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THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD AND ITS ROLE IN REDUCING OCCURRENCES OF FRAUD

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ABSTRACT

The role of the public company audit is vital to investor confidence and the economy. As history has demonstrated, the complex nature of accounting combined with the competitive nature of business and at times poor ethical standards of management has led to many frauds. Frauds are damaging for a number of reasons since they wipe out investors' money and reduce public trust in management making people less likely to invest which hurts the economy. Performing an audit requires a vast amount of work particularly with the size of companies today and the complexity of accounting making detection of fraud difficult for even highly skilled teams of CPA's. With the Enron, WorldCom and other scandals making clear that severe deficiencies existed in auditing standard, overhauls were made through the Sarbanes-Oxley Act of 2002 (SOX).

While most will agree the auditing standards today are a lot more extensive than pre-SOX and oversight has greatly increased, it is debatable how effective these measures have been in reducing fraud. SOX brought into effect many changes that will be mentioned in this thesis but the main focus will be on the creation and effectiveness of the Public Company Accounting Oversight Board (PCAOB). The role of the PCAOB is to promote the accuracy of public company audits through the standard setting and direct review of work performed by auditors. Before SOX audit firms were essentially self-regulated as the AICPA set auditing standards; this proved ineffective. With stricter, independent regulation and the threat of audit firm's work being reviewed by the PCAOB, the idea was auditors would be more diligent in performing audits. In this thesis, I will analyze fraud before and after SOX and the work of the PCAOB to determine if the PCAOB has been effective in increasing audit quality, which should in turn reduce the occurrences of fraud.

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Introduction

Looking back on the last couple of decades in the field of accounting it is extraordinary to think about the lack of proper regulation that allowed so many abuses and fraudulent activities to occur on an epic proportion. Even for those with limited knowledge in accounting it is easy to see how the lack of effective regulations left the door wide open for these abuses to occur. The vast number of accounting frauds prior to 2002 came in all kinds of shapes and sizes, from very basic tricks to incredibly complex accounting frauds that played off a lack of clear accounting standards in the area.

After famous cases such as Enron and WorldCom and other frauds, the public and political outcry became large enough to force some kind of regulatory action, which came in 2002 in the form of the Sarbanes Oxley Act. SOX implemented many changes to try to prevent these abuses from occurring again and aimed to restore public confidence in the accounting profession. It instituted many changes such as clear requirements for the audit committee, audit partner rotations, limits on other services that firms can provide to audit clients, the creation of the Public Company Accounting Oversight board (PCAOB), among others.

The creation of the PCAOB was a key component of SOX:

"The Sarbanes-Oxley Act of 2002, which created the PCAOB, required that auditors of U.S. public companies be subject to external and independent oversight for the first time in history. Previously, the profession was self-regulated." (About the PCAOB, 2018).

The PCAOB initially adopted the Generally Accepted Auditing Standards (GAAS) and worked to expand them further. The end of self-regulation meant audit firms were much more likely to be held responsible for audit failures, which should serve as a deterrent against the kind of negligent work that allowed so many frauds to occur. The answer to whether SOX and the PCAOB reduced the occurrence of fraud may seem obvious, that it did, but we still have seen frauds occur after SOX so analyzing how these were carried out and what the PCAOB can do better are important questions. Accounting is always evolving and people find new tricks to deceive the public and their auditors, so regulation and accounting standards must also evolve to ensure investors can have confidence in management and rely on financial statements being presented fairly.

What is Accounting Fraud

Accounting fraud has been occurring for as long as accounting has been around but as economies and companies grew, the scale of fraud became more problematic. It was not until the 1930s that clear-cut federal rules began to develop to help govern and regulate accounting practices. Before this, it was very difficult to prosecute anyone for fraud since they were not necessarily breaking any laws. Fraud is defined as:

"Fraud is intentional deception for personal gain. Accounting fraud is the deliberate misstatement of financial information for the benefit of managers and is closely related to earnings manipulation."(Giroux, 2013, p.40)

Fraud can occur in a variety of different ways including manipulation of earnings and hiding expenses and liabilities. Accounting involves many estimates and management's judgment so there is often a fine line between aggressive accounting policies and fraud. It is often the case that frauds start out small when a company faces hard economic times, frequently during recessions, and then start making poor decisions to try to boost earnings and meet targets. This only amplifies the company's problems in the end and frauds often spiral out of control into massive amounts. While it is common for normal, usually ethical, managers to be tempted into fraud and poor circumstances let it get out of control, there are also cases where people have deliberately set out to deceive investors from the beginning. Bernie Madoff is one such example. He orchestrated a huge Ponzi scheme in which investors were being paid their "returns" with other investor's money and Madoff was not actually making any investments. Some people lack proper morals or ethics and will try to abuse the system in any way possible which makes the task of effective regulation a challenge. The Securities Acts of 1933 and the Securities Act of 1934 were the first real step at regulation and as fraud continued to occur regulations and accounting policies attempted to adapt to prevent further abuses.

One tool used to help explain fraud is called the Fraud Triangle, this focusses on the motivations that lead people to commit fraud. It breaks it down into three categories. Pressure/incentive, opportunity and rationalization. Pressure/incentive is the possible gains of committing fraud such as bonuses or actual stealing along with the pressure of others demanding you perform certain tasks that may be fraudulent. Usually rewards are financial but also the threat of being fired can force people to do what they otherwise would not. Opportunity is the ability to commit the fraud, being in a position to make the accounting entries or direct people to do so. Often a weakness in internal controls presents opportunities for fraud. Finally, rationalization is someone's ability to convince themselves what they're doing is okay. This may be easy for those lacking good ethics. When these factors are all present, fraud becomes much more likely. (The Fraud Triangle, 2018)

The fraud triangle is just one tool to help understand motivations for committing fraud and there are many other factors that explain fraud with plenty of cases demonstrating the different ways it is carried out. That is why effective regulation is so important. Regulation aims to reduce the ability of companies to perpetrate frauds and increase the punishments when caught. The PCAOB has the ability to detect fraud through inspections of audit work and punish auditors for not conducting audits up to standard. An increased audit quality should decrease the occurrence of fraud as the probability of getting caught increases and SOX increased many of the punishments for fraud related offenses.

The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act (SOX) of 2002 was legislation passed by the U.S. Congress in direct response to a number of large-scale frauds in the early 2000s that resulted in investors losing billions of dollars when the discovery of the frauds led to the collapse of their stock prices and in many cases their bankruptcy filings. It became apparent to the public that the current regulatory environment was ineffective and the U.S. Congress set out to write legislation to try to prevent such large and damaging frauds from occurring again. The law brought in sweeping reform on reporting requirements, oversight, criminal penalties and other issues. In total, it contains eleven sections covering the new requirements.

One of the main provisions of SOX was the creation of the Public Company Accounting Oversight Board (PCAOB). Details of the role of the PCAOB will be discussed later but it was a much needed response to what had previously been self-regulation by the audit firms. When analyzing pre-SOX frauds the negligence of auditors such as Arthur Anderson was made painfully clear and one reason for this can be explained by the fact they had no real fear that their work would come under scrutiny. Therefore, they would rather just issue an unqualified opinion than confront their clients. Now that the PCAOB could come in and review the work of the audit firms, they are held accountable for work that was not up to audit standards.

Title III of SOX set out requirements for the audit committee and corporate responsibility. The audit committee is tasked with appointing the external auditor, deciding on its compensation, overseeing the work of the auditor and resolving any disputes that may arise. Members of the audit committee need to be on the board of directors but must be independent in all other regards. This is designed to help limit conflicts of interest between the auditor and the company. Furthermore, the audit committee must have a “financial expert” defined as someone with experience in financial reporting and it describes different ways to meet this requirement. For example, a member of the committee being a CPA would fulfil that requirement. Another requirement is that the committee sets up clear procedures for employees to report wrongdoing. Title III also describes the requirements for the CEO and CFO to sign that they have reviewed the financial statements and they have not knowingly misrepresented their financial position. Furthermore, they must assert that the internal controls have been evaluated and are operating effectively.

Title IV deals with criminal penalties and whistle blower protections. Penalties for altering or destroying documents with the intent to impede an investigation now carries fines and possible imprisonment of up to 20 years. The penalty for knowingly committing securities fraud was set to a maximum prison sentence of 20 years. It included protections for those lawfully providing evidence of fraud so that they could not be fired or punished by their employer. Title IX is known as the white-collar crime enhancement. It increased many of the maximum fine amounts and prison time amounts for mail and wire fraud and certifying false financial statements. (Sarbanes-Oxley Act of 2002)

These are some of the main requirements important to understanding the difference in the regulatory environment before and after SOX. The PCAOB, audit committee requirements and extensive required disclosures are the major changes and will be referred to when evaluating frauds after SOX to analyze its effectiveness. The focus is on the role of the PCAOB but with other important factors effecting the occurrences of fraud they must be evaluated to determine the impact the PCAOB had.

The PCAOB

Background and Mission

The PCAOB was established as a nonprofit organization separate from the U.S. government tasked with overseeing the audits of public companies registered with the Securities and Exchange Commission (SEC). Its creation was a major step in ending self-regulation of audit firms and a big change to the industry. At first, the PCAOB adopted all the current Generally Accepted Auditing Standards (GAAS) and worked to further develop them with the aim of reducing potential abuse. Overseeing all public company audits is a huge task and it would take time from its creation to develop into an effective organization. I will review how it operated to achieve its mission and some of its key focuses.

The PCAOB breaks down its role into four sections: registration, inspection, standards and enforcement. Registration requires that any accounting firm that issues audit reports for a public company that files with the SEC to register with the PCAOB. Inspection is the process of the PCAOB coming in and reviewing the work of the accounting firm to make sure it is up to an acceptable standard. It describes inspection as:

"PCAOB inspections assess registered accounting firms' compliance with applicable laws, rules and professional standards in the portions of audits selected for inspection and in the firms' systems of quality control. In 2016, the PCAOB examined portions of more than 780 audits performed by 198 accounting firms." (PCAOB, 2017).

The PCAOB has a big role in standard setting and continually updates and adjusts to changes in applicable laws to try to have the most effective rules in place to prevent abuses. Finally, enforcement is the board's ability to take a range of disciplinary action against firms that fail to conform to standards. The severity of which varies based on the offense, repeat offenders may face serious action.

One of the largest failures seen prior to SOX was in internal controls so these became a huge focus for the PCAOB and auditors, as addressed by SOX section 404. Management now had to assert that the internal controls had been tested and found to be effective and the auditor then has to attest to this as well. After conducting discussions, evaluations and a public comment period the PCAOB came to the following conclusion:

"Audit quality would be best improved by integrating the auditor's examination of internal control into the audit of a company's financial statements. The costs of an audit of internal control must be reasonable, particularly for small and medium sized companies. Outside auditors may rely on the work of internal auditors and others, based on their competency and objectivity. An assessment of the effectiveness of a company's audit committee is a vital part of an audit of internal control and consistent with existing standards." (PCAOB, 2004)

An important part of the PCOAB is its role in enforcement and ability to penalize firms found to be noncompliant. This threat acts as a deterrent to audit firms that in the past were not held accountable for poor quality work. The PCAOB can impose punishments as severe as revocation of an audit firms registration, which would effectively ban them from conducting public company audits, and imposition of monetary penalties up to $15 million per offense (PCAOB, 2004). The PCAOB released this guidance on how it would go about enforcing its standards:

"Speed. The Board believes it is important that it promptly and efficiently investigate significant instances of apparent audit failure. Prompt investigation will help shore up investor confidence. Fairness. The Board is committed to the principle that persons charged with violations should have a full and fair opportunity to present relevant evidence and arguments in their defense before any final determination is made. Thoroughness. Disciplinary proceedings should be based on a comprehensive assessment of the relevant facts." (PCAOB, 2003)

The PCAOB had a clear mission and targeted the problem areas in auditing that had allowed such large frauds to occur. So now it is important to analyze how effective these measure were in implementation and whether companies would still find ways to avoid the new regulation and commit fraud. In addition, whether or not the threat of inspection would be enough to improve the quality of auditing firms work.

Inspections and Operation

The main function of the PCAOB is providing a third party review of audit firms by inspecting their work to determine if they meet auditing standards. The role of inspections is defined by the PCAOB:

"PCAOB inspections focus on how a firm conducted selected audits and on the effectiveness of the firm's quality control policies and procedures. Inspections are designed to identify whether there are deficiencies in how the accounting firm performs public company audits and whether there are weaknesses in its quality controls over public company auditing."(Center for audit quality, 2012)

As mentioned earlier, all accounting firms that audit public companies must be registered with the PCAOB as well as foreign firms involved with audits of U.S. firms. The selection process ensures that firms with over 100 public company audits have some of their work inspected every year and for smaller firms with less than 100 have some work inspected every three years. Deciding what work to inspect is described as a risk based approach:

"In the case of the largest accounting firms, the PCAOB generally takes a risk-based approach to selecting audit engagements to review. As a result, inspections do not involve a random or representative sample of a firm's public company practice. The PCAOB has developed a variety of tools to identify audits that may pose difficult or complex issues. Risk factors include the nature of the company, including its industry and market capitalization; audit issues likely to be encountered; and whether the company has significant operations in emerging markets."(Center for audit quality, 2012)

This approach ensures that the areas that are most likely to contain problems are inspected but perhaps leaves certain audits with little chance of being inspected so could be potential motivations for abuse. However, in reality it is unfeasible to inspect every audit so inspecting those with the highest risk makes sense.

Once the PCAOB decides what audit they are going to inspect they notify the firm and get preliminary details such as who worked on the audit. An inspection team will normally go to the firm and begin review which focuses on the audit work papers The team analyze how the audit was performed and checks to see whether it has met all the standards of the PCAOB, GAAS and other relevant standards and regulations.

If the inspection uncovers issues they do not agree with the PCAOB has a process for trying to resolve the issue. The first step is simply to discuss with the engagement team and partner to let him/her make their case for the approach they took. If it cannot be resolved through dialog then a formal comment form is issued for the auditor to respond in writing making its case for the position he/she took. Since accounting and audit work often involve professional judgment, different approaches can be taken and it is common to have differences of opinion that need to be discussed. This does not necessarily mean the auditor has done anything wrong. In cases where the PCAOB believes a violation has occurred it may enter into an enforcement proceeding. This involves a hearing and a decision on possible punishments.

Upon conclusion of the inspection, the PCAOB creates a report that it issues and sends to the auditor after it has been approved by the PCAOB. The auditor can review the report and have a chance to request a review by the SEC before it is published. The report is described as:

"The inspection report is a record of what the inspectors concluded based on their work. All reports have a public portion (Part I). Most reports also include a nonpublic portion discussing firm quality controls (Part II). If the inspection did not result in any criticisms of the firm's quality control system, Part I states that fact. In those cases, there is no nonpublic portion of the report." (Center for audit quality, 2012)

Publishing the report allows the public to see what the PCAOB has to say about audits performed on companies in which they may be looking to invest. If concerns about the audit quality are found, they may want to reevaluate their thoughts on investing.

When part I deficiencies are found the auditor will often have to perform some additional work to support its audit opinion. Depending on the issue it is sometimes the case that audit firms need to withdraw their opinions and at times it is found that firms need to reissue their financial statements. If a part II deficiency is found, "A firm has 12 months to satisfactorily "remediate" the PCAOB's quality control criticisms described in Part II of the inspection report. Failure to do so results in public disclosure of Part II."(Center for audit quality, 2013) This would be very harmful for the company and would likely damage their stock price among other things.

The PCAOB has rigorous standards and its inspection teams usually come away with issues they want resolved. The firms then work with the PCAOB to resolve these issues until they are satisfied. It is common to find complaints and deficiencies in reports for most auditors and the important issue is that the deficiencies get resolved. PCAOB inspections are certainly not popular with audit firms but they clearly do have an impact on the quality of audits even if it can be a difficult process for those involved.

Evaluation of Pre-SOX Frauds

Enron

Enron is one of the most infamous pre-SOX frauds due to its immense scale and complexity. It was a Houston based energy company that traded natural gas, electricity, bandwidth capacity and other products. “Revenues increased from $13.3 Billion in 1996 to $100.8 billion four years later” (Clikeman, 2009, p.235). It engaged in a number of different fraudulent accounting policies to inflate earnings and hide losses. One method was the use of a vast array of special purpose entities (SPE’s) to hide its debt and deteriorating financial position while consistently beating earnings projections and presenting misleading reports to its investors. In addition, Enron used mark-to-market accounting on its assets to aggressively recognize profits. Its declaration of bankruptcy in 2001 was one of the factors that led to the collapse of Arthur Anderson, a renowned and at the time Big Five accounting firm, that failed to detect or take action on Enron’s fraudulent accounting. .

Formed in 1985 after a merger between Houston Natural Gas Co. and Omaha-based InterNorth Inc. CEO Kenneth Lay changed the company’s strategic direction into that of an energy trader and supplier. The industry had changed from highly regulated to deregulated and Enron hoped to profit from the ability to take advantage of fluctuating and now freely moving prices in natural gas and other commodities. At first Enron saw success becoming the largest seller of natural gas in North America. In November 1999 it created EnronOnline which was a platform for trading with Enron as the counterparty on all contracts. It was around 1998 that Enron started to face financial troubles and began to heavily engage in fraudulent activities.

Enron had a huge number of contracts and while some were successful, many were not. However, instead of recognizing losses in the correct manner it would bury them in creative ways often selling off the related assets to its SPE's. Aggressive use of mark-to-market accounting involved tEnron recognizing profits on projects that had not made any money yet. (McLean & Elkind, 2010) A deal with blockbuster is a good illustration:

"Here's one of the more audacious examples, pieced together by The Wall Street Journal: Enron invested a bunch of money in a joint venture with Blockbuster to rent out movies online. The deal flopped eight months later. But in the meantime Enron had secretly set up a partnership with a Canadian bank. The bank essentially lent Enron $115 million in exchange for Enron's profits from the movie venture over its first 10 years. The Blockbuster deal never made a penny, but Enron counted the Canadian loan as a nice, fat profit."(Keller, 2002)

These policies greatly inflated revenues that in reality were not there and as their financial situation got worse and worse, they had to come up with more ways to hide the losses and inflate revenues. Another large problem with Enron's accounting was in many of its contracts where it acted as an agent in a trade but it would recognize the entire value of the trade as revenue. When in fact it should only be recognizing the profit it made on the transaction since they were only acting as an intermediary to the transaction.

Enron is a prime example of the abuse of related party transactions and the ease of simply not disclosing large off balance sheet amounts. It established a huge number of SPEs that it was effectively controlling and using to hide debt. SPEs can serve a legitimate purpose for securing credit but need to meet certain requirements such as the 3% percentoutside equity investment.

This means 3 percent of the equity value of the SPE must be from outside sources. This was not the case in many of Enron's SPEs and they should have been consolidated which would have revealed Enron's huge unsustainable debt levels.

Arthur Andersen was Enron's auditor and faced investor lawsuits after Enron's collapse for its poor quality of audits. Andersen failed to find or act on any of Enron's fraudulent activities and issued an unqualified opinion on Enron's financial statements year after year. During the collapse of Enron, Andersen shredded huge amounts of paperwork related to Enron audits and was later found guilty of obstruction of justice. The firm likely did this since it was already on probation with regulators for their poor job on the Waste Management audit - another poor audit would result in severe penalties against them.

Enron's stock price eventually collapsed from a high of $90.75 to $0.67 and after a failed buyout attempt declared bankruptcy under Chapter 11 of the U.S. bankruptcy code. (Enron fast Facts, 2017) The fact this fraud was able to take place highlighted the failures of audit processes and the regulatory environment at the time. It is a complex issue but had stricter regulations been in place the likelihood of Enron going undetected would have been reduced. Arthur Anderson saw many of its clients be discovered as the perpetrators of massive frauds and this led to the dissolution of the firm. Had the PCAOB been around and inspected even one of these audits they likely would have found serious problems and investigated further. It is impossible to say for sure but with the nature of these frauds often appearing easy to detect, a neutral third party audit review could have discovered them. Even if more difficult to detect an experienced team of professionals with accounting knowledge should be able to detect them when they know what red flags to look for.

One of the main problems at the time was that auditors became complacent. They had been performing audits for the same clients for many years and became predictable and arguably lazy. In the case of Arthur Andersen, many employees in both firms became great friends and knew each other so well that their independence as auditors became highly questionable. Furthermore, Enron was such a large client that Andersen did not want to lose Enron's business and were afraid to put pressure on Enron. So for example, when Arthur Andersen requested additional documents for the audit Enron flat out denied them and Andersen took no further action. Clearly, this kind of relationship for an auditor is a huge conflict of interest and should not have been allowed to go on. Audit partner rotation may have helped in this case since partners may become complacent after working with the same client for a long time and a new set of eyes and possibly new approach may have had a higher chance of detecting the fraud.

Waste Management

Waste Management, as the name suggests, was a waste disposal company that operated garbage collection and disposal. It was involved in a huge fraud that often is overshadowed by the Enron and WorldCom scandals even though it arguably had more of a part to play in the collapse of Arthur Andersen than Enron did. Over the period 1993 to 1996 management manipulated financial statements to inflate earnings by $1.4 Billion (Clikeman, 2009, p.200). It engaged in a number of improper accounting practices including: decreasing depreciation by extending useful lives and inflating salvage values, failing to record expenses related to landfills, improperly capitalizing certain expenses and using reserves to hide current period operating expenses. Furthermore, just like in the Enron case its auditor, Arthur Andersen, took no effective action despite being aware of the improper accounting.

The pressure of earnings targets often puts stress on companies and can tempt them to play with the numbers to ensure meeting these numbers. The expectations of Wall Street are a big factor in determining stock price, which often has a direct effect on top-level management's compensation. In the case of waste management, it was determined to meet these earnings targets and whenever it appeared it might not, management made top down adjustments to expenses and revenues to boost current period earnings.

One of the main areas it manipulated was depreciation. Since these are estimates, it can be hard for the auditor to argue with the company's policy but Waste Management greatly inflated salvage values and useful lives with no reasonable basis for doing so. Garbage trucks that realistically would have little to no value in the future were assigned large salvage values. Furthermore, "(waste management) assigned arbitrary salvage values to other assets that previously had no salvage value" (SEC release, 2002). Industry practice for garbage trucks was useful lives of 8 to 10 years with no salvage value however Waste Management began using useful lives of 12 years with $25,000 salvage values starting in the 1990's. With a large number of trucks, costing around $150,000 per truck, this added up to a huge difference (Clikeman, 2009, p.200). These kind of practices hide capital expenditures and pretend they are being incurred over longer periods and in smaller amounts.

When landfills became full, Waste Management often failed to record appropriate write-downs and impairments for the landfill site assets that were no longer useful and often had environmental costs to close. They built up large reserve accounts that could be netted against current period expenses to inflate earnings.

One of the remarkable things about this case was Arthur Andersen's knowledge of the faulty accounting and inability to take effective action. They tried to get them to change their accounting:

"Andersen annually presented company management with what it called Proposed Adjusting Journal Entries ("PAJEs") to correct errors that understated expenses and overstated earnings in the company's financial statements." (SEC Release, 2002)

However, these were ignored and Waste Management instead managed to come to an agreement where it would make write offs of incorrect amounts over up to a 10 year period and correct its accounting policies over time. The agreement reached was in no means GAAP compliant and Arthur Andersen must have known this and yet it continued to issues unqualified opinions.

The Fraud was eventually uncovered when a new CEO was brought in, ordered a review of accounting records and discovered it. In 1998 the company restated its financial statements acknowledging that it had overstated earnings by around $1.4 Billion. The resulting stock price decline caused estimated losses in market value around $6 Billion to investors. A class action suit was filed against Waste Management and a suit was filed against Arthur Andersen for its role in the scandal.

This case showed clear collusion of management and incompetence, or arguable collusion by the auditor, to perpetrate quite a simple but very large accounting fraud. If the PCAOB had been around reviewing the work of auditors, it would have easily uncovered what Waste Management was doing and stepped in to take action. This is only if they selected this audit for review since it would be impossible to review every audit. The threat of this action would have incentivized Arthur Andersen to perform its role as auditor to the appropriate standard but the climate at the time allowed them to be completely complacent as management manipulated the numbers right before their eyes. Waste Management actually did recover from the scandal, reaching settlements for the lawsuits and today continues as a very large strong company, which is not usually the case for such large scandals often end in bankruptcy.

Evaluation of Post-SOX Fraud

With such a huge number of frauds becoming known around 2002 prior to SOX and immediately after, it is not too surprising to see that there was a break in large-scale frauds in the period after. It was not until the financial crises of 2008 that the huge scandal of Bernie Madoff broke and the collapse of Lehman Brothers happened, I will analyze these in this section. There were of course some minor cases and some noteworthy cases that I will not go into great detail on.

American Insurance Group (AIG) was involved in an accounting scandal that became known in 2004. They engaged in a number of fraudulent transactions including falsely boosting loss reserves by $500 million in reinsurance transaction with General Re Corporation. They also engaged in a transaction with Capco Reinsurance Company, Ltd. (Capco) to conceal approximately $200 million in underwriting losses (AIG to Pay $800 Million to Settle Securities Fraud Charges by SEC, 2006). These mainly occurred in 2000 and 2001 so since this were prior to SOX and the creation of the PCAOB the new laws could not have prevented the fraud.

A couple of other notable frauds involved Parmalat and Satyam. Parmalat is an Italian dairy and food company that entered bankruptcy in 2003 after serious accounting issues. Since this is so close to SOX it is difficult to judge whether it could have had any impact to prevent this fraud. Satyam is an Indian IT company serving large companies all over the world. The scandal broke in 2009 when the founder admitted to falsifying accounting records most notably grossly overstating cash. Since both these companies are foreign based it is a more complex issue to analyze the role that SOX and the PCOAB had to play since they are faced with their own countries regulations. Although it is important to consider the difficulties of regulating large multi-national corporations, I will focus my analysis on the cases of Bernie Madoff and Lehman Brothers.

Bernie Madoff

Bernie Madoff was the perpetrator of the largest Ponzi scheme in history. He founded Bernard L. Madoff Investment Securities LLC in 1960 as a wealth management firm and it is unclear exactly when it turned into a massive fraud but it is estimated to be around the mid 1980's. His investment division collected large amounts from clients and feeder funds and instead of actually investing it, it just sat in bank accounts. He boasted of consistent high returns through his "Split-strike conversion" strategy but in reality investors were just being given other people's money when they wanted to make withdrawals from his fund. He encouraged people to leave their money untouched to keep earning returns and aggressively pursued more investors. The scam began to collapse in 2008 when the financial crises made it very difficult to find new investors and people wanted to withdraw their money. Madoff actually ended up confessing to his sons of the Ponzi scheme who then turned him in to the authorities who proceeded to arrest and charge him with securities fraud.

The collapse and news of the fraud was truly devastating to its investors who in many cases lost their entire life savings. There were a wide range of investors from the very rich to more middle class. He often required minimum investments so not just anybody could get in on the fund but those who did often were persuaded to invest huge amounts. So even the rich who invested may not have been completely wiped out but the loss of millions and millions of dollars is still a huge deal to them. The fallout was so bad that some former investors ended up committing suicide and Madoffs son, Mark, committed suicide two years after the fraud was uncovered. It hit the elderly particular hard who were relying on their investments for retirement.

This scheme was going on before SOX but also long after SOX but was never discovered. It took his own sons, who worked at the firm, turning him in for the fraud to be unraveled. The SEC had investigated Madoff's firm on and off through the 2000's after tip offs and complaints but were never able to uncover anything. There are even reports dating back to the 1970's of people claiming his fund was a fraud but the SEC seemed to take little to no action. The auditor of Madoffs firm was Friehling & Horowitz, CPAs, P.C. (F&H), a tiny accounting firm that was mainly just David G. Friehling who was a good friend of Madoff's and they had known each other for a long time. The SEC filed charges against Friehlings firm:

"The SEC's complaint alleges that Friehling enabled Madoff's Ponzi scheme by falsely stating, in annual audit reports, that F&H audited BMIS financial statements pursuant to Generally Accepted Auditing Standards (GAAS), including the requirements to maintain auditor independence and perform audit procedures regarding custody of securities." (SEC release, 2009)

It is unlikely Friehling ever did any actual work auditing Madoff and just signed off on fake audits year after year. Either way it was completely inappropriate that such a small firm that clearly was not independent audit a huge investment fund. Simple common sense could tell someone it did not have the resources to successfully perform an audit of such a large investment fund

It is hard to decide who fault truly lies with for not discovering this case. The SEC is certainly in part to blame for its failed investigations. The earlier investigations are suspected of being so poor because of SEC execs having ties to Madoff and purposely not conducting a proper investigation. It is hard to understand how later investigations after having clear reports of the fraud failed to see through Madoffs fictions lists of trades and financial statements. The role of the PCAOB is interesting to look at in this case. Since it is not necessarily at fault for not performing a review of the audit since it only performs checks on those selected for review.

However, it could have identified this as a suspect case based on evidence at the time and gone in for a review. While the SEC investigations failed, one would hope that professionals with experience in audit could have detected that this tiny accounting firm was conducting no real attempt at an audit. This would have opened Madoffs firm up to all kinds of additional scrutiny.

Lehman Brothers

In September 2008 Lehman Brothers, one of the world's largest investment banks, filed for bankruptcy making it the largest bankruptcy in history. It had been adversely effected by the developing financial crises due to the housing market collapse and their bankruptcy made the financial crises even worse. Its heavy investments in the subprime mortgage market caused huge losses when it collapsed and led to their demise. In this case, it was not necessarily fraudulent accounting that led to their failure but they manipulated their accounting to hide their poor financial situation from investors. Their infamous use of "Repo 105" moved billions of debt off their balance sheet. This case proved that once again weaknesses existed in the auditing profession and in corporate governance that could allow companies to get away with poor accounting practices.

Lehman Brothers had been aggressively using leverage to boost its earnings which worked out well at times when the economy and other things went their way. However, with the housing market troubles and other financial problems being highly levered causes huge issues and amplifies losses. It used repurchase agreements which is perfectly legal when done properly but Lehman Brothers abused and disguised them to hide their large debt levels. "The effect of the accounting was to artificially and temporarily lower the firm's debt levels to hit certain targets, making the firm look healthier than it really was."(Merced and Sorkin, 2010) The use of what they had called "Repo 105" falsely classified Repo's as sales when they were actually short term loans and they were obligated to buy back the assets that were effectively collateral to the loans.

With Arthur Andersen no longer around to blame in this case, Lehman Brothers auditor was Ernst and Young. They failed to detect the accounting issues despite warnings. "By May and June of 2008, a Lehman senior vice president, Matthew Lee, wrote to senior management and the firm's auditors at Ernst & Young flagging "accounting improprieties." Neither Lehman executives nor Ernst & Young alerted the firm's board about Mr. Lee's allegations, according to the report." (Merced and Sorkin, 2010) Ernst and Young was sued for its failings in auditing Lehman Brothers and reached a $10 million settlement with the New York attorney general's office (Chon, 2015). It was accused of approving the fraudulent accounting policies regarding repo's among other things.

The collapse of Lehman Brothers lost investors huge amounts of money, worsened the financial crises and set other events in motion. Earlier detection by Ernst and Young, or the PCAOB could have limited the damages although their problems were much wider than accounting issues and stemmed from an over investment in the subprime mortgage industry. This case was different to Enron and the pre-SOX cases since the extent of auditor negligence is a lot less severe and different in nature. The role of the auditor is not to assess a company's business decisions but to provide assurance that its financial statements are fairly stated and evaluate internal controls. The issues at Lehman are a better reflection of problems in the banking industry than they are of accounting issues but the accounting issues still should have been caught.

Conclusion

The passing of SOX and the creation of the PCAOB had a big impact on auditing and regulation of public companies and has been successful in reducing the occurrence and severity of fraud. The huge frauds of Enron, Waste Management, WorldCom and many others shocked the world and made it clear that dramatic change was needed. The PCAOB and SOX are not perfect and have faced criticism but are constantly evolving with the aim of being as effective as possible. Accounting is a vast and complex profession and there will always be people looking to exploit it with the goal of making money. Trying to keep regulations up to date and identifying potential problem areas is key to trying to prevent future abuses and not just being left to react to frauds after they have occurred.

The pre-SOX cases demonstrated how the audit firms being “self-regulated” was ineffective since their work was receiving no meaningful review by an independent party. Lacking any serious threat of punishment meant auditors became complacent and lazy in their work, putting too much faith in the ethics of management rather than following auditing standards properly. Arthur Andersen was particularly bad as many of the worse cases were their clients. Arthur Andersen had severely violated independence rules and even when it detected problems did not want to stand up to its clients. SOX and the PCAOB focused on these issues with independence and internal controls to ensure a similar fraud could not occur again. Creating the PCAOB responded to these issues as it developed and enforced stricter independence rules and reviewed the now required audit of internal controls.

The cases after SOX show that it is very difficult to be one hundred percent effective and even with all the new rules things can still slip through the cracks. The Bernie Madoff case was particularly bad and highlights how hiring a small auditor can be a red flag. Especially one that was clearly a related party. Whether a firm actually has a legitimate auditor is something the PCAOB should be on the lookout for in the future. The Lehman Brother's case showed again how it is often in tough times that companies get tempted into fraudulent activities so this is when auditors should be extra vigilant and on the lookout for sketchy accounting.

The PCAOB's role in inspections provides effective third party review and in many cases results in more audit work being done to satisfy the PCAOB. Standards are constantly being reviewed and updated to help ensure quality audits are being performed. One of the largest criticisms of SOX and the PCOAB's regulations is cost. Requiring internal control audits can be burdensome for small companies and increasing the work that goes into audits in general results in a higher cost to companies as auditors have to spend more time on their clients. The cost of quality audits needs to be balanced with the need to prevent fraud and adequately provide assurance to the public that they can trust the companies they invest in. It is inevitable that problems will occur but the PCAOB has to ensure that these are quickly detected before they can spiral out of control and so far has proved to be a valuable regulatory entity.

Overall, the PCAOB has been effective in its role of increasing audit quality and we have seen less occurrences of fraud because of this. Its audit reviews usually require extra work be done and audit firms are having to work harder and require a higher standard of work otherwise they know running into trouble with the PCAOB is likely. Audit firms know that not catching clients that are committing fraud could be incredibly costly to their firm because the PCAOB will take disciplinary action against the firm. The PCAOB develops auditing standards to make sure they are up to date and reduce the risk that weaknesses could be exploited. It is impossible to be one hundred percent effective but except for a few cases, most frauds that occurred post SOX were small in scale and involved violations nowhere near the scale of the pre-SOX cases. This is a great improvement and is largely attributable to the work of the PCAOB.

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Alexander Sebastian Bunney

EDUCATION

The Pennsylvania State University — **University Park, PA**
Schreyer Honors College, Smeal College of Business — Class of May 2018
Masters of Accounting, Bachelor of Science in Finance, Minor in Economics

EXPERIENCE

Deloitte Tax LLP — **New York, NY**
Tax Intern, Global Employer Services (GES) — January – March 2017

- Advised and provided tax consultation services and tax preparation to global clients
- Collaborated in teams to reach solutions to complex tax issues
- Participated in multiple trainings including a trip to Deloitte University

Penn State Food Services — **State College, PA**
Student Supervisor — February 2014 – December 2016

- Managed a team of student employees and ensured they were following all correct procedures
- Responsible for opening and closing stations
- Dealt with any problems that arose with customers or staff

ACTIVITIES/SERVICE

Phi Kappa Psi Fraternity — **University Park, PA**
Scholarship Chair, Assistant Treasurer, Grievance committee, Philanthropy committee — 2013 – Present

- As scholarship chair, ran study hours and helped those struggling with certain classes and other academic issues
- Assist in managing the house's finances including budget planning
- Participated in many community service and philanthropy activities including THON. As a fraternity raised over $100,000 last year for children fighting pediatric cancer
- Resolve problems between members through dispute resolution proceedings

KPMG Discover Summer Leadership Program — **Philadelphia, PA**

- Selected to attend program and learn more about firm — Summer 2016
- Participated in leadership exercises and presentations to develop skills as a leader

Deloitte and PwC Case Competitions — **University Park, PA**
Trueblood Audit case competition, consulting case competition and PwC Challenge — February 2015 and 2016

- Won first place with my team's solution to a case simulating what Deloitte employees do. It involved goodwill impairment and the decision whether or not to go through an IPO
- Presented our solution to several Deloitte partners and other employees
- Worked with PwC to present a solution to a tax case with the goal of minimizing tax liability

Penn State THON Finance Committee — **University Park, PA**
Administration Chair — 2014 – 2015

- Worked to ensure all the financial aspects of THON ran effectively
- Inputted checks into system and ensured all money was accounted for and credited correctly
- Took meeting minutes and other administrative tasks to help the committee run effectively

Accounting Society — **University Park, PA**
Member — 2013 – Present

- Attend professional events to develop personal networking skills
- Take part in fundraisers and other activities to further the community and the personal experience of our members