is not the type of law that, once implemented, is supposed to take effect, such as a new driving law. Maybe the scandals discovered after the Act (Lehman Brothers) are only a discouragement that keeps capitalists from pointing the finger at the SEC. It is obvious that SOX needs improvements, but can a law that has been in place for only eight years that is supposed to have such a large impact be judged yet?

Whistleblowers and Accounting Scandals:

Whistleblowers may be the primary source that catching corporate frauds run on. SOA may catch or prevent some frauds, but if no one has the courage to be the whistleblower, whether an employee of the corporation, member of the SEC, or auditor, these scandals may continue for years. Furthermore, whistleblowers should be taken seriously or at least highly considered. Sherron Watkins VP of Corporate Development at Enron is loosely considered a whistleblower, because her actions and concerns were only sent to Kenneth Lay, the CEO and primary problem of the scandal. She blew the whistle to inform

Lay that there may be *other* whistleblowers throughout the company who were catching on to Enron's many fraudulent transactions. However, the memo she wrote was not distributed to the public until five months after she wrote it.

The SOA has increased protection of whistleblowers in three prime ways, recognizing that they may have significant roles in uncovering scandals (Sarbanes Oxley and Whistleblower Protection, CPA Journal). Enhanced protection of whistleblowers is extremely important, but it is difficult to analyze whether these three areas are effective. Let's take a look. First, Public companies are required to have a system in place where reports of anonymous whistle-blowers can disclose their concerns or speculations of the company. In fact, Section 302 of the Sarbanes-Oxley Act states: "Each audit committee shall establish procedures for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters." A concern with the new whistleblower protection is that, as mentioned in the CPA Journal, committees (specifically, internal control) identifying the "anonymous" whistleblower is probable since internal control committees update their statements and records on a day-to-day basis. Therefore, harassment and ridicule may occur if an identified individual is seen as a whistleblower.

Second, Section 806 of the act states that "no publicly traded company, or any officer, employee, contractor, subcontractor, or agent of such company may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee." But is this specific enough? Many questions arise with what constitutes harassment and how can we define a lawful act? Upper management may go out of their way to cover up any "threat" or "harassment" that was directed to an employee. Also, companies tend to use outside special counsel in order to maintain independence during investigations of letters. Outside special counsel are primarily concerned with identifying any truthfulness behind the allegations found in the anonymous letter, not in identifying the whistleblower themselves. This is a drawback of whistleblower protection that should be further developed and perfected.

Lastly, Sarbanes-Oxley provisions have made it clear that retaliation against whistle-blowers will not be tolerated. Furthermore, with the additional of a new law in Title 18 of the U.S. Code, it is seen as a criminal offense to retaliate against whistle-blowers. The carrying penalties range from a large fine to 10 years in prison. A concern about this protection law is the term “retaliation” is not defined and can be easily bypassed or twisted by the one who is committing the criminal act to look harmless.

A Lehman veteran, Matthew Lee (mentioned above), who was let go in June of 2008 after voicing his concern about Lehman's risk management strategies, is another prominent whistleblower. It was suspected by Lee that Lehman's securities firm was temporarily moving \$50 billion in assets off its balance sheet to hide the firm's risky techniques with Repo 105 (*Lehman Brothers Management Violated Sarbanes-Oxley*). Was firing Lee a violation of the Act under Section 806? The United States is the only country that acts on an “At-Will” Employment law. Any employer may dismiss their employees at will, be many or few, for good cause, for no cause or even for cause morally wrong, without being thereby guilty of any wrong. In this case, dismissing Lee from Lehman for any reason other than one that would violate Section 806 is acceptable, right? It seems the heroes are the ones getting punished by getting fired, harassed or simply ignored by management and auditors that should be taking whistleblowers more seriously.

Sarbanes-Oxley is said to protect whistleblowers, but there is still the fear of potential blackmail, who to trust, and losing one's job. In addition, “Outside special counsel has no motivation to seek out the identity of the whistle-blower. They are merely concerned with ascertaining any truthfulness behind the allegations found in the anonymous letter”. If Watkins told Arthur Andersen about her concern with Enron's financial statements and reporting, they would have to follow more rules in analyzing the letter. In this case, the Enron external auditors were wrapped around Lay's and Skilling's fingers because to Andersen, the money and their greed was a huge factor, not the ethics or the whistleblowers.

“Since Sarbanes-Oxley was enacted, about 1,000 cases have been filed. According to CFO.com, almost all of those were dismissed without merit or had settlements between employees and their

companies” (*Whistleblowers and Sarbanes-Oxley*, Tracy Coenen). If Sarbanes Oxley still needs improvements since not all frauds are being caught, whistleblowers may be the first step for the SEC and PCAOB to take certain audits more seriously and cautiously than others, instead of just going through the motions and following the SOA, GAAS and SAS rules (See “No Sass with SAS 99”).

In another instance, a whistleblower notified the SEC in 1999 that Madoff may have been engaging in illegal corporate activities in terms of their finances and record-keeping, but the SEC ignored the warning because they claimed they had limited resources on the case. Although Madoff was not a publicly held company, shouldn't the SEC still have checked with Madoff's whistleblower, Harry Markopolis, to determine if those supposed illegal corporate activities were actually occurring (*How Regulators Missed Madoff*, Liz Moyer)? We will see more about this case in the section called “Madoff & Greed.”

David Welch is a significant whistleblower who was the first individual to obtain protection after Sarbanes-Oxley was enacted. He is the former CFO of Cardinal Bancshares, and he claimed that the company fired him after he challenged the bank's accounting policies and internal controls. Furthermore, he claimed that “accounting entries were being made without his knowledge, and that people without financial expertise were directing these accounting entries.” Because of his skepticism, he refused to certify the company's financial statements without receiving an answer as the CFO of the company. Welch brought lawsuit to the court against Cardinal Bancshares for firing him, but the Accounting Research Bulletin ruled that allegations made by Welch were not protected under Sarbanes-Oxley. How could this be? Under the law, Welch would have had to prove that income was overstated and that a reasonable person with his level of expertise would believe the same thing. Therefore, ARB stated that “the misclassification of loan recoveries did not meet this test because, in fact, the recoveries were made and the resulting financial statements reflected that recovery”. In other words, the board decided that the financial statements did not provide misleading information, so David Welch was out of luck to receive any benefits from the protection of Sarbanes-Oxley as a whistleblower.

To summarize, although there are rules to follow and guidelines to abide by, one can never be certain that public companies are properly following the Act since it is rather vague. So, a problem with whistleblower protection may not reflect major flaws in Sarbanes-Oxley itself, but rather, may reflect the dishonesty of management and other individuals who simply choose to *interpret* the law as they please. Furthermore, whistleblowers cannot be confident in who they can trust and who they should report their concerns to (audit committees, board of directors or other individuals in a company). For instance, Sherron Watkins reported her concern to Kenneth Lay, who was the source of the Enron fraud along with Jeffrey Skilling. As an employee, the rule of thumb is that one should never report issues to those who have an equal or lower position than oneself in terms of hierarchy, but many times it is the higher-up managers and CEOs who are the causes of the manipulation in financial statements and other reports. This is a challenge and struggle for those suspecting the company's controls and other actions.

Madoff & Greed:

The fraud behind the Bernard Madoff Investment Securities scandal involves whistleblowers that were initially ignored, and red flags that should have been investigated. The Madoff case is best known for its large amounts of money "earned" through a Ponzi scheme. A Ponzi scheme is a fraudulent investment operation that involves money being paid to investors not through profits earned within the company, but from a company's own money or money paid by subsequent investors. This is done by the company offering high amounts of money in short-term returns, where the payments are unusually high or oddly consistent. This entices new investors to get involved because of the high amount of return. The more people that get involved keeps the scheme going. However, what is unknown to participants is that the scheme is bound to collapse because the actual earnings a company has is always less than the amount of money paid to investors.

According to the SEC website, Madoff's corporation would not have survived without the fraud, and the intensity of this fraud required a coordinated effort within the company. The SEC asserts that

Bonventre, the company's Director of Operations, personally siphoned \$1.9 million from the scheme by directing that profits from fake, backdated trades be put into his own investor account at BMIS. The criminal mind behind the fraud was not only Madoff, but Bonventre as well. Furthermore, it was not the SEC, or any governmental agency that discovered the fraud. Rather, it was Madoff's own sons who turned their own father in to the police at the end of 2008, after Bernie admitted to the fraud that had been going on for numerous years (Forbes). More importantly, however, was the significant role that Harry Markopolis played in suspecting Madoff. In 2000, 2001, 2005, 2007 and 2008, Markopolis made submissions to the SEC regarding Madoff's unusual investment techniques. However, the SEC ignored all five letters, never making a single phone call to investigate the firm's activity. Harry Markopolis crunched numbers for a mere 4 hours until before realizing there was undoubtedly a fraud occurring at his competitor's firm. Although Madoff's Investment Bank was not a public company, and therefore was not forced to comply with SOX, it was still the SEC's responsibility to investigate the multiple notifications and red flags that were presented to them by whistleblowers. So why did the SEC ignore these facts?

Bernard Madoff was not oblivious to ethics. In fact, it was the very opposite. Madoff was so smart and knowledgeable that he knew ethics and *how* to get around the potential suspicions. After all, he played a major role in creating the Nasdaq, as well as being on the board of the National Association of Securities Dealers. It was Madoff's "knowledge of the way the markets worked and of the way regulators thought that may have helped him design his alleged scheme so it could escape detection" (Forbes). Madoff not collecting management fees for the advisory services kept regulators quiet and prevented any red flags from being raised. His financial service regulators (broker-dealers) did not have customer accounts because it held itself out as a "wholesale market-making firm." FINRA, the regulators whose motto is to protect investors and encourage market integrity, treated the investment company as a counterparty and not as a firm that managed customer relationships. In other words, Madoff's investment bank was seen as "the other party" (counterparty) that participates in financial transactions,

placing a division between the investor and the investment bank itself. One thing is for certain, Madoff, holding prominent roles in securities industry groups, used his deep knowledge of the market to drive his \$50 billion Ponzi scheme right past the regulatory system. Unfortunately, “Rather than uncovering fraud, regulators are often playing catch up when the frauds themselves unravel and the fraudster goes on the lam or is forced to confess” (Forbes Magazine).

Bernie Madoff’s Ponzi scheme is officially the largest financial fraud in history, affecting not only America’s economy, but international investors. With Madoff’s criminal and civil charges, he received 150 years in prison. The millions of investors who trusted him and his investment company should be happy that he is getting the jail-time he deserves, but unfortunately, they are financially in jail and will be for the rest of their lives. Madoff’s trust from investors started from an Affinity Scam – a fraud that deceives members of identifiable ethnic, religious or professional groups, where the member running the scam (Madoff) identifies himself as “in” the group. Madoff’s Jewish descent enabled him to get other Jewish members to invest in America and Internationally. After all, he needed as many people as possible to be in the group to keep his Ponzi scheme going.

“It’s impossible for a violation to go undetected, especially for a long period of time”, says Madoff in a 2007 meeting with a nonprofit organization. Desperate charities, trusting Hollywood actors and many other innocent bystanders invested in Bernie Madoff’s Investment Bank, and with those confident words, who wouldn’t? Madoff was close with SEC regulators, as his niece’s husband was a regulator himself, and Bernie said the SEC was doing a great job (60 Minutes, Bernard Madoff Scheme, 2011).

One of the most important topics may not only lie within the securities regulatory system, but within the auditors of Madoff’s finances. Friehling & Horowitz, Madoff’s three-person audit company, was enrolled with the American Institute of Certified Public Accountants peer review programs for privately held companies. However, F&H did not have a review since 1993 (AICPA spokesman Bill Roberts). The firm annually informed the AICPA for 15 years that they do not perform audits. The Madoff scandal obviously triggered the AICPA to do an ethics investigation”, and quite the ethics

investigation it was. For all those years, Frierling deceived regulators by declaring that Madoff's enterprise had a clean audit record (Journal of Accountancy, James Clarkson). Auditors F&H also failed to audit the internal controls of Madoff and therefore had no reason to assume there were *any* material misstatements and inadequacies. But then again, privately-held companies do not require their internal controls to be tested; rather, for private companies, testing of internal controls is only highly suggested and encouraged.

"Madoff pleaded guilty to 11 felonies and admitted to, among other things, operating a Ponzi scheme, committing securities fraud and investment adviser fraud, and filing false audited financial statements with the SEC, according to the regulator." The Journal of Accountancy states that the financial statements of Madoff's investment bank conformed to GAAS and that Frierling did perform reviews on internal controls at Madoff's firm. According to the SEC's complaint, Frierling knew that the firm regularly distributed the annual audit reports to Madoff customers and that the reports were filed with the SEC and other regulators. The complaint alleges these statements were "materially false." "Potential red flags weren't pursued, including the fact that Madoff kept the assets in its own custody and used a tiny auditing firm to sign off on its books."

"For many years after the creation of the Sarbanes-Oxley Act, the Securities and Exchange Commission waived the requirement for privately held firms. This waiver allowed the accounting firm that was responsible for auditing Bernard L. Madoff Investment Securities to avoid registering with the Board and to avoid the type of governmental oversight that Sarbanes-Oxley was designed to create." Because Madoff somehow found a way to not register with the Board, as of January 2009, it now requires auditors of privately held firms to register with the Board and to be held accountable for the ethical and professional standards set forth by the Board (*The Sarbanes-Oxley Act: Success or Failure*).

Would the fraud have been caught if Madoff's auditors were registered with the SEC? Although Sarbanes-Oxley was not applicable in this case, should it have been? The SOX Act was designed to protect investors, but what about those "customers" who lost money in Madoff's scheme? Shouldn't

they have been protected just as an investor in a public company is under the Act?

Sam Antar, the former CEO of Crazy Eddie's and convicted felon, presently spends his time lecturing about corporate fraud and mistakes he has made in the past. He states that antifraud provisions of the Sarbanes-Oxley and the newly enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, does not, by any means, prevent bad guys, both internal and external, from cooking the books of their corporations, just as authority had during the Enron and WorldCom days. "Wall Street analysts are just as gullible, internal controls remain weak, and the SEC is underfunded and, at best, ineffective. Madoff only got caught because the economy tanked", says Antar (*Where There's Smoke, There's Fraud*). How can we feel safe if the SEC and Sarbanes-Oxley are ineffective in terms of fraud? Auditors may argue that their primary responsibility during an audit is to determine the "fairness of the financial statements", but is it not true that they have a further obligation to detect any unusual activity in transactions – fraud?

Beyond The Fraud Triangle:

In criminal fraud cases such as those with Enron, Madoff and Lehman, one may wonder the mindset of a greedy corporate CEO, or auditor, as we saw with Arthur Andersen. We constantly see fraudulent acts and accounting scandals, and we worry about what will come next. What if we took a more detailed look at the minds behind CEOs, Chairman, and CFOs of these corporations? Would auditors be quicker at identifying corporate scandals?

Understanding the reasoning and psychology behind those who commit fraudulent acts may be better understood through the "fraud triangle". The fraud triangle is also described in the Statement on Auditing Standards 99 (SAS 99), which is discussed in the next section, issued by the Auditing Standards Board in October 2002. The fraud triangle was set forth including three key components: pressure, opportunity, and rationalization. "These extensions have enhanced professionals' ability to prevent, deter, detect, investigate, and remediate fraud". A flaw of the triangle is argued, however. Fraud

investigators state that "pressure" and "rationalization" are generally non-observable behaviors. In addition, pressure can commonly occur with auditors since they do not recognize the symptoms associated with it. This is because "they often have limited interactions with potential perpetrators and lack a baseline from which to evaluate current behavior." Fraudulent acts, as defined in SAS 99, are *intentional* acts that result in a material misstatement in financial statements. Fraud is always *intentional*; mistakes and errors alone are not necessarily fraud.

Authors and investigators of corporate criminal minds provide an additional stage to the Fraud Triangle, turning this triangle into a diamond. The theory of the Fraud Diamond was set forth by David T. Wolfe and Dana R. Hermanson. They argue that after pressure, opportunity and rationalization comes capability. "Focusing on capability requires organizations and their auditors to observe, assess, and document the capabilities of top executives, key personnel, and employees who have the capability to perpetrate and conceal fraud acts." They provided four observable traits for committing fraud as follows: Having an authoritative position or function within the organization; Having the capacity to understand and exploit accounting systems and internal control weaknesses, possibly leveraging responsibility and abusing authority to complete and conceal the fraud – management manipulation; Demonstrating a certain confidence (ego) that one will not be detected, or, if caught, that one will talk oneself out of trouble; Having the capability to deal with the stress created within an otherwise good person when one commits bad acts. A further explanation of capacity set forth by the CPA Journal asserts that corporate management with "capacity" self-declare that they "have the necessary traits and abilities to be the right person to pull it off" ... and they "have recognized this particular fraud opportunity and can turn it into *reality*" (*Fraud Diamond*, CPA Journal).

Author of *Pigs at the Trough*, Arianna Huffington, mentions in her novel something called the "Psychopathy Checklist" (Dr. Robert Hare). The checklist included traits and characteristics that diagnosed psychopaths have. They have "the inability to feel remorse, a grossly inflated view of oneself, a pronounced indifference to the suffering of others and a pattern of deceitful behavior" (p.7). Although

most of these characteristics seem to match those of the Presidents and CEOs at Lehman Brothers, Enron, Madoff and other public companies, I feel the most significant and relevant aspect is the “pronounced indifference to the suffering of others”. Of course, “others” suffering can be seen as the normal, everyday investors and customers of these companies. It is because of the lack of protection that investors had before Sarbanes-Oxley and the Public Company Accounting Oversight Board that prompted a creation of a new law and Board that could start building up the confidence of investors again. By observing actual individuals with these greedy characteristics, this may hit closer to home.

Charles Ponzi was born in 1882 and developed the illegal “pyramid scam”, used over one hundred years later by Bernard Madoff within his investment bank. Ponzi was seen as the epitome of a swindler, as he was cunning, independent, and flamboyant, always mocking rule-keepers and the rules themselves. At the age of 17, Ponzi came to America from Italy with \$2.50 and “a million dollars in hope.” He achieved wealth by simply borrowing from Peter to pay Paul. In other words, he used the money he received from one party, to pay his debt to another, and eventually turned this swindling process into a business, promising his investors fifty percent returns. Charles Ponzi served nearly four years in prison following the 1920 collapse of his “get-rich-quick” scheme.

Of course ethical individuals are fully capable of borrowing and repaying each other in a fair manner, but what is most alarming about Ponzi’s means of gaining wealth is that the first guy that gets involved must be the first one out in order to receive their investment back wholly. In other words, the first guy who successfully gets out with the money and a decent return does not care about the last guy who is financial stuck and in danger. It is all self interest – it is all greed. Ponzi, as invincible as he may have thought he was, could not keep the swindling going. Anyone in their right mind would see this illegal issue, but once the inflated ego and failure to recognize others’ suffering comes into play, self-interest overrides all else.

Bernard Madoff, Charles Ponzi, Richard Fuld and Jeff Skilling’s personality traits do not match the “Diamond”, “Triangle” or even “Psychopathy Checklist” by chance – I have presented that there is truth

to this. Recognizing the four traits of the fraud diamond, how the fraud triangle works, and importance of investors' protection, is not stated in Sarbanes-Oxley, but does it have to be? Auditors and even investors do not need more laws, but we do need more common sense now than ever before, especially in this 21st century with arising accounting scandals. If an auditor is performing due professional care and using skepticism, why not add these theories into the auditors' bucket of knowledge to enhance solid, professional audits?

In brief, anyone can follow laws, Codes and Acts, but consequently, anyone can break them just as easily, or even mock them. If scandals begin with specific portrayed elements, it could strongly benefit the accounting profession, especially auditors, to study behavioral psychology in more depth; this may include more training in the field of psychology and analytics, or just having deep understanding, prominent common sense, and personal continuance of professional development.

No Sass with SAS 99.

SAS 99: Consideration of Fraud in a Financial Statement Audit. "SAS 99 clearly says that auditors have a positive, affirmative, duty to detect fraud"; "The auditor must set aside past relationships and not assume that all clients are honest" (Journal of Accountancy). It is imperative that those who must comply with this rule remember brainstorming with auditing engagement teams is a *required* procedure and should be applied with the same degree of due care as any other audit procedure.

"The expectation gap is the primary cause of malpractice liability. It occurs when you believe that SAS 99 is the *maximum* level of work required. Thus, you often perform work below the level required. But judges, juries, SEC, etc. have said, over and over again, that audit standards are the *minimum* level of acceptable performance." Regulators cannot emphasize enough the importance of professionalism in the accounting industry, including skepticism and due care. Going through the motions of a profession is not proactive and productive; it is complacency.

"It's not treating everyone like a corporate criminal...it's identifying the exceptions with analytical

tools and psychology methods”, says owner of the El Al Israeli airport. He mentions that the best way to catch terrorists is by means of interviews. Although inquiring with management (interviews) as an auditor is not seen as highly reliable, it is still a crucial procedure and highly emphasized with SAS 99. Some corporate criminals will never budge, but others get defensive and nervous. We can only hope many corporate criminals reflect the latter. SAS 99 encourages auditors to make additional inquiries in order to gather or corroborate a wide variety of information that aid in identifying or assessing risks of material misstatement due to fraud (Journal of Accountancy). Of course making rash assumptions is not professional. SAS 99 provides guidelines to how auditors should respond when determining that a misstatement is, or may be, the result of fraud. If an auditor is convinced that a misstatement exists, whether material or not, auditors are required to evaluate the implications of their belief, especially those dealing with the organizational person(s) involved.

The Future of the Auditors:

Enron had Arthur Andersen wrapped around their finger, paying Andersen 1 million dollars a week as Enron’s auditors. Enron collapsed only five months after receiving a clean auditing opinion from Andersen, and Andersen closed their doors soon after, when realizing their reputation was stripped all because of the scandal.

What about the remaining Big 4 Auditors left? On auditing HealthSouth, “Ernst & Young did not detect or investigate beyond the scope of normal audit procedures any other substantive questionable activities outside of the capitalization issue” (*Anatomy of Financial Fraud*, CPA Journal). Although they did not have any lawsuits piling up against them in the HealthSouth case, their reputation was hit with the collapse of Lehman Brothers. One defender feels this is not Ernst & Young’s Enron. Still, is it possible that Ernst & Young would go under after failing to fully understand or recognize their client’s red flags of cooking the books? Lawrence Cunningham in *To Big to Fail* says that “more important than honesty, auditors must command a reputation, believed by management, for ruthlessly scouring managerial

assertions and not allowing questionable reporting.” When ethics are faltering throughout audits, there must be an emphasis on auditor independence (Section 201-209 of SOX). Maybe E&Y was negligent and acted with malpractice in the case with Lehman, but this was still too innocent of a case for the accounting firm not to remain reputable and professional in the public accounting industry. Cunningham further asserts that “auditing standards require auditors to seal gaps in their knowledge by adopting the fundamental habit of professional skepticism. This involves routinely second guessing managerial assertions and judgments”; something E&Y “forgot” to do.

In August of 2005, KPMG LLP admitted to criminal wrongdoing, agreeing to pay \$456 million in fines, restitution and penalties as part of an agreement to defer prosecution of the firm (IRS.gov). That year, there were nine individuals in total (this included six former KPMG partners and the former deputy chairman of the firm) who were criminally prosecuted in relation to a multi-billion dollar criminal tax fraud conspiracy. The fraud related to the design, marketing, and implementation of fraudulent tax shelters. Attorney General Alberto R. Gonzales said that “corporate fraud has far-reaching consequences, both to the marketplace and those whose livelihoods depend on companies that maintain honest business practices.” Between 1996 and 2003, KPMG engaged in a fraud that generated at least \$11 billion dollars in phony tax losses which cost the United States at least \$2.5 billion dollars in evaded taxes. Therefore, KPMG, by creating four phony tax shelters, enabled the firm’s wealthiest clients to pay smaller amounts of taxes at the end of each year. Taken from the outcome of this tax fraud, KPMG was dishonest and lacked integrity, but what about their reputation? Can they maintain honest business practices as seen in the eyes of their clients?

A common question lingers. Will these public accounting firms go under? According to Lawrence Cunningham, “there is a reasonable basis for concern that the government would intervene with financial support that would enable the firm to survive or offer funds to provide compensation or restitution to victims of audit failure.” With this said, having the government step in to help the Big 4 remain the Big 4 is not a preferable alternative, “because of the moral hazard they reinforce and also

because the government is likely not as good as private insurance markets at pricing risk or otherwise managing it”.

When a public accounting firm, such as Arthur Andersen, acts with no professionalism, lacking due care and honesty, the firm faces the risk of closing entirely. The only asset an accounting firm has is their reputation – the integrity of the service provided. As long as Ernst & Young and KPMG can continue to be trusted by the SEC and their clients, their reputation is preserved. If they continue to be negligent or act in bad faith, committing tax crimes, will the Big 4 still be preserved with the intervention of the government? More importantly, *should* they be preserved when they are acting unethically?

Capitalism, Corporate Scandals and Sarbanes-Oxley:

“Capitalism is a social system based on the recognition of individual rights, including property rights, in which all property is privately owned. Under capitalism the state is separated from economics (production and trade), just like the state is separated from religion” (Capitalism.org). In terms of individual rights, rights are moral principles defining a man's freedom of action in society.

Many believe free-market and capitalism are being infringed upon because of the Sarbanes-Oxley Act. This seems true to an extent, but Sarbanes-Oxley is not meant to tell you *how* to run your company in terms of what you can and cannot sell, what supply-chain to use, and what customers to attract. Therefore, it seems a law to protect investors is not entirely infringing upon capitalism, it is giving investors more confidence and auditors more guidelines to keep capitalism thriving and prevent scandals. Others still beg to differ. “SOA interferes with the traditional conventions of capitalism by attempting to legislate away the phenomenon of risk” (Hastings, 2003). It is said that capitalism naturally allows for risk, so adding laws that decrease risk is eliminating the *freedom of risk* within capitalism. Risk is never completely eliminated because humans make mistakes. No matter how closely an external auditor or corporate manager follows Sarbanes-Oxley and acts ethically, humans are bound to make errors, and hence, be vulnerable to risk. However, taking risks that hurt others financially and

emotionally is exactly what Sarbanes-Oxley is trying to prevent. With several individuals opposing SOX, it will only make it more difficult for others to comply with the law (*Risk, Capitalism and Sarbanes-Oxley*).

On capitalism and improving our economy, in October of 2009, Warren Buffet says “You have to put in something where there is downside to people who really mess up large institutions and we need some new help in that...There have to be incentives – not only to get rich, but to behave well.”

“In theory, capitalism can be considered an amoral system, since it relies on perfectly competitive markets, with knowledgeable, rational participants, to achieve the general welfare” (*Corruption in Corporation America*, p2). With the Invisible Hand Theory, knowledgeable consumers and producers seek their self-interest, as theorized by Adam Smith, which yields the greatest good for the greatest number. In present day, corporations seek self-interest, but fail to acknowledge the interests of investors and consumers. In other words, they ignore the greater interest of the entire society. Everyone’s conscience is not as clear as Adam Smith’s ideal world portrays. Over the years with greed and corruption in the corporations, terms such as conscience and ethics started to become less and less understood. Is that why Sarbanes-Oxley came into play - to be a reminder of what right and wrong is? Is SOX just a handbook of commonsense rules and guidelines that auditors would not need if they just listened to their conscience and followed their moral compass?

“Instead of simply gathering evidence and prosecuting individual perpetrators accordingly, our leaders passed a law that forces *all* businessmen to prove to the government that they are *not* cooking their books” (*Repeal Sarbanes-Oxley*, *Capitalism Magazine*), argues one capitalist. Still, no one wants to wait around to see another Enron scandal, putting investors in another financially horrifying predicament. Although it does not make sense for capitalism to progress with laws and regulations since it seems rather counterintuitive, laws arise directly from wrongdoings and human error – ethical or not ethical. Even Warren Buffet, a prominent investor and businessman, sees the need for more action to be taken to regulate large corporations who thrive on greed. Sarbanes-Oxley may have many flaws that

need to be altered in the future, but it stands as a great guideline and aid to our society's public companies. Capitalism may be infringed upon with SOX, but investors are better protected with the Act. At least it seems to have awakened many corporations' consciences.

What I Would Change About Sarbanes-Oxley:

After analyzing the pros and cons of SOX so far, it seems that managers and auditors who must follow the Act see SOX as "just another accounting rule to follow" (Bethany McLean). Every rule can be broken and avoided if auditors and corporations devise a strategy where they feel they will not get caught for many years (or at all). We can see that SOX was not only implemented to prevent scandals and protect investors, but to also build up the confidence in these investors (PCAOB). Millions of investors trusted Enron as a corporation with most of their retirement funding and a large percent of their assets overall. How can we improve Sarbanes-Oxley and get investors and auditors to think outside their comfort zone?

First of all, we must understand the difference between requested audits (nonpublic companies) and required audits. For example, an insurance company that voluntarily hires auditors to come into their company to check the financial statements, records and policies may be assumed to be trusted by insurance holders and even auditors, to a certain degree, because of the voluntary *request* for an audit. Throughout the audit, auditors may discover evidence is not matching with the companies' records and documents, but we can assume the company requesting an audit will have more willingness to accept these flaws and change them to better improve their company. I experienced a similar scenario first-hand after contributing to an engagement team during my internship in public accounting. A client that has concern for the health and plausibility of their records, or in this case, insurance policies, would not request an audit if they were cooking the books. With client-requested audits, most auditors will only discover honest mistakes – not fraud.

However, most corporations have annual required audits (e.g. investment banks, towns and other

companies with investors) and cannot be as highly trusted because they can run their business fully knowing what auditors will look at and what they will ignore. In other words, a public company with required audits may deliberately hide records and financing methods (foreign accounts) because they know another annual audit will be occurring. This is where auditors' professional skepticism trumps even compliance with GAAS and SAS, in terms of the level of importance.

It seems additional required training on professional skepticism and studying past fraud cases to understand the "minds of the criminals" could be beneficial to an auditor. The CPA exam tests knowledge on business law and ethics, but what about the psychology of a *corporate* criminal mind? It is important to have confidence and integrity as an auditor in your work, findings and identification of unethical behavior. If we were all as confident, inquisitive and determined as Bethany McLean, the editor of Fortune Magazine who asked to interview Enron before the scandal occurred, we could foresee scandals before they even happen. If an accounting firm as greedy as Arthur Andersen never existed, we would not be visiting these alternatives to catching fraud and scandals. But then again, maybe Arthur Andersen was not as greedy as we think, but rather their conscience was shot, and it took their confidence with it. Auditors have to be just as confident going into an audit as investors are when they choose to invest in a certain company. If auditors do not have confidence in their own work, how can investors? After all, that is what auditors signed up for – it is their job to be confident and have reasonable assurance in findings.

One of the changes I hope to see is to add a section to Sarbanes-Oxley forensic accounting and fraud examination procedures. The SOA does not state the roles that forensic accountants may have to play, but in the future, they may have a bigger role than we predict. External auditors' job is to determine the fairness of the financial statements and issue an opinion about the findings. Although auditors do have a duty to identify fraud if any unusual transactions are found, it is not their primary responsibility. Forensic accountants', however, responsibility is to identify fraudulent activities and transactions by analyzing the presented information specifically for this purpose. What if an additional requirement of Sarbanes-Oxley was for auditors to use a similar expertise of forensic accountants?

According to Joe Centofanti, a forensic accountant and fraud examiner of Kostin, Ruffkess & Company, “Anyone can do external audits, but to do the analysis is much different, and the effectiveness of internal controls is really important.” Centofanti emphasizes that there has to be more training in the area of fraud for auditors, being able to make the connection between weak internal controls, corporate structure and individual transactions themselves, and finally being able to analyze the meaning of the compilation of findings. Maybe the auditor’s responsibility should be altered; maybe there has been too much emphasis on determining the fairness of financial statements and not enough fraud detection and analysis done by the auditor. Should SOX make a new section pertaining to an equal responsibility of the auditor of determining fairness and fraud detection? Certainly a small number of entities are involved with fraudulent acts, but why not teach external auditors how to analyze in case the auditor encounters a scandal.

Stephen Pedneault asserts that specialized training, credentials and degrees are all important, but nothing places experience. He sees forensic accounting as a mind set and series of skills, which in large part, is built upon traditional accounting, but builds beyond that. Mastering skills such as communications, interviewing, observation and having a sixth sense are qualities most auditors lack still today, according to Pedneault. Forensic accountants require “knowledge of psychology...to understand the impulses behind criminal behavior and to set up fraud prevention programs that motivate and encourage employees” (CPA Journal, Corporate Governance and Forensic Accounting). Imagine if Lehman Brothers had auditors with forensic accounting knowledge to analyze the investments and investment trends within these companies. Would a properly trained and prepared auditor who has the responsibility to specifically detect fraud and understand the psychology behind the activities be able to identify the Repo 105 transactions?

Auditing Services – Solving the Problem:

If everyone is in it for self-interest, is there really a *common* interest? Managers of corporations are supposed to be the agents of the principal - absentee owners (investors) and the auditors are the neutral ground – keeping investors confident that financials are stated fairly and the corporate managers are doing their job properly. The investor/management conflict of interest has never been a simple issue to smooth, but Manuel Tipgos and Thomas Keefe present an insightful solution to the post-Enron SOA problem.

Corporate governance, an oversight mechanism in place to help ensure the proper stewardship over an entity's assets, is a large factor in the effectiveness of implementing the SOA. The CPA Journal says that "researchers are finding that poor corporate governance is a leading factor in poor performance, manipulated financial reports, and unhappy stakeholder." Currently, the comprehensive structure of corporate governance is a "tone at the top" approach; the idea is if top managers uphold ethics and integrity so will employees. However, this approach focuses primarily on checks and balances at the top of a corporation's hierarchy, such as the board of directors, top management, and employees. Corporations such as Enron, Tyco and WorldCom had a type of imbalance of power in favor of top management within the organizations, which was, no doubt, a symptom of the company's downfalls.

SOA does not diminish existing discretions of management in conducting and pursuing the business of the corporation, according to Tipgos and Keefe. The force of the law, therefore, cannot stop management fraud. Management fraud can be stopped only by management itself (CPA Journal). So the question becomes, how can we alter the "tone and the top" approach and rebalance power? Authors have proposed a new corporate structure where there is recognition of employee groups as members of a corporate team. This corporate process involves the direct communication of board of directors, management, and employees within and outside the confines of the board to discuss critical information about the business of the corporation. Since employees have traditionally been viewed as under the control of management (board of directors and top management), the proposed relationship among

different levels of corporate workers present a balance among power. Therefore, there is accurate financial reporting, prevention of management fraud, and improvement of integrity of the financial markets.

With the implementation of the SOA, a restructuring of corporate governance is highly possible because of the allowance for changes that can be made within controls. As I presented in the discussion of Section 404, management must sign off on financial records within the entity, verifying the adequacy of statements, but management can easily override what employees have accurately reported. However, assigning internal control to the employees will enhance the integrity of the financial records by preventing management from overriding controls and therefore manipulating the transactions. Ensuring harmony and cooperation between the management and employees in goals and objectives of the entity will promote newly integrated corporate governance. Lastly, with management being portrayed as the leaders of the employees in terms of the code of ethics (morality and ethical standards), management will not be seen as the “cops” or overbearing management in the eyes of the employees (*A Comprehensive Structure of Corporate Governance in Post-Enron Corporate America*).

Furthermore, Cunningham, from the article *Too Big to Fail*, suggests a solution that lies within financial statement insurance, which is meant to minimize conflict of interest. We saw in the Enron case (other accounting scandals as well) that a huge weakness of Arthur Andersen as auditors was their greed for money. If there was insurance involved, where the buyer (the company being audited) directly paid the insurance company, which then paid the auditing company, the auditors are therefore beholden to the insurers, not the clients. This way, if material misstatements are detected and identified as potential fraud, the auditors would be more likely to report this, since the audit team is not disillusioned by the money they are receiving to hide the misstatements as Arthur Andersen did.

If Sarbanes-Oxley included this newly proposed idea of restructuring corporate governance and business environments, auditors could ensure the proper hierarchy was in existence. If corporate governance is balanced, integrity of the entity and their internal controls will have a greater chance of

being stronger and effective. Even management fraud will be prevented because management cannot cook the books under the watchful eyes of employees. An effective and ethical atmosphere will eventually be highly recognized by investors, understanding the positive steps being taken to create better relationships throughout the corporate structure. If financial statement insurance was used, conflict of interest would be limited among both the auditors and the companies being audited. The integrity and ethics being demonstrated with such proposals will boost investor confidence, but in a logical and strictly non-illusory or manipulative manner. Boosting investor confidence with Sarbanes-Oxley is *not* meant to be a “falsely-inflated” confidence; rather, it should reflect reality and effective remedies being taken to prevent future Enron’s from occurring.

Final Words & Corporate Greed:

Bush’s reform bill that was signed in July 2002 was supposed to guide the new era of corporate responsibility. He was quoted saying, “No more easy money for corporate criminals, just hard time”. The problem is the law seems to be a “new and improved” label slapped on the same old package of deceit (p.19). What we see so far with Sarbanes-Oxley may be best illustrated with a metaphor.

For instance, assuming there is a house that has had a history of termites. Termites are suspected to still be inside the house, but they cannot be detected by the owners because they are hiding in the walls and make minimal noise. Therefore, the owners try to ignore the termites in the walls, hoping that they die eventually. Nonetheless, the owners hire some workers to patch all the cracks they can find on the outside of the house where they feel more termites may enter one day. The workers seem to do a good job finding all the cracks and crevices on the outside of the house so the owners are pretty content. Not long later, they hear a noise, and termites start appearing, but this time, the termites have unexpectedly reproduced and there are more coming from the walls and entering the house. Suddenly, the owners realize they have to move because they have lost all confidence in the security of their home. If only they had exterminated the termites already in the walls of the house before they patched

the outside of the house, hoping to prevent more from coming in. Read this analogy again, but assigning the termites as greedy corporate managers committing corporate scandals, home owners as investors who are feeling unconfident, the workers as the auditors, and the patches on the house as Sarbanes-Oxley. If corporate scandals (termites) keep appearing, many investors (owners of the house) will keep losing confidence in our market and capitalistic society, especially when workers (auditors) are ineffective with catching corporate fraud. Sarbanes-Oxley was the rescue (patches on the house), but we have failed to clean up what's going on in corporate America (the house) before applying SOX (patches to *prevent* further fraud).

"There's a lot more employee fraud and embezzlement today than there was 10 years ago, and this past year there was much more than a year ago," says Steve Pedneault of Forensic Accounting Services. "People blame the economy, but much of the fraud and embezzlement that's coming to the surface now was in the works for 4 or 5 years before the recession hit." (Where there's Smoke, there's fire, March 2011).

As Benjamin Franklin said, "A small leak will sink a great ship". Enron was a great ship. So was Lehman Brothers. Both companies had confidence from investors in their companies and felt the future would be filled with innovation and high stock prices, but the once *small* leaks led to unfortunate circumstances and crashing confidence of investors. What about HealthSouth and Lehman? All the innocent bystanders (investors) were faced with a giant nightmare - again. Too many times corporate fraud has failed to protect the investors and auditors were sucked into the millions of dollars they were being paid rather than focusing on protecting investors and protecting their own reputation. Sarbanes-Oxley is a patch, a bandage covering an infection that needs to heal before it's covered. Working from the inside out (forensic accountants, financial statement insurance, understanding corporate minds with the fraud triangle/diamond, etc.) may be the only way to protect investors and heal corporations before we can sleep peacefully at night.

Since the SEC and legislators did not take the inside-out approach since it was implemented in a

panic, those who must comply with Sarbanes-Oxley have to continue looking for further opportunities to improve (not eliminate) the Act– and improve it significantly. If CPAs, members of the SEC and management fail to be professional, analytical and skeptical as seen with Ernst & Young and Lehman Brothers, we will only keep *learning* about these major frauds rather than *preventing* them in the future. Actively seeking solutions and remedies in auditing and managing public companies is the only way we can comply with the law and continue to improve the condition of corporate America and protect our investors that keep these corporations alive.

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