

# **The Effectiveness of The U.S. Government's Response to Accounting Scandals**

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## **Abstract**

Many accounting scandals have occurred in the recent past in the United States. In some industries there was a decline in regulation and in others there was questionable company-auditor relationships. This paper will discuss and analyze some of the largest accounting scandals of the last two decades, concluding with an evaluation of the government's response to these scandals and what precedent it set for companies going forward.

Many different types of companies were involved in accounting scandals including, Enron, Waste Management, WorldCom, HealthSouth, American International Group, Lehman Brothers Holding Company and General Electric. Some of the companies are still in existence today while others were destroyed due to the unscrupulous events that occurred. These scandals involved many different types of accounting procedures and misstatements to the shareholders. One of major responses by the Government to some of these scandals was the Sarbanes Oxley Act. However, not all of the scandals caused regulation, rather some sort of fine or discipline of the executives was implemented instead. Finally, we consider if the actions taken by the government and regulatory agencies were effective.

## **Enron Background**

Enron was an American energy and commodities service company most prevalent during the 1990s. It also had an online website for trading commodities, Enron Online, which eventually accounted for the majority of its revenues ("The Rise and Fall of Enron"). It reached a stock price high of \$90 on August 17, 2000 (Ellison). However, less than a year later, problems began to appear. After just posting revenues of \$100 billion a year earlier in 2000, the

company suffered a loss of \$618 million for the 3<sup>rd</sup> quarter of 2001 (“The Rise and Fall of Enron”). The downhill spiral was fast to occur, as the SEC launched their investigation, and by the end of 2001, the company had filed for bankruptcy and saw its stock price listed at a measly low of 26 cents on November 30th (Ellison). Enron executives were convicted on charges of conspiracy, fraud, false statements, and insider trading (Mulligan).

**Mark to Market:**

Enron utilized an accounting method called mark-to-market, in which it records its balance sheet accounts at market value instead of book value. It had been using this accounting method since 1992, under the permission of federal regulation. Under this method, Enron was able to count revenue from its long-term contracts as complete, instead of a more revenue-to-expenses matching approach such as percentage-of-completion, where revenue is recorded as work is performed. Enron’s revenue from these contracts were therefore recognized much sooner than the completion of the project. Since revenues always appeared high, due to the “total revenue” approach, it was easy to inflate the revenue, disguising the “real” revenue that was actually being generated. For example, the company could make zero dollars in revenue, but when it counted the revenue from one of its long-term contracts, it could now be profitable. It also used this mark-to-market approach to account for its futures contracts.

Enron had a large business in derivatives, and reported them at the fair value of the underlying asset instead of the cost. It reported gains on these futures contracts based on the fair values before the contracts reached their agreed upon date. Some of their futures contracts were for 20 years in the future, and because of this, it was easy for Enron to manipulate their gains and losses on these contracts because there was no active market that far in time. It recognized the

entire amount of the estimated gain in the first year, on the claim that revenue is earned when the contract is entered into. The potential risk to this method of accounting is when the date of exercise does come, if markets are the opposite of what Enron expected they would experience huge losses. When this did occur, Enron chose to delay the recognition of these losses, hiding them net of gains on the financial statements, or not even reporting them at all (Cunningham). Because of this accounting method, Enron was able to appear very successful for a long time after it actually was; this provides reasoning as to why it collapsed so quickly after it was uncovered (Obringer).

### **SPEs:**

Enron also began making many acquisitions of different ventures as profit centers, but was keeping these ventures off of their balance sheets, and instead reporting them as special purpose entities. These special purpose entities became known as “the Raptors” (Holtzman). When special purpose entities are created, it is documented as to what special activities they are to perform and carry out. For Enron, their problems with special purpose entities arose when they were using these entities for things they were not designed for. Enron had thousands of SPEs which compared to other companies was huge (Cunningham). The problem with this arose when Enron began transferring the debt from its company onto the balance sheets of these special purpose entities. This allowed the company’s credit rating to appear high. The Raptors became a way for Enron to hide its problems, such as losses on its mark-to-market approach. The equity method of accounting requires that if one’s investment in a subsidiary is greater than 50 percent, it must report consolidated financial statements. Enron did not do this for many of its special purpose entities, and because GAAP is not

enforced by the law, this allowed Enron to keep ill-performed subsidiaries off of its balance sheet. It was the Raptors, however, that first marked Enron's downfall. In its 3<sup>rd</sup> quarter 2001 financial statements, Enron included in a footnote a number of losses that had occurred on several of its special purpose entities, including one at \$1 billion due to asset impairment. These losses caused investors to worry.

**Management:**

Another problem with Enron that led to its downfall was its management team. Its CFO was on the board of both Enron and the Raptors, showing the connection between the two and how they would all eventually be brought down together. During the time of the SEC investigation in late 2001, the Wall Street Journal produced an article reporting how the CFO realized millions of dollars in profit on one of his partnerships with Enron (Smith). This caused investors to start to worry about the CFO's duty to Enron if it has a role in these linked partnerships. The CFO then ended his relationship with these partnerships after pressure from Wall Street and Enron shareholders grew. The partnership also had written put options on Enron stock and settled early, causing it to realize huge profits. This occurred right before Enron stock's price declined. If the options had been exercised after the decline, the partnership would have realized losses. The same Enron executives managed many of these special purpose entities, even holding large equity stakes in and receiving monetary compensation from them. Before the CFO ended his relationship with them, Enron had granted him exemption from their conflict of interest policy, allowing him to actively manage both sides of their dealings. When Enron wanted to report more revenue, it sold services to these special purpose entities. Under accounting for investments using the equity method,

GAAP says that a company that owns greater than 20 percent of its investment must recognize its portion of profit and loss from the investee's net income. However, when Enron's investments experienced losses, Enron would transfer the investment off of its balance sheet and onto a special purpose entity (Cunningham). It would then not consolidate these SPE's, under the 50 percent rule, onto its own balance sheet, thereby keeping the loss off entirely. It used a similar method with its debt. Enron used the cash proceeds it received from the bank, but did not report this liability on its balance sheet, but instead on that of a special purpose entity. GAAP also specifies that a company should include disclosures in its notes to the financial statements about investments in subsidiaries, special purpose entities, etc. Enron disclosed some information regarding these things, but remained very vague and broad with its disclosure (Cunningham). By early November, Enron restated financial statements, showing drastically different numbers than its successful past.

### **SOX on Mark to Market:**

Mark-to-market accounting for revenues was a special situation granted to Enron. It is not standard GAAP accounting; therefore, it was not addressed in SOX. Many believe the SEC enabled Enron to commit fraud by allowing them to use this recognition approach for its long-term contracts (Haldeman).

### **SOX on SPEs:**

Section 401 discusses off-balance sheet transactions and states that all off-balance sheet arrangements of a material amount must be included in the company's financial statements ("Sarbanes-Oxley Act of 2002"). SOX does not include many details about this, but instead

issued a release after publishing SOX that goes into more detail on these transactions. A company should report on its consolidated balance sheet those assets and liabilities of entities in which it has control over and assumes the risks and rewards of (“Report and Recommendations...”). Previously, accounting rules stated that if 3% or more of the assets were owned by the parent company, they must issue consolidated financial statements. This black and white approach was changed to be more subjective. Instead, companies must examine whether they are exposed to the risks and rewards of the special purpose entity, no matter what amount of control or ownership they have. This filing also enhances the requirements that the Management Discussion and Analysis (MD&A) section must fulfill in the financial statements. The section is meant to discuss events, uncertainties, future events likely to occur, and other material disclosures that management is aware of and that stakeholders should be aware of. In regards to special purpose entities, the company must create a sub-section within MD&A that explains all off-balance sheet arrangements.

### **SPEs Post-SOX:**

Because of the increased disclosure required in financial statements for special purpose entities and other partnerships, their use by companies has decreased. Because, in its purest form, the special purpose entity is meant to protect the companies involved, it was never intended to be combined with the operating company. Therefore its transactions with the parent company would represent a true sale, and not merely just a re-shifting between balance sheets. The costs of using these special purpose entities are higher because of the consolidation required when there is a controlling interest by the company (Reed). Many

companies restructured their special purpose entities upon issuance of SOX so it would not fall under the new requirements that entail consolidation.

The SEC has observed that many companies are increasing their consolidating of partnerships such as joint ventures and LLCs, but not SPEs, due to the increase in disclosure requirements. The partnerships that companies want to keep off of their consolidated financial statements are being adjusted in a way to not be considered necessary for consolidation under the SOX legislation. This, however, might not always be a bad thing. If the SPE is restructured so as to not require consolidation, it may have been done so in a way that actually transferred risks and rewards, and therefore really deserves to not be consolidated. If this is the case, the legislation was effective in reducing the material amounts that investors are unknowingly exposed to (“Report and Recommendations...”).

### **SOX on Management:**

SOX Sec. 302 covers regulation in regards to executives’ involvement in financial reporting. SOX requires the following regulations outlined below of the CEO and CFO for quarterly and annual report filings (“Sarbanes-Oxley Act of 2002”). The officers must sign the report acknowledging that they have reviewed it and, to the best of their knowledge, does not contain any false information of a material amount or leave out any material information. The information presented in their statements fairly represents the operations of their company. Their signatures also indicate that they are in charge of instituting and upholding internal controls. They must report to their auditors if there is any collapse in these internal controls or fraud that has occurred because of a lapse in their controls.

### **Management Post-SOX:**

In a study done by accounting professors at Florida International University and University of South Florida analyzing pre-SOX and post-SOX Accounting and Auditing Enforcement Releases (AAER) from the SEC, data found that the number of fraud cases in which upper executives, such as CEOs and CFOs, were involved hardly diminished post-SOX, even with Section 302. These releases provide data about companies that have been investigated for fraudulent financial reporting. The report indicated that further reform needs to be in place on the detail of an auditor's review on internal controls, specifically on the seemingly ethical nature of the top executives, as well as their distinction from the Board (Lynch).

### **Auditor Fraud:**

Arthur Andersen was Enron's external auditor. There was also a great deal of accounting scandal committed on this end of the case. One of the biggest problems was Arthur Andersen's role as both Enron's auditor and its financial advisor (Cunningham). This is a very big conflict of interest. Part of the auditor's role is to look into the company internal controls to see how much they can rely on the company's information based on how strong the controls in place are. Enron clearly had very big weaknesses in its internal controls, and Andersen completely disregarded this step. Andersen itself is also supposed to have strong internal controls, and evidence revealed in the aftermath showed that it did not. This was exhibited when the national auditors advised the "on-site" committee auditing Enron to make certain changes but there were no controls in place to ensure that this advice and peer review of sorts was followed (Cunningham).

**Auditors Regulation:**

SOX established the Public Company Accounting Oversight Board (PCAOB) with Title I of its act to oversee the auditing of public companies. One way it does this is in its inspections of public accounting firms to ensure its compliance with the auditing standards the board sets forth. In addressing internal controls, which was the main problem between Enron and Andersen, each accounting firm, in its audit of a company, tests its internal control structure and identifies any weaknesses it finds (“Sarbanes-Oxley Act of 2002”). SOX also implemented the requirement that the primary auditor must be rotated periodically so that the same person isn’t continuously auditing the same company throughout its life. This internal control within the accounting firms aims to increase exposure of the companies’ financial statements among partners of the firms (Pearson). Information regarding a company’s internal control structure is required in their financial statements under SOX Section 404 (“Sarbanes-Oxley Act of 2002”).

**Auditors’ Post-SOX:**

Auditors still need more education to be more efficient and effective at their role. Even after having the PCAOB in place, SEC inspections have found that high quality audit services are still not being performed by CPA firms; citing that these firms are not upholding auditing standards, and are failing to identify accounting not in accordance with GAAP (Pearson).

## **Waste Management Background**

Founded in 1971, Waste Management, Inc. provides waste and environmental services. In 1997, Waste Management was discovered to have misrepresented financial statements since 1992. The CEO and five other top executives were sued by the SEC for perpetrating financial fraud in which they falsified and misrepresented financial performance to the shareholders (“Waste Management Founder...”). This suit was later settled for a substantial amount of money, as well as barring the officers from obtaining a director position of a public company into the indefinite future. Earnings had been reported at an amount overstated by \$1.7 billion, and the financial statements were restated in 1998 (“Waste Management, Inc...”). The scandal was discovered by the new CEO, who requested a review of the financial statements. When the company announced the restatement of \$1.7 billion after having done the review, their stock price rapidly declined (“Waste Management Founder...”).

## **Accounting Fraud**

Waste Management performed a number of techniques that enabled it to enhance its bottom line. The company had projected earnings targets and when its revenues were not big enough to reach these goals, they employed a number of “expense-lowering” activities to offset the lower-than-expected revenues. These techniques included things such as increasing the salvage value and useful life on depreciable assets so as to reduce the amount of depreciation expense incurred each year and capitalizing costs that should have been expensed. They also did not record some expenses altogether that should have been recorded and did not write-off of certain assets (“Waste Management Founder...”). The biggest problem with these inaccurate accounting practices is the relationship that Waste Management had with its

auditor, Arthur Andersen. There were many conflicts of interests that allowed Waste Management to get away with these normally corrected accounting errors. Andersen continuously issued unqualified audit opinions on WM's financial statements, indicating they believed that WM was sound and free of material misstatements. Andersen did identify WM's improper accounting techniques and presented what they called Proposed Adjusting Journal Entries, or PAJEs, to correct these errors. Waste Management, however, refused to make these correcting entries and instead made an agreement with Andersen to write-off the accumulated amount of these errors over a long period of time and change their accounting practices at some point in the future. Ultimately, Andersen had agreed to allow WM to cover up these frauds by committing future frauds. For WM, this still was not good enough. Using the techniques outlined in the agreement would still not allow them to meet their targeted earnings, so they continued to go beyond the agreed upon techniques of accounting for their expenses and improperly record them ("Waste Management Founder...").

The most notable part of Waste Management's scandal was the part Arthur Andersen played in it. Performing consulting and other services beyond that of an auditor, the relationship had become too cozy and went into the realm of being a conflict of interest. Until the new CEO entered in 1997, every Chief Financial Officer and Chief Accounting Officer that worked at WM had been previously employed at Andersen. Andersen received more in fees from WM for non-auditing services than it did for auditing services. Even when Andersen provided WM with ways to correct its financial statements, WM chose not to implement these recommendations and Anderson still issued unqualified opinions, and WM would just state

that the misstatements were immaterial (“SEC Fines Arthur...”).

### **SOX on Conflict of Interest:**

SOX Title II covers Auditor Independence and lists a number of roles the auditor may not play in addition to auditing a company’s financial statements. Section 206 specifically covers conflicts of interest and states that an auditor of a client must wait at least a year before serving an executive role for that client (“Sarbanes-Oxley Act of 2002”).

### **Conflict of Interest Post-SOX:**

There were several key items that SOX did not include that have proven to continue to be a problem in warding off conflicts of interest. SOX does not require rotation of accounting firms for a company, just rotation of auditors within a company. It also failed to ban a number of the non-auditing services that accounting firms continue to provide for their audit clients. Many also complain that the one-year period between being an auditor of a company and then an executive officer of that company is not long enough. In inspections done between the years of 2004 and 2007 of accounting firms, many problems were still found to exist. Of these included problems such as auditors simply accepting their client’s opinion on certain item instead of developing their own, and the reliance on controls without actually evaluating them. Since SOX, the PCAOB has developed statements aimed at continuing to implement changes in regards to conflict of interest. The combination of the verbiage in SOX and that from the PCAOB has improved auditor independence (PCAOB Investor Advisory Group).

## **WorldCom Scandal**

In 1996 a Telecommunications Act was passed with the objective to let anyone enter any communications business. This was the largest overhaul in over 60 years. The overall goal of the legislation was to create a more competitive market by decreasing regulation of converging broadcasting and telecommunications markets and allowing more entrants into the market place to create more competition. However, the deregulations actually lead to a marketplace laden with mergers and acquisitions between providers, which lead to a few giant corporations dominating the market. WorldCom was one of the giants that emerged in the market through mergers and acquisitions. WorldCom came into existence in 1995 when the CEO of Long Distance Discount Service changed its name. In 1996 it purchased MFS Communications the world's first commercial Internet service provider, in 1997 it bought MCI the world's first competitive long-distance phone service provider (the largest merger in history at that time), in 1999 it acquired Wireless One, which had licenses in different wireless bands and SkyTel a wireless network.

At its peak, in the summer of 1999, WorldCom's market capitalization exceeded \$180 billion (SEC v. Bernard Ebbers 2005). Subsequently, business results worsened and its stock price began to drop due to reduced demand as the dot-com bubble collapsed and the economy entered into a recession. In spite of this, the CEO Bernard Ebbers continued to set high performance targets and made optimistic statements about the company's future performance but the performance did not meet Wall Street's expectations. To mitigate the shortcomings of the company's financials, WorldCom's CEO, Bernard Ebbers, CFO Scott Sullivan, and other senior Company executives engaged in a fraudulent plan to make false adjustments to the

accounting records to make the Company seem more financially stable than it really was. These fraudulent entries included classifying over \$3.8 billion in payments for line costs, which were what WorldCom paid companies for the use of their communications networks, as capital expenditures rather than current expenses. These line costs primarily consisted of access fees and transport charges for messages for WorldCom customers. In 2001, \$3.055 billion were misclassified and in the first quarter of 2002, \$797 million were misclassified (Lyke and Jickling 2002). The reason why this misclassification was beneficial to WorldCom was because it understated expenses, which increased net income and overstated assets. Expenses were understated due to the line costs, which are current expenses, being categorized as a capital expense and therefore expensed over a period of time instead of in the current accounting period. Assets were overstated because capitalized costs are viewed as an investment and therefore are considered an asset. Essentially, this accounting maneuver would have allowed WorldCom to spread its current expenses into the future for many years.

Another accounting manipulation that WorldCom did was improperly use its reserve accounts to change reported earnings. Reserves are supposed to be used as a cushion for unpredictable events. In March 2002, the SEC questioned WorldCom's accounting methods; this was the first time their financials were questioned. The CEO Bernard Ebber resigned in April from WorldCom. In May 2002, WorldCom replaced its current auditor, Arthur Anderson, with KPMG. Arthur Anderson had served as their outside auditor since 1989. In June 2002, WorldCom admitted to its misclassification of line costs and in July admitted to improperly using reserve accounts. After these announcements, WorldCom's stock fell below \$1 a share and went to pennies after there was news of speculation of more accounting irregularities. It was discovered through internal documents and emails that WorldCom executives knew as

early as the summer of 2000 that improper accounting treatments were occurring. (Lyke and Jickling 2002)

On July 21<sup>st</sup> 2002, WorldCom filed for Chapter 11 bankruptcy protection. At that time the company reported \$103.8 billion in assets and \$41 billion in debt. However, the assets only included \$1.5 billion in cash. \$50.6 billion of the assets were goodwill and other intangibles (Lyke and Jickling 2002). These intangible assets represent the significance of the acquisitions but it makes one question if it was all truly goodwill or an overpayment for assets. In bankruptcy, goodwill is not treated as a real asset so the large amount of goodwill on the books compared to more liquid assets amplified the bankruptcy. At the time it was the largest bankruptcy in the U.S. After further review, operating expenses that were improperly capitalized totaled \$11 billion.

Other things that occurred at WorldCom that contributed to an atmosphere conducive to fraud committal was the fact that many of the company executives were incentivized by stock options and therefore had a vested interest in the stock's performance. The board was composed of insiders and executives of the acquired companies. They enjoyed numerous perks including use of the corporate jet (Giroux 2008). The board also approved mega loans to the CEO Ebbers totaling \$400 million. These facts should have been red flags to the auditors and regulatory agencies that the company was not being governed in the most appropriate manner.

As a result of the accounting scandal, the U.S. Securities and Exchange Commission charged the company with accounting fraud and quickly obtained court order constraining the company from destroying any financial documents, restricting the pay of past and current executives, and requiring an independent monitor. Federal prosecutors charged Scott Sullivan, the former CFO, and David Myers, the former controller, with securities fraud, conspiracy, and filing false statements with the SEC. The CEO Bernard Ebbers was indicted on securities fraud and making false statements to the SEC and sentenced to 25 years in prison. In 2005, ten former WorldCom Directors contributed \$18 million of their own money as part of a \$54 million settlement (Meyerson 2005). The payments were roughly one-fifth of each director's net worth. At the time this was an abnormal concession in a securities case. This action by the government was one of the first to create more personal financial responsibility of executives for negligent behavior.

### **Government's Role: Deregulation Pre-Scandal and The Sarbanes-Oxley Act**

The government played a role both leading up to the WorldCom scandal and in responding after the accounting fraud had been revealed. In the years preceding the WorldCom scandal the Federal Communications Commission (FCC) was committed to deregulation and creating a more competitive marketplace. The Telecommunications Act of 1996 aided with the official deregulation of the telecommunication industry. The FCC viewed regulatory controls, such as reviewing accuracy of earnings reports or scrutinizing the financial qualifications for a license as a waste of time because they impeded on the workings of the free market. They believed that market forces of competition would deter financial fraud and enforcement actions against financial fraud would only stop some players from entering the market. This

notion did not hold true in reality as we saw from the massive accounting fraud that was committed by WorldCom. That leads to the inquiry, if the government had not deregulated the telecommunications industry would the WorldCom scandal not have occurred? Of course, this is an impossible question to answer however; one can speculate that if there would have been tighter controls on the distribution of licenses and more scrutiny on the financial statements it might have at least curbed the overall amount of falsified accounts by WorldCom. On the other hand, would the monetary cost of having more regulation and scrutiny over the telecommunications industry had been worth possibly preventing WorldCom's accounting scandal? To do proper and thorough examinations of the different companies in the industry would have been very costly since it requires knowledgeable, skilled accounting professionals. The WorldCom scandal not only hurt its stockholders and employees but also affected other players in the industry; other companies cut employees and took other cost cutting measure to reduce expenses to compete with WorldCom and their falsified financial statements. The deregulation definitely helped create an environment that was more conducive to accounting fraud and unsavory business practices but in no way did it cause the fraud to happen. I think it is more important to look at the government's response to this scandal because their actions have set the expectation of what companies should expect as consequences when accounting fraud is committed in the future.

On July 30, 2002 President George W. Bush signed into law the Sarbanes-Oxley Act. This was in response to the accounting scandal fiasco at WorldCom and other the previous scandals including the one at Enron. This Act was put into place to help restore investor confidence in the U.S. financial markets. SOX mandated financial reporting and corporate

disclosure reform. It also established the Public Company Accounting Oversight Board. This act took some of the pressure off industry-specific regulators to enact rules or enforce them. It also holds chief executives directly responsible for the financial statements since they now must sign off on them. After, the WorldCom scandal and other accounting scandals preceding it was obvious that some sort of regulation needed to be put in place to prevent such devastating scandals from occurring again and to restore the investors trust in publically traded companies. I think SOX was an appropriate response to these large accounting fraud cases that had occurred at major public companies.

### **HealthSouth Scandal**

HealthSouth was a leading provider of outpatient surgery and healthcare services. Their goal as a company was to provide more affordable high-quality healthcare services than traditional inpatient hospitals. After Sarbanes-Oxley was passed in 2002, public companies, including HealthSouth had to start having their CEO and CFO certify their financial statements. In 2002, CEO Richard Scrushy and CFO William Owens signed the 8-K for 2001. At the beginning of 2003, HealthSouth was subpoenaed by the U.S Attorney's Office seeking documents regarding common stock and within the month the SEC launched a formal investigation of HealthSouth. The investigations uncovered massive accounting fraud at HealthSouth. The SEC discovered that each quarter, the CEO Scrushy and other senior executives would pick a preferred earnings per share number, and the company's accounting staff would then come up with a method to inflate earnings to meet this desired number. To create income, HealthSouth accountants capitalized operating expenses and overestimated reimbursements from health care insurers. Specifically, fake revenue numbers were placed in

accounts called, contractual adjustments, to make it seem like they were going to collect more from patients than they knew they would actually be able to collect. They also failed to properly record the sale of technology to another company and twice reported the sale of 1.7 million shares of stock in another company. In total, the company misstated \$2.7 billion in fake revenues from 1996 to 2003. (Associated Press 2005)

Besides the pure accounting scandal, there were other things occurring that were abnormal or alarming. First, in 2001 the CEO Scrushy had a compensation that totaled ten times the industry standard for healthcare CEOs at that time. Also, Scrushy had purchased a large mansion in Alabama, a multimillion-dollar lake front weekend home, two beach houses, a seaplane, and a yacht. Both the inflated compensation and immense amount of personal assets seemed alarming regarding Scrushy's morality and true motives as the CEO of HealthSouth. A few concerning transactions occurred for example; HealthSouth purchased \$89 million in computers from Scrushy's father. This was definitely not an arm's length transaction. Also, when acquiring companies HealthSouth board members would often have a vested interest in the company being acquired (Abelson and Freudenheim 2002). These events should have caused auditors to be more speculative of the accounting transactions occurring. In my opinion there appeared to be a lack of checks and balances, and whatever Scrushy wanted was what occurred.

### **Government's Response: Punishments Given**

In 2003, fifteen HealthSouth employees, including all five former chief financial officers, pleaded guilty to criminal charges of fraud. However, Former CEO Richard Scrushy denied

that he knew what was going on regarding the scandal and would not state that he was a part of the false accounting. Richard Scrushy was originally indicted on 85 criminal counts relating to the HealthSouth fraud but after the public hearing he was acquitted on all counts of the criminal charges. Eventually, in 2007 Scrushy settled the SEC civil suit by agreeing to pay \$81 million and was prohibited from serving as an officer or director of a publicly traded company for at least five years (Whitemire 2007). Scrushy was later convicted of bribery and mail fraud for paying former Alabama governor Don Siegelman \$500,000 for a seat on the Alabama agency that regulates hospitals and other health facilities. He was sentenced to six years and ten months in jail. The results of this accounting scandal show that the executives were held accountable for their misguidance and wrong doings. I think this has set a precedent going forward that section 302 of Sarbanes-Oxley will be enforced seriously; if you as the CEO or CFO sign the financial documents you are ensuring they are correct and a fair representation of the company.

### **American International Group, Inc.**

In 2004, investigations into American International Group, Inc. (AIG) brought fraudulent accounting practices to light. The Attorney General's office and New York Insurance Department had already brought AIG to court after questioning their practice of "loss mitigation insurance" and whether they were helping companies hide their losses on their financial statements. They settled out of court to pay a \$126 million fine, but didn't admit to committing any fraud (Brady, Vickers, and McNamee).

The investigation brought to light a transaction that had occurred in 2000 and 2001 between AIG and General Re Corporation. AIG had been under pressure from Wall Street and investors to increase its reserve holdings. AIG essentially paid Gen Re \$5 million to transfer \$500 million worth of insurance contracts and their premiums to AIG, but did not transfer any of risk and the money would eventually be paid back to Gen Re. It was broken up into two transactions of \$250 million- one in the fourth quarter of 2000 and the other in the first quarter of 2001. AIG booked this money as premium revenue, and had it added to their reserves on their financial statements (Brady, Vickers, and McNamee). However, the money wasn't actually revenue- but a loan, and AIG had inflated its financial statements to mislead investors about their performance.

As the government continued to investigate AIG, they found more questionable items worth investigating. For one, AIG had "unusual" arrangements with a couple of private entities. The first was Starr International Co. (SICO), which owned around 12% of AIG stock and was controlled by multiple members of upper management in AIG, hardly making it "independent." It controlled much of senior management's compensation. Another independent entity was C.V. Starr and Co., which controlled 1.8% of shares and developed business and policies for AIG. This was another situation where the independent entity was controlled by AIG management- it was owned and operated by AIG executives- therefore creating a conflict of interest. Union Excess Reinsurance Co. was a company based in Barbados that was governed under the English system. "The Barbados-based insurer was incorrectly treated as an independent company since its ownership is closely linked to Starr International, a private offshore company that owns 12 percent of AIG stock and whose board

is filled with current and former AIG executives” (Pethokoukis, Lavelle and Lim). Over a decade, many transactions were improperly accounted for, totaling up to over \$1 billion.

In addition to the Gen Re transactions and the not-so-independent entities, AIG misclassified and concealed losses, accounted incorrectly for life settlements, understated the value of certain hedge fund trades, and claimed gains on bonds they didn’t actually sell (Brady, Vickers, and McNamee). Greenberg had also ordered AIG traders to buy the company’s stock to prop up the price, and directed staff to make adjustments that reclassified capital gains as investment income. Greenberg also had the ability to “override” certain accounting controls on his own, and moved around revenue and expenses to boost reported earnings.

General Re executives did plead guilty to conspiracy charges, and AIG had to delay its annual report three times, while calculating its adjustment for its earnings. After they were restated, there was a \$1.7 billion dollar difference for the previous four years. Their earnings weren’t the only thing that changed- Greenberg, the CEO was forced to step down, and was replaced by Martin J. Sullivan, who claimed “there should be no restatement going forward”. Much of the upper management was changed as well. Aside from the \$800 million to be paid out by AIG, the company didn’t suffer any other punishments- but some Gen Re and AIG executives involved, excluding Greenberg, served jail times and paid fines. Greenberg has since filed suit to reclaim his portion of lost value due to the government takeover.

Sarbanes Oxley (SOX) was put in place in 2002 to prevent major fraud from occurring. Even though some of the fraud had been committed pre-SOX, it continued until 2005. According to a statement by the SEC, they were able to add on an additional \$100 million to be paid by AIG into the Fair Fund, money that was to be paid back to eligible claimants, because of SOX. However, in other aspects, Sarbanes Oxley failed. It does not mention how reinsurance should be categorized. Reinsurance was brought up years later during Dodd-Frank discussions. Also, the purpose of the act was to prevent companies from misleading investors. It took them years to actually get caught, and for many investors, the damage was already done.

However, AIG has since spent millions complying with SOX and other regulations to ensure that its financial statements are correct and not misleading. When AIG declared “too big to fail” by the government, and had to be bailed out, it wasn’t because of accounting inaccuracies; they had made bad investing decisions.

### **Lehman Brothers Holdings Inc. and Repo 105**

Lehman Brothers also demonstrates the weaknesses in government regulation of financial firms. They committed around \$50 billion dollars in accounting fraud, through a maneuver known as “Repo 105”, from 2000-2008. The accounting “gimmick” was not caught until after the company filed for bankruptcy, and the SEC had thoroughly investigated their financial statements. Court appointed bankruptcy examiner Antony Valuskas released a 2200 page report that thoroughly examined Lehman’s financial statements and how Repo 105 became possible (Harrington).

“Repo” is short for repurchase agreement, a money market instrument. In a typical repurchase agreement, the dealer sells securities to an investor with an agreement to buy them back, usually the next day. The difference between the selling price and the repurchase price can be viewed as interest (Chang, Duke, and Hsieh). However, “contrary to the usual practice of accounting for repurchase agreements, or ‘repos,’ as short term loans, Lehman characterized Repo 105 transactions as a sale of assets. By using the cash obtained from these ‘asset sales’ at quarter-or year-end to pay down other debts, Lehman reduced the amount of total liabilities it reported and improved its reported leverage ratios and balance sheet metrics” (Verschoor). These transactions were with European counterparties, and the amount of these transactions would drastically rise at the end of each quarter. Lehman was also able to hide the toxic assets, such as the subprime mortgage loans, from its financial statements as it “failed to disclose its liabilities arising from the obligations to buy back the transferred assets.” They misclassified some of the transactions as “secured borrowings” on SEC filings, and then went on to classify them as “sales” (Chang, Duke, and Hsieh).

Even though "Lehman was unable to obtain a true sale opinion from a law firm based in the United States related to Lehman's Repo 105 transactions” (Jennings), they creatively utilized loopholes to pull off the transactions for the eight years. They were, however, able to retrieve a sale opinion from Linklaters, a London-based law firm, but it only applied to U.K. instruments-many of which were unregulated- and many of the securities used in the transactions originated from the United States.

According to an article in Applied Business Research by Chang, Duke, and Hsieh, a transfer of financial assets has to meet three requirements to be properly classified as a sale. First, the asset being transferred needs to be isolated from the transferor. Next, the transferee can then pledge or exchange the assets. The third condition, and the one companies will creatively account for, is that the transferor does not hold on to effective control of the transferred asset—either through an agreement to repurchase the asset or mandate its return by the transferee. “Effective control is maintained only if the transferor has the ability to repurchase substantial amounts of the transferred assets.” According to the Statement of Financial Accounting Standards No. 140 (SFAS 140), the repurchase right is guaranteed only when the repurchase price is 102% or less of the cash received (Chang, Duke, and Hsieh). Lehman purposely tacked on an additional 3%, making the total collateralization 105%, giving it the name “Repo 105”, allowing them to argue that they didn’t have sufficient cash to repurchase the transferred asset and maintain effective control. As a result, they reported the Repo 105 as a sale. The CFO, Erin Callan, had written an email to the COO/CEO, Mr. Fuld, stating that Lehman’s balance sheet was “the key to future” (Jennings). With these transactions, they were able to continue to meet the expectations of investors and Wall Street by “window-dressing” until they filed for bankruptcy in 2008.

Companies in the United States need to comply with the GAAP (Generally Accepted Accounting Principles), which outlines the rules of how the transactions must be recorded, making technicalities the focus of auditors. In an article in Strategic Finance, Verschoor states “In the U.K., auditor opinions specifically state that the client’s financial statements do in fact

present a true and fair view, whereas U.S. audit standards only opine that statements are presented in accordance with U.S. GAAP.”

New York’s Attorney General filed a lawsuit against Ernst & Young, the company’s auditors. It may have been unethical, but the Repo 105 transactions may not technically have been illegal. In an article in the Corporate Finance Review, The Dean of the Leventhal School of Accounting was quoted, "If I'm the audit partner and I have concluded that what we are doing is correct and consistent with [standards], I don't know why I would take that to the audit committee, as I'm the expert.” This statement can help explain why Lehman never reported the transactions to regulators.

More recently, there has been an “emphasis on accountants to look at the economic substance of a transaction rather than to just rely on form” according to the article in Applied Business Research. The Financial Accounting Standards Board attempted to help fill in regulatory inefficiencies by issuing SFAS 166 in 2009 to improve the reporting of transferred financial assets. However, companies can still try to exploit a loophole by not including an agreement allowing the transferee to mandate the repurchase.

Lehman wasn’t the only firm classifying repurchase agreements as sales. “Bank of America and Citigroup were both found to misclassify repo transactions as sales... with the amount ranging from \$573 million to \$10.7 billion for Bank of American and \$5.7 billion to \$9.2 billion for Citigroup” (Chang, Duke, and Hsieh). This clearly demonstrates the ineffectiveness of government regulation for this type of fraud.

Up until this point, Sarbanes Oxley had been the only significant legislation regarding accounting (and financial) fraud. After Lehman fell and the financial crash that ensued, government officials worked to bring new reform and legislation. What resulted was the Dodd-Frank Act, which was signed into law by President Obama in July of 2010.

### **Dodd-Frank Wall Street Reform and Consumer Protection Act**

The Dodd-Frank Wall Street Reform and Consumer Protection act was signed in to law in July of 2010 in response to the financial crash. Obama's statement described it as "a sweeping overhaul of the financial regulatory system, a transformation on a scale need seen since the reforms that followed the Great Depressions" (Wade) It took around two years to write and pass through Congress. While it was geared towards large financial firms, and preventing another "too big to fail" bailout, it did address issues from past accounting and corporate scandals.

According a report from the senate, it improved "transparency and accountability for exotic instruments" through working to eliminate loopholes for risky practices that in the past had gone unregulated; gave shareholders a voice in executive compensation; established the Consumer Financial Protection Bureau and Financial Stability Oversight Council; and "empower[ed] regulators to aggressively pursue financial fraud, conflict of interest, and manipulation of the system." It also encouraged whistle blowing, and addressed reinsurance.

This is the largest reform firms have had to adjust to in years, but according to Jared Wade from an article in Risk Management, unlike Sarbanes-Oxley, “there is a lot more to this reform than simply conducting exercises in compliance”. The mass amount of reforms has not been fully implemented yet, and there are still uncertainties as to how parts of the act will be put into action (Malakian). A lot of time and money was spent on lobbying this act as well, so some question the sincerity behind some of the reforms.

### **Dodd Frank and Lehman Brothers**

In 2011, the Federal Deposit Insurance Corporation (FDIC) released a report titled “The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act.” The purpose of the report was to demonstrate what would have happened if the act had been in place during the time of the financial crisis. After the bail out of Bear Sterns and AIG, the executives at Lehman may have felt they were “too big to fail” and would be given a bail out by the government as well. That wasn’t the case, and they filed for bankruptcy, and many investors were harmed in the process. The proceedings have shown to be timely and costly for all those involved.

According to the FDIC’s report, leading up to its bankruptcy, Lehman had been in contact with Bank of America, JP Morgan, Met Life, and Korean Development Bank about their interests in investing into the company. However, after performing due diligence, the firms discovered that Lehman had overstated its assets. They also had too many risky assets in their portfolio, and decided not to invest.

According to the FDIC's report, If Dodd-Frank had been in place; Lehmann would have received help from the government to be liquidated rather than filing for bankruptcy, which would have been better for everyone involved. However, this report was based off of multiple assumptions. Only time will tell if the regulation is truly effective since it has yet to be tested.

### **General Electric**

A relatively recent company charged with committing accounting fraud is GE, who was charged on August 4, 2009 by the Securities and Exchange Commission after a 4 ½ years investigation regarding fraud dating back to 2002 and 2003 (Goldman, 2009). The SEC charged GE with misleading investors by “reporting materially false and misleading results in its financial statements.” According to the SEC, GE used improper accounting methods to increase their reported earnings and to avoid reporting the negative financial results the company had actually encountered. GE's accounting violations were uncovered when the SEC initiated a risk-based investigation of the company's accounting practices. In this type of investigation, the SEC identifies a possible risk in an issuer or industry and develops a plan to tests whether or not that problem truly exists. In GE's case, the SEC was investigating the potential risk of misusing hedge accounting as a possible risk area. The investigation led to the SEC discovering four separate accounting violations with GE correcting the last violation in 2008. GE did not admit or deny the allegations made by the SEC, but they did agree to pay a penalty amounting to \$50M and also agreed to an order that permanently directed them to not violate the “antifraud, reporting, record-keeping and internal controls provisions of the federal securities laws” (Bergers, 2009).

The four final violations according to the SEC were:

- January 2003: Improperly allocating accounting standards to their commercial paper funding program in order to avoid unfavorable disclosures and approximately \$200M charges to the company's earnings. (Bergers, 2009)
- 2003: Failed to correct misuse of certain accounting standards on some interest-rate swaps
- 2002 – 2003: Reported sales at the end of the year (2002) in the locomotives sector that had not occurred yet in order to record \$370M + in revenue. (Bergers, 2009)
- 2002: Increasing net earnings by an estimated \$585M by improperly changing their accounting for commercial aircraft sales. (Bergers, 2009)

In two of the instances where fraud was committed, executives were acting negligent; however, two of the other instances included executives committing outright fraud (Goldfarb, 2009). In one instance of GE's violations, the SEC said that if GE had reported accounting according to GAAP, the company would have missed analysts' earning per shares expectations. GE's false reporting helped the company to meet or exceed analysts' forecasts in each quarter 1995-2004. (Bergers, 2009)

As of February 2008, GE adjusted the books and cleaned up the accounting, concluding that it "is in the best interests of GE and its shareholders to resolve this matter. The errors at issue fell short of our standards, and we have implemented numerous remedial actions and internal control enhancements to prevent such errors from recurring" (Leone, 2013).

GE was in violation of various sections of the Securities Act of 1933 and the Securities Act of 1934 (Exchange Act). The Securities Act of 1933 had 2 main objectives. First, it required that companies provide investors with financial and related information regarding securities offered for public sale. Second, it prohibited deceit, misrepresentation, and fraud in the sale of securities. The Securities Act of 1934 (Exchange Act) created the SEC and gave the Commission authority over every aspect regarding the securities industry. In addition, the Act identified and prohibited specific behaviors in the markets, while also giving the Commission the disciplinary powers of regulated entities and people associated with the entities. Lastly, this Act allows the SEC to require that publicly traded companies periodically report information. (The Laws That Govern the Securities Industry, 2013)

### **Has Increased Regulation Decreased Accounting Fraud Committed by Companies?**

Although financial statement fraud has continued to be a focus for the SEC, the amount of these types of cases has been decreasing in the past decade. The Securities and Exchange Commission filed 79 accounting fraud cases in fiscal year 2012, 11% less than the 89 filed in 2011. The amount of accounting fraud cases in 2012 (89) was the lowest in 10 years. (McKenna, 2012)

Two worthy questions to ask regarding these types of cases are *where* have they gone and *why* have they decreased in number? One possibility that many forensic accountants have considered is there is simply less fraud being committed now. Also, executives may now be less inclined to risk not only their company's financial security and liberty, but also their own by "cooking their employers' books." In addition to this, the requirements enforced by

Sarbanes-Oxley Act have forced senior executives to look at their company's reported financial results before signing off their authority. (The Insider, 2012)

The issue with the previous explanation is that knowingly committing fraud was no less illegal pre-2002, but yet the accounting scandals during the 1990s, including Waste Management, clearly did not deter any later companies from committing similar fraud. The most logical reason to explain the decrease in number of cases is a combination of the following factors: newly instituted SOX procedures and the incentives provided for professionals and accounting firms who follow them, law enforcement shifting focus, and a subtle shift in how public companies are reacting to accounting scandals. (The Insider, 2012)

First, SOX's overarching impact on companies is mainly administrative. It may now be more difficult for misstatements and mistakes to go unfound with the added involvement of legal professionals brought on by increased regulatory oversight. Second, the scrutiny made by the SEC and other regulators, as well as the public, to the conduct of accounting firms has also probably impacted these firms behavior. Significant risk sectors and major revenue recognition decisions have been receiving much more attention from auditors than prior to the previous decade's scandals, making it difficult for problems to occur. Increased internal compliance regarding reporting processes has also made it more difficult to label material accounting-related differences as fraud, bringing actual mistakes to light before reports have been finalized and signed off by executives.

Third, a shift in focus for law enforcement has also contributed to the decreasing number of cases as well. Government is focusing more on insider trading and antitrust inquiries – cases that not only gather a significant amount of press, but that are easier for the general public and juries to understand. These cases usually involve less complexity and uncertainties for the government, which may also explain the shift in focus. (The Insider, 2012)

### **Sarbanes-Oxley Improvement to Corporate Governance of Fraud**

Sarbanes-Oxley requires that companies make it known whether or not a code of ethics is followed, and if one isn't followed, they must acknowledge why. This requirement made it clear that the SEC expected a code of ethics from all companies. Although companies that follow a code of ethics usually have decreased fraud occurrences, Enron had a code of ethics implemented that prohibited some of the behaviors' later committed by the board and company's executives. This made it clear that the existence of a code is useless if the company doesn't comply from top executives to lower employees. (Maleske, 2012)

One of the most significant features of SOX as a whole is the creation of the Public Company Accounting Oversight Board (PCAOB). The Board oversees “the independent auditors of public companies, replacing a self-regulatory scheme and mandating true independence” (Maleske, 2012). The PCAOB helps to promote audit transparency, update audit reports and ensure audit independence. SOX also created a rule that the SEC “requires in-house and outside lawyers practicing before the SEC to report evidence of a material violation to the company's CLO or CEO” (Maleske, 2012). The violation must be investigated and reasonable steps must be taken to respond to the findings. The role of in-house lawyers has changed by

acknowledging that their client is not management, but the company as a whole, and they need to focus on the overall needs of the corporation.

It has been made obvious to the public that SOX implementation costs companies an exorbitant amount, but the underlying question still remains: *Do the long term benefits outweigh the costs?* A survey by Protiviti found that companies in their first year of implementing SOX find the costs to outweigh the benefits, but then after the first year, these same companies say the benefits outweigh the costs. Some benefits include a more thorough understanding of the design of internal controls and an increased efficiency and effectiveness of the company's overall operations. The effect of increased costs in the first year of implementing SOX has caused many companies to avoid registering with the SEC. In the 2000s, there was a drop in the number of US initial public offerings but IPOs in foreign countries rose. This fact can be interpreted two ways: one perspective may say that SOX is not efficient because it drives companies away from going public and registering with the SEC, but another perspective may say it is efficient because only the strongest companies will go public (Maleske, 2012).

### **Sarbanes-Oxley – ‘Feel Good Litigation’**

Sarbanes-Oxley was aimed at restoring the public's faith in the truthfulness and integrity of companies and executives through the financial statements these firms produce. Some experts say, however, SOX has failed at doing so and has in fact, created expensive paperwork procedures for companies. The large amounts of paperwork these companies must produce document their financial operations and corresponding data, but they don't actually prevent

fraud. SOX is sometimes thought of as a “feel-good legislation” that was implemented to make investors and financial statement users feel better when relying on a company’s financials. The cost of companies having to implement Sarbanes-Oxley has been estimated to cost companies hundreds of millions, one estimate saying more than \$1T. This has served as a revenue generating opportunity for consultants making a living on SOX compliance, but the real question is what the benefit was for corporate stakeholders? Some companies have realized the benefits from working to comply with SOX, even though few actual changes are required through the legislation. Through implementing the regulation, though, some companies have followed by improving their basic internal controls. These internal control changes include improving reconciliations, implementing stricter security standards for digital data, and employing greater segregation of duties. Internal auditors of some companies have gained a bigger presence when auditing company’s controls and risks, and their work now adds more value. The Board of Directors has always been influential members in a company; they now play a much more interactive role in a company, mainly in the areas of control and governance. Some companies even saw it upon themselves to take on fraud prevention efforts that were not required by SOX regulation. (Coenen, 2013)

### **Deterring and Detecting Financial Reporting Fraud**

The Center for Audit Quality (CAQ) is “committed to enhancing investor confidence and public trust in capital markets” (Hooper, 2010). The CAQ organized 5 roundtables with 100+ participants to hear views on successful fraud deterrence and detection measures as well as ideas for different approaches. Within the roundtables, the corporate executives involved identified the three main motives for a company’s executives to commit fraud for personal

gain. These motives were titled “The Fraud Triangle” and include *pressure* to commit fraud to reach a company’s goals, *rationalization* that the fraudulent actions are justifiable and the apparent *opportunity* to commit fraud.

In order to successfully deter and detect financial reporting fraud, the CAQ found that the underlying theme would be to implement a vigorous system of internal controls. Although the CAQ found through the roundtables that companies recognize SOX as legislation that has had an effect on publicly traded companies, through improving corporate governance and decreasing fraud, more recent studies have found that senior management and investors still have concerns regarding financial statement fraud. With that being said, the CAQ identified three main themes that, when utilized by public companies, can help to mitigate the threat of financial reporting fraud. These themes include:

1. *A strong and ethical tone set by senior management that filters through the corporate culture.* Setting this tone includes creating an effective fraud risk management program. The program is spearheaded by someone in senior management and begins with an assessment of the company’s fraud risk. The assessment is updated each year and identifies the opportunities and current incentives to commit fraud. Internal controls designed to prevent and identify fraud are also identified. An example of a control that a company can implement is a whistleblower program. (Hooper, 2010)
2. *Skepticism by all participants in the financial reporting process.* Skepticism is the questioning frame of mind that can help to strengthen the objectiveness of professionals. This involves validating information through inquisitive questions, critically assessing available evidence, and paying attention to obvious

inconsistencies. A lack of trust is not required, but rather an attitude of expressing trust while recognizing your responsibility to confirm what you are being told i.e. trusting but verifying. (Hooper, 2010)

3. *Strong communication from all financial reporting participants.* Planned, open, and healthy communications from all participants involved in the financial reporting process are vital to recognizing gaps in the efforts to decrease any risk of financial reporting fraud. (Hooper, 2010)

Fraud is an issue that isn't going to disappear by implementing more regulation. Additional regulation is costly to companies and doesn't usually add any significant benefits in regards to preventing and detecting fraud. The main way to prevent fraud is through companies implementing higher ethical standards through their corporate environment in combination with procedures and policies that in fact prevent fraud. Internal controls aimed at decreasing and eradicating fraud is what is needed in the long run. (Coenen, 2013)

Through our analysis of the efficiency of the government's response to companies committing accounting fraud, we have found that regulation in place has shown to be effective at preventing previous accounting scandals, however, we can't prevent new types of fraud that has not occurred in the past. The most proactive steps that government and companies can take in deterring and detecting accounting fraud would be the government continuing firm implementation and companies creating higher ethical standards and internal controls throughout the organization.

## **JOBS Act**

On March 27, 2012, the House of Representatives of the U.S. Congress passed a Senate-amended Act to make it easier for small businesses to attract investors and acquire capital while still complying with the U.S. securities laws. The name of the legislature is “Jumpstart Our Business Startups Act.” Under this Act, “emerging growth companies” do not have to comply with Section 404(b) of Sarbanes-Oxley for up to five years. This section of SOX requires a public company’s auditor to attest to and report on management’s assessment of internal controls. Also, it bars them from having to comply with any future PCAOB rules that might be adopted regarding mandatory audit firm rotation or analysis reporting. The companies that are considered “emerging growth companies” are those having less than \$1 billion of total annual gross revenue. They will remain classified as a EGC until the first of four dates: the five year anniversary of their initial IPO, the date the company can look back on having issued more than \$1 billion in nonconvertible debt over a three-year period, the year the company reports annual revenues of \$1 billion or more, or the year the company is deemed to be a “large accelerated filer.” According to a Protiviti Flash Report, SEC chairman Mary Schapiro, institutional investors and consumer advocacy groups are concerned that the legislation goes too far in removing SEC oversight and creates opportunity for the repeat of accounting scandals, like Enron (Protiviti 2012). Both Congressmen Sarbanes and Oxley commented on the new provision: Sarbanes called the JOBS Act “a scandal waiting to happen” due to the large amount of emerging growth companies that could be exempt. Oxley seemed to agree with his comment, “They are going to have a scandal, and then the investors are going to complain that the regulators screwed it up, or it’s Sarbanes-Oxley’s fault, or something else” (Amato 2012).

Despite the support for this Act in Congress, it seems to be apposed and criticized by many other industry players that rely on the regulations that SOX established. This Act weakens SOX and creates opportunity for companies who are categorized as “emerging growth companies” to not be held fully responsible for their internal controls. These companies are now not pressured to fully develop their internal controls at an early point in their company’s development. Since this Act has not been in place for a year yet it is hard to say if any large accounting scandal will arise due to the decrease of SOX implementation. However, it does give theses EGC more of an opportunity to commit fraud or engage in unscrupulous behavior due to the lack of regulation.

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