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CORPORATE ACCOUNTING MALFEASANCE AND FINANCIAL REPORTING RESTATEMENTS IN THE POST-SARBANES-OXLEY ERA

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ABSTRACT

The U.S. Congress passage of the Sarbanes-Oxley Act of 2002 (SOX) was a direct response to the accounting scandals of the 1990s and an attempt to reform the financial/business reporting process. Due to corporate malfeasance in the United States since the mid 1990s, there has been a significant increase in the number of companies restating their financial statements. After a large increase in restatements over the first years after SOX, for the past five years, fewer companies are restating financial statements. This paper provides an overview of corporate accounting malfeasance, the state of corporate accounting malfeasance, reasons for its occurrence, comprehensive listings of the types of corporate accounting malfeasance activities, and the U.S. legislative response. The paper also theorizes that not only is corporate accounting malfeasance is here to stay, but malfeasance is an inherent part of the U.S. and global financial system, regardless of the policies implemented by the Securities and Exchange Commission (SEC), other regulatory bodies, or leading institutions of the accounting profession. The paper suggests that certain aspects of the Sarbanes-Oxley Act have been effective in helping companies to detect fraud more easily, and corporations have added internal controls and provided restatements of financial statements to demonstrate their commitment to compliance. Future commitment to internal controls for corporations and auditors is necessary to ensure transparency in financial statements.

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KEYWORDS: Accountant, Accounting, Auditing, Fraud, Malfeasance, Sarbanes-Oxley, Financial Reporting

INTRODUCTION

The paper discusses the extent of financial statement restatements for acts of corporate malfeasance in the post SOX years. This paper discusses the roots of malfeasance, including motivations for malfeasance, methods of malfeasance, and the impact of malfeasance. In addition, post SOX, the paper notes, how internal control frameworks for corporations and auditors have increased transparency.

This paper will provide an overview of malfeasance activity in the United States since the early 1990s. The paper will discuss commonly cited reasons for malfeasance activities, in the section Six Critical Reasons for Corporate Malfeasance Activity. The paper will next provide a comprehensive listing of the types of corporate malfeasance activities that result in restatements, entitled Examples of Malfeasance. The Path Forward section evaluates the SOX related policies implemented by COSO and the PCAOB over the past 15 years.

LITERATURE REVIEW

Corporate accounting malfeasance is defined as the use of false or misleading accounting information, or omission of these entries, in the financial reporting process (announcements, filings, etc.). This malfeasance, where material, later requires that the financial statement be restated. This restatement approach, which considers restatements to include accounting errors, accounting misstatements, and/or any other accounting irregularity, is similar to the approach utilized by the United States General Accounting Office (GAO) in their restatement study (GAO, 2002).

The passage of SOX in 2002, the formation of the Enhanced Business Reporting Consortium (EBRC) in 2005, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 are the most recent attempts to mitigate corporate malfeasance and empower the users of publicly reported information of companies. One important question remains: will these initiatives help to curb the volume and magnitude of corporate malfeasance?

CONSEQUENCES OF ACCOUNTING MALFEASANCE ACTIVITIES

Corporate accounting malfeasance has led to legislation and has increased the cost of doing business for publicly traded companies. Below is a summary of some of the effects:

Increased Legislation

As a result of the growing number of accounting restatements from 1997 to 2002, new laws and regulations have been enacted to help curb this epidemic of malfeasance. The Sarbanes–Oxley Act of 2002 was one of the most significant pieces of legislation. SOX has resulted in more requirements for internal compliance by corporations, materially increases in the cost of business expenses, and greater accountability. The Internal Auditing industry has been one beneficiary of SOX. However, whether accounting malfeasance has actually decreased since SOX is an open issue. Recent research such as Scholz (2014) reports that the number of restatements reported has decreased from 2007-2012, which coincides with SOX's 404 internal control requirement. However, whether this recent decline in reported activity is a direct effect of SOX is an open issue that researchers need to address.

Stock Price Declines

Companies engaged in malfeasance have experienced significant declines in stock price, and this downward trend continues over a longer time frame (compared to non-malfeasance companies). Investors tend to penalize these companies, and institutional investors shy away from these companies, until confidence in the company is restored.

Increases in Reporting of Corporate Malfeasance in The United States: Pre- and Post-SOX

In the United States, the number of companies that file restated financials, as well as the magnitude of the restatement amount in dollars, has significantly and steadily increased since the mid-1990s up until approximately 2006, as measured by the sheer number of restatements filed with the SEC as well as the number of restatements announced publicly. Recent evidence shows a different trend, i.e., that the number of restatements has leveled off from 2007 to 2012.

Files (2012, Table 2) documents that the number of publicly announced restatements increased steadily each year, from 33 in 1997 to 407 in 2005, which is a 1,100% increase over an eight year period. The U.S. Government Accountability Office (GAO)'s 2002 study (GAO, (2002) also documented a similar increase in announced corporate restatements, with 92 announced restatements in 1997 and the 225

restatements in 2001, which is a 245% increase over a four year period. Similarly, a Huron Consulting Study in 2003 found that the number of corporate restatements filed in 1997 was 116, while the number filed in 2002 was 330, which is a 285% increase.

Over the mid-1990s until about 2006, the number of companies that were publicly registered with the SEC decreased, which suggests that restatements were more frequent within a set number of firms: The GAO study in 2002 noted that the average number of companies listed on New York Stock Exchange (NYSE), NASDAQ, and American Stock Exchange (AMEX) decreased annually from 9,275 in 1997 to 7,446 in 2002. The Huron study in 2003 also noted that over the period from 1997 to 2001, the number of public registrants decreased by 14%, while the number of restatements rose by 53%. The CPA Journal in 2003 further reiterated that the total number of registered companies decreased from over 10,500 in 1999 to around 9,000 in 2002, including all U.S. publicly traded companies. Although some of the decrease can be attributed to company delistings and bankruptcies related to corporate malfeasance, some of this trend is driven by a number of public companies that have chosen to become private (Grant Thornton, 2003). The results of these studies, and the sentiments expressed in a 1998 speech by Arthur Levitt of the SEC, demonstrate that the increase in corporate malfeasance existed even prior to the occurrence of the subsequent accounting scandals at Enron and WorldCom in late 2001.

Recent evidence shows a different trend, i.e., that the number of restatements has leveled off from 2007 to 2012. For example Scholz (2014, Figure 1) reports that the number of restatements announced peaked at 1,784 in 2006, shortly after the implementation of SOX's 404 internal control reporting requirements. After that, the number of restatements has declined to about 738 in 2012, which is a decrease of 141%.

Given that the effect of SOX in 2002 on corporate malfeasance activity has been both mixed and inconclusive (taking a minimum of five years to have an effect on the declining number of restatements beginning in 2007), this prompts the following questions: What are the causes of corporate malfeasance activity? Since it is likely that legislation, such as SOX 2002, may have no effect on the incidence of corporate malfeasance, restatements may be a permanent fixture in companies traded in the U.S. stock market.

Six Critical Reasons for Corporate Malfeasance Activity

We will explore six critical reasons for corporate malfeasance activity: internal pressure in meeting unrealistic earnings expectations, income smoothing, short-term thinking, ambiguity in accounting rules. difficulty in assessing accountability, and lack of internal ethical environment.

Executives may feel internal pressure of meeting corporate earnings expectations, and may try to falsify information to ensure that stockholders remain confident and that their personal performance incentives are fulfilled. A company's failure to meet earnings expectations can have a significant negative effect on the company's stock price, which can lead to lower profits, lower executive bonuses, and underwater stock options.

Executives also have an incentive to engage in Income Smoothing: volatile and erratic earnings patterns are considered to indicate high risk, which can potentially increase the required rate of return that investors demand from companies and can potentially lower the company's stock price. Since volatile earnings are considered undesirable, managers of companies may have incentives to engage in earnings management tactics to smooth revenues and profits, thereby showing continuous company improvement.

Many investors and managers view the short term as the critical time frame without regard to the long term, which may lead managers to engage in malfeasance behavior. Also, since there is the possibility

that malfeasance activity will not be detected, some managers may have the mindset that the fraud will not be discovered or that future accounting adjustments can be made to cover the misstatements.

Unclear or Ambiguous Accounting Rules also add to the ability to engage in fraud. Many individuals consider accounting rules to be vague, non-uniform, ad subjective (i.e. the definition of "materiality"), which may lead some managers to engage in manipulation of accounting reporting. Additionally, some accounting reporting requires individuals to make internal assumptions, which may be subjective or unreasonable.

There is difficulty of Assessing Accountability in fraudulent activity. Assessing whether an individual's actions are intentional versus unintentional, or fraudulent versus non-fraudulent, is difficult and sometimes an impossible task. As a result, only in very extreme cases like Enron or WorldCom is the evaluation of such actions as fraud clear cut. In the majority of cases, criminal and/or civil penalties are difficult to enforce. In general, the penalties of malfeasance are less than the overall cost, which presents a problem to discourage such behavior in financial reporting.

Finally there is often a Lack of Internal Ethical Environment in the firms represented. Malfeasance activity is human in nature and may be caused by several things, such as the stresses of management to meet goals to the lack of personal ethical behavior. Additionally, internal ethical guidelines may be non-existent or not reinforced by management, which adds to the problem.

EXAMPLES OF MALFEASANCE

Revenue Related Malfeasance: Revenue Can Be Falsified, Revenue Recognition May Be Manipulated or Revenue May Be Misclassified

False revenues are methods of creating the impression that there is additional revenue include: Round-tripping; which is sale of contract from company A to company B, and then from company B back to company A (there is at least one "round-trip", and there can be more) to increase revenues for each company. Another n\method is back-to-back; sale of assets from company A to company B at a gain, and then from company B back to company A at a gain, to increase the income for each company. Round tripping is a form of "back-to-back" but usually with no gain. A third method is fraudulent sales; Revenue created from fictitious sales transactions with or without sales' orders and/or shipping documents (customer names can be either legitimate or fictitious).

Revenue Recognition involves Revenue Timing. A valid sales transaction recognized as complete in a different accounting period than when the actual transaction was completed. This overstates revenue in one period and understates revenue in another. Premature revenue recognition is recognizing revenue on a valid sales transaction before the sales transaction is completed. Backdating sales or software invoices/contracts is a form of premature revenue recognition in which the date for a completed sale or software contract transaction is changed to an earlier accounting period than when the actual transaction was completed.

Revenue Misclassification and Other Improprieties include Recognition or misclassification of sales transactions that are not valid sales transaction due to terms being incomplete and/or other contingent information. Improper classification/recognition of revenue; recognition of revenue from sales that are not completed sales transactions – i.e. goods on consignment, overselling goods to distributorships, and/or other buy-back/return agreements. Improper revenue disclosures include recognition of sales transaction (one-time revenue gain) without disclosing in footnotes that this was a one-time gain/transaction. Reduction of inflated reserves; revenues created by reversing previously created expense reserves (cookie

jar reserves – reserves that are created in good times to be used in bad times in order to increase income). Revenue reduction includes skimming revenue for regulatory rate increases.

Expense Related Malfeasance: Expense Related Fraud Includes Misclassifications and Shifting of The Timing of Expenses

Misclassification, non-recognition, or unauthorized expenses of the period include Compensation Abuses. Unauthorized pay and bonuses, excess/unauthorized use of company assets, and backdating of stock options are examples of this practice. Another method of fraud is fraudulent capitalization of current expenses; capitalizing expenses as assets (to be written-off over a period of time), when those expenses should be included as costs in the current period. A third example is Expense or Cost Misclassifications/Manipulation; recording expense(s) in a later period than the period incurred, or changing the amount of an expense in the current period. In addition, there can be non-recognition of losses and disregarding or erasing expenses of the period. Finally, fictitious or inflated expenses can boost regulatory rates.

The process of recording more costs and expense during an accounting period than normal when (1) a restatement resulting in lower income is required to be filed or (2) a significant loss has occurred for the reported period. Restructuring Costs (Fraudulent or Misclassified) include using a loss/restatement situation to create a reserve (asset) for future restructuring/reorganization of the business by expensing the dollars in the current period (as required by Generally Accepted Accounting Principles, or GAAP). As the restructuring occurs in the future, the charges will be written off against the reserve account. However, if the reserve is not needed, or if the reserve is overstated, then the unneeded dollars are added to income in the period for which it was determined the reserves were not needed. There are also erroneous or inaccurate reserves recorded; recording expenses in periods of high income to build "cookie-jar" reserves and/or to reduce income. Finally, write-downs are used; using a loss/restatement situation to write-down or write-off assets that will be used or sold at a later date. This will reduce the asset cost when sold in a later period thereby increasing income.

Other Malfeasance Including Income Inflation-Assets-Liabilities

Income can be inflated. Earnings inflation is motivated by meeting analyst expectations; using inappropriate use of reserves, false financial statements and other items. Improper accounting is used to inflate income; bundling leases, insufficient disclosures. Fraudulent accounting schemes, can be employed; Use of shell companies, erroneous reserves. There are Accounting errors; overstatement of perishable inventory, and premature revenue recognition. Finally, Improper internal controls; indicate that internal controls that do not detect errors.

Assets may be overstated. Any situation where the specific revenue or expense detail is not available, but the resulting asset(s) detail or impact is provided. In Mark-to-market abuse; companies recognize gross revenues as profits, which results in accounts receivables being overstated. Where Assets are not properly written down; inventory is overstated, goodwill is overstated._Overstating reserves through restructuring is another problem; Creating excess reserves based or cookie-jar reserves (see revenue above).

Non-Disclosure or inadequate disclosure of liabilities can have a large impact; debt and guaranteed loans are not disclosed, and liabilities are not included in the financial statements in the appropriate manner. Other methods include, improper off-balance-sheet financing of assets or inappropriate synthetic leases. Fraudulent use of SPEs and inadequate disclosure of SPE accounting issues; inappropriate reclassification of debt related to special purpose entities (SPE), SPEs listed that do not meet the SPE criteria, unauthorized SPEs; transfer of bad debt and other items to SPE inappropriately. Finally Non-recognition of liability presents a transparency issue; liabilities are not disclosed that should have been disclosed or

presented in financial statements.

Theft and Misappropriation

Theft includes inappropriate purchases/payments to/for employees/officers and Misuse of company assets by employees and officers. Misappropriation can include compensation and/or stock abuse by officers; granting of options or other stock payments to officers that are not included in the contract or does not meet company requirements for such actions. Other misappropriation includes, inadequate or no repayment of loan by officers/directors; loan repayments are dismissed, which result in a decrease in assets or earnings of the company.

Other Abuses

Insider trading is an external factor impacting the financial statements; an employee trades his/her company's stock based on knowledge of an impending downturn or upturn in the company's financial position, which thereby increases the employee's financial position. Also, the employee's sharing of this information with others (e.g., family or friends), who then act upon the employee's privileged information. Bribery/Influence Peddling; illegal payment by a company to a public official or private individual to gain favorable treatment for that company or the company's goods and services. Conflicts of interest can manipulate reporting outcomes; Taking a fiduciary position in a situation or making a fiduciary decision on an issue where the individual is not considered to be "independent" (i.e., the person has a personal or business relationship, stock owner, etc.). Abetment/Accessory to malfeasance of others; assisting others in misrepresenting financial information is another issue. Loan guarantees for executives have been an area of abuse; Excessive or inappropriate loan guarantees for employees or board members. Related party transactions; Transactions occurring with the approval of, or sanctioned by, individuals with a personal or business relationship with the individual, organization or company that requires approval.

A PATH FORWARD

The importance of Internal Control Standards: The Committee of Sponsoring Organizations (COSO) has been a prolific source of post SOX advice for corporations, in the area of Internal Control and Enterprise Risk Management (ERM). Stressing Internal Controls and corporate accountability, COSO standards advise corporations understanding about Enterprise Risk Management and understanding Key Performance Indicators (KPIs) including the effectiveness of the overall process for gathering and verifying relevant financial report information.

Auditor Standards: The PCAOB has also engaged in creating Internal Control Standards for Auditors and Auditing firms. Creating a comprehensive framework for auditors provides a quality control that will hopefully be more likely to detect malfeasance.

Would IFRS Adoption End Corporate Malfeasance?: The Move toward a Standardized Worldwide Accounting Reporting System: There has been a major shift around the world to standardize accounting reporting systems. By implementing such as system, the unclear, inconsistent and arbitrary accounting rules will move towards standardization. Effective in 2011, Canadian, Australian, and European publically traded companies are required to adhere to International Financial Reporting Standards (IFRS). Many believe that a single global set of accounting standards will minimize accounting malfeasance, while increasing comparability of diverse and global companies' financial statements. Others believe that IFRS standards are even more inconsistent than current US GAAP, and will lead to more cases of malfeasance. The SEC worked with the IFRS on special joint projects, with the ultimate goal of adapting IFRS by the end of 2014. However, in November 2014, the SEC's Chief Accountant James Schnurr had

not made a formal announcement as to the SEC's adoption of IFRS. As of December 8, 2014, the SEC announced it will explore voluntary IFRS adoption, but overall adoption of IFRS is unlikely.

CONCLUSION AND NEXT STEPS

The number of corporate financial statement restatements in the post SOX era reflects the fact that executives and auditors have embraced stronger internal control practices and have prioritized implementing internal controls. The discovery of malfeasance and misstatements using stronger internal controls, in turn, led to providing public transparency through restatements of financial information.
The reduction in the number of restatements in recent years indicates that these companies have implemented effective internal control and audit programs to prevent material misstatements in the financial statements.

Although it is possible that the incidence of corporate accounting malfeasance can be reduced, due to its inherent nature, it is likely that corporate malfeasance will remain a permanent burden on the financial system. This paper gives an overview of corporate accounting malfeasance, explains some of its causes and the resulting legislative laws it has created. Additionally, a comprehensive listing is provided for the many different types of malfeasance activities, separated into the categories of income, expense, asset, theft-misappropriation and exogenous factors. What should be the role of the auditor in identifying accounting malfeasance? It is clear that the auditor's role is of critical importance in detecting malfeasance not detected using other internal controls.

In future research, we also could explore the difference in malfeasance materiality and its resulting consequences between self-reported versus SEC imposed financial statement restatements. An effective system of internal control, accountability in the executive and auditor roles will be the overall best method to decrease the presence of corporate malfeasance.

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