



Fraud Shaping American Business

Senior Project

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By

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# **Fraud Shaping American Business**

## **Abstract**

The business world has been significantly impacted by financial fraud cases that have taken place since the beginning of the 1900s. Since the 1900s, the United States has followed a cycle of scandals and regulations. Monumental fraud cases have laid out new regulations that have severely impacted the way that financial reporting is conducted by businesses. Organizations have been created strictly to influence the accounting practices of companies. The roles of accountants, auditors, and corporate management have changed since the beginning of 1900s. Fraud has led to new regulations being put in place to make corporations more transparent and to protect investors and consumers. These higher standards and more regulations have been enacted to help prevent future fraudulent behavior from occurring.

# **Fraud Shaping American Business**

## **I. Origins of the SEC**

October 29, 1929, also known as Black Tuesday, is the day when the stock market crashed. This stock market crash of 1929 was the beginning to the Great Depression, the longest-lasting economic downturn in US history. The crash of the stock market was preceded by the roaring twenties, where the stock market reached all-time highs. High speculations on the value of stocks gave the stock market its high values. Investors sought to take advantage of the stock market's success and borrowed funds from banks to put into the stock market. This became a huge problem once the stock market crashed in 1929 as the funds invested in the stocks would not be able to be paid back to the banks. The banks used depositor's funds to loan money to investors, and that meant that the banks would not have the funds necessary to pay back its depositors. This led to people rushing banks and demanding their money back, yet banks could not fulfill their demands.

More than 11,000 of the nation's 25,000 banks failed by 1933 (Bank, n.d.). Depositors saw over 140 billion dollars disappear once the banks failed (NewsCore, 2016). The large bank failures caused the public's trust in banks to significantly fall along with the public's trust in the stock market. The Federal Deposit Insurance Corporation (FDIC) was created to build trust in banks and the Securities Exchange Act of 1934 helped to build trust in the stock market again.

After the stock market crash of 1929, concerns were brought to congress as to why this huge crash occurred. The trials became known as the Pecora Hearings and brought about three major legislative acts: The Glass-Steagall Act of 1933, The Securities Act of 1933, and The Securities Exchange Act of 1934. The Pecora hearings exposed many of the scandals that were large factors leading the stock market to crash. During the hearings National Citi Bank, now CitiBank, admitted that they would give cash bonuses to traders who sold the most stocks and bonds, preferable the riskier stocks and bonds. Pecora shined a light on the private banking sector, which had been nearly invisible to the public. Pecora's hearings proved that banks like the House of Morgan were engaging in fraudulent behavior. Morgan would give out financial privileges in order to gain influence over other banks. Chase Securities Corp. financed stock pools that lead to having significant power in artificially raising stock prices.

The Pecora hearings were the start of companies and the stock market becoming transparent to the public as they exposed the fraud, greed, and criminal behaviors. These hearings revealed how some of the most trusted companies were misleading investors and took part in irresponsible investing behaviors. The regulations that arose from these hearings were major legislative acts that have reshaped the financial industry.

The Glass-Steagall Act of 1933 created the FDIC and gave the Federal Reserve more power over banks. Franklin D. Roosevelt was elected president as enacted the FDIC to provide protection for deposits in protected banks. He enforced a 'bank holiday' where

every bank was closed for a three-day period. After those three days, only a specific number of banks were allowed to re-open, but with strict regulations put on their operations. The FDIC provided protection for depositor's funds up to \$100,000 and now that limit is up to \$250,000 with President Bush's new regulations.

The FDIC proved to be an effective way to gain the public's trust back as more depositors were willing to put their money back into banks. The three-day bank holiday and the newly enacted FDIC were put in place after the stock market crash to help build back the trust in the economy. The FDIC also set restriction to help prevent bank institutions from using depositor's money for stock investments. Banks are not allowed to use depositor's money to lend to investors and this new regulation helps to prevent another financial crisis like the one in 1929. The FDIC separated commercial banks from investment banks to help prevent further issues that caused the dramatic crash. The Glass-Steagal Act was later repealed in 1999 to allow commercial banks to participate in the investment and trading of securities.

The Securities Act of 1933 is also referred to as "the truth in securities" law. The Securities Act of 1933 is focused on prohibiting misrepresentations and other fraud in the sale of securities. This act requires that companies that sell stocks and bonds must report truthful information to investors. Public companies were required to publish a registration statement that would include audited financial statements before they could issue any public securities.

By implementing this act, companies could be held liable for misleading or false information to investors and could face civil or criminal suits. The Securities and Exchange Commission (SEC) was established on June 6, 1934 due to enactment of the Securities Exchange Act of 1934. The Securities Exchange Act of 1934 created the SEC to enforce securities laws. This act also required disclosure of periodic financial reports for the public to access through the SEC. Companies that sell securities on the market must register with the SEC before selling or trading any public securities. These two acts helped to make companies more transparent to the public and help investors by disclosing a fair representation of their financials.

Both acts have proven to help in the market by watching for investors and market participants who may be partaking in insider trading. Investors are protected by these acts by requiring companies to fairly present their financial statements. The SEC is a federal agency that was a part of President Franklin Roosevelt's New Deal programs that focused on relief and recovery from the Great Depression. These two acts helped to restore confidence in the market after suffering from the stock market crash of 1929.

## **II. Stock Market Crash of 1987**

October 19, 1987 was a large stock market crash that led to the largest single day percentage drop in the history of the United States, also known infamously as Black Monday. The Dow Jones Industrial Average (DJIA) fell 508 points that day which represented a 22.6 percent drop that day. Stock markets all over the globe experienced

drastic drops during the final quarter of 1987. All the stock markets impacted each other and showed the public that the concept of globalization is real and that other countries economies have a significant impact on the United States. Multiple factors played into the stock market crash that dealt with derivatives, liquidity issues, trade deficits, and bond investments. The stock market crash of 1987 also brought about new reforms as an attempt to prevent another crash like this from happening again.

Similar to the stock market crash of 1929, overvaluation played a part in the stocks crashing. In the preceding months, stock prices reached new highs and gave investors high hopes for future increases. During this time, there was an increase in the amount of futures and derivatives that were being purchased. Derivatives get their value from the underlying assets. These derivatives relied on the values of the stocks, but the stock market and future indexes had not been in sync.

The illiquidity of the stock markets also contributed to the crash. As investors looked to sell a large number of stocks, the stock market found it difficult to find buyers for the prices that they were selling for. This illiquidity led to the market crashing so much in one day. Another factor to the crash was the announcement by United States legislation on October 14 of the largest trade deficit since 1960. This led to the U.S. stock market dropping in comparison to foreign securities because this meant the value of the dollar was declining and that assets, like stocks, that are dollar denominated were losing value.

Reforms and regulations were created to counter a future crash. The Federal Reserve announced that they would be a lender of last resort to help with the liquidity issues. The Fed began by adding its reserves into the financial system through purchases on the open market. The federal funds rate also decreased making it more favorable for banks to use the money they received to be put back into the market through credit. This promise by the Fed, built confidence in the stock market and the public's trust in banks also increased due to this announcement. The Fed encouraged banks to continue their lending as normal.

Circuit breakers were put in place to help regulate trading when the stock market is in decline and declining quickly. These circuit breakers will help to prevent investors from selling or making rash decisions when the market is volatile. The circuit breakers helped to create a more sustainable market by keeping the public calm during fluctuations in the market. The stock market crash happened in part by investors acting fast and attempting to cut their losses early because of the scare of the declining value of the dollar. This crash taught investors to spread their risk and be able to withstand these "flash crashes" and how they should structure their investment portfolios.

The Stock Market Crash of 1987 was not long lasting. In the following three days the Dow recovered 288 points and recovered all losses on stock by 1989. The stock market crash was not nearly as devastating as the Stock Market Crash of 1929 thanks to the fast-acting Federal Reserve and the power of introducing circuit breakers. Although the crash was not long lasting, it left a lasting effect the stock market and brought about new regulations to help prevent future crashes. The Stock Market Crash of 1987 was the

single worse day in stock market history and led to changes in the American financial system.

### **III. Milken and Milken**

Michael Milken was notoriously known as the “junk bond king.” Milken with Drexel Burnham Lambert Inc. lead the junk bond scandal as they flourished by using high-yielding bonds in the 1970s. Michael Milken joined the investment bank, Drexel, in 1969 and from there he expanded the market for junk bonds. Junk bonds are high-risk, high yield security options that are typically issued by a company that is looking to raise fast capital. Milken made connection with people like Ivan Boesky, where Milken provided him with capital and information that Boesky used to manipulate stocks. Boesky would manipulate stocks in order to benefit both him and Milken. This insider trading lead to new legislation and regulations to be put into place.

Junk bonds, before the 1980s, were not very popular as only few companies issued them. Most of the junk bonds on the market were issued by established companies that had been under a hard time. However, in the late 1970s the junk bond market saw significant growth as young companies with no credit issued these junk bonds to help them get started. By the early 1980s, junk bonds became a popular and common investment tool. Milken was a large promotor of junk bonds while he worked for the investment bank, Drexel Burnham Lambert, as he believed that the advantages and rewards far outweighed the probability of default. He would advise investors and issuers to take advantage of junk bonds, and so he catalyzed the popularity of junk bonds. Milken would use junk bonds to finance hostile takeovers of companies. Milken would use those junk bonds by supplying one company enough capital to takeover another company, of which the newly acquired assets were used to pay off the junk bonds.

Milken’s practices were looked down upon by the public as they believed it infringed on their idea of fair business practices. There were also protest involving the tax treatment of the interest payments made on those junk bonds, as they are tax deductible, therefore promoting the use of financing through junk bonds. During this time the junk bond market hit record highs and was certain to crash soon. By the end of the 1980s, the junk bond market crashed as no investors were willing to purchase them.

The crash of the junk bond market coincided with the SEC civil proceedings against Milken, Boesky, and Drexel Burnham Lambert. These proceedings led to multiple large fines and jail time for Milken. Milken was sentenced to ten years in prison where he only had to serve 2 of those years and was recently pardoned of those charges this year. This case lead to tighter regulations regarding insider trading and hostile takeovers.

The Insider Trading Sanctions Act of 1984 allows the SEC to seek a civil penalty, of up to three times the amount of profit or loss, from those found guilty of using insider information in trading, as well as those who provide the information. This act also allows for criminal fines to be levied on the . This act was passed to help the SEC prosecute those involved with insider trading and make the penalties greater than the benefits.



Before this act was passed a person could make way more through insider trading than what they would possibly be fined. When Milken was in front of Congress in April of 1988, there was not strong legislation on takeovers or insider trading. Representative Dingell and Markey created an insider trading bill that would increase penalties for insider trading, penalize firms that did not police employee behavior, and awarded those who were informants in securities fraud cases.

In 1988, amendments were made to the act of 1984 adding to the authority of the SEC where they can seek civil penalties against any person who directly or indirectly controlled a person's violation. However, the penalty for a controlling person is limited to the greater of either \$1,000,000 or three times the amount of the profit gained, or loss avoided. These regulations were put in place to help deter insider trading and make the stock market act in a natural fashion, not forced by the hands of few.

#### **IV. Savings and Loans Crisis**

The savings and loan crisis marked another economic downturn for the United States in the 1980s. The crisis was caused due to high inflation rates and interest rates that both increased significantly in the 1970s and 1980s. Savings and Loans, also known as thrifts, are smaller than your typical bank and mainly focus on helping people to purchase a house. In the 1980s, there were over 4,000 thrifts that accounted for \$600 billion of assets. Within those \$600 billion of assets were \$480 billion in home mortgages. Roughly half of all home mortgages were represented by these saving and loan companies, and therefore had a significant impact on the mortgage industry. With the rise in interest rates, the value of those mortgages decreased and almost wiped out the entire savings and loans industry's worth.

The savings and loan industry relied on deposits with short maturities to fund themselves, leading them to be heavily impacted by changes in interest rates. As the economy was already starting to suffer during this period the rising interest and inflation rates cause many savings and loans to experience large losses. The rates set by the Federal Reserve on how much they had to pay on deposits rose as the rates earned on those long-term mortgages remained the same, cutting into their profits and later causing those large losses. In the early 1980s, the inflation and interest rates started to decline which gave a little relief to the savings and loan industry., However there were no resources available to save the ones that became insolvent. In 1983, it was estimated to cost \$25 billion to pay off the insured depositors of those failed institutions, but the FSLIC only had reserves of \$6 billion (Robinson, n.d.). Due to the insufficient amount of funds to bail out those savings and loan institutions, the FSLIC allowed for many insolvent institutions to remain open and caused the financial problems to grow and worsen over time.

Regulators reacted to this crisis with multiple different legislative acts and standards. For example, federally chartered savings and loans were given the authority to make new, riskier loans other than residential mortgages. This was enacted in several states while

other states made the standards for savings and loans even more expansive to try and revamp the industry.

During this time, there was also an increase in the deposit insurance coverage amount from \$40,000 to \$100,000 to encourage even the insolvent institutions to attract deposits to lend with. The increase in the deposit insurance coverage was a part of the Depository Institutions Deregulation and Monetary Control Act of 1980. This act was put into place so that the Federal Reserve could have more control of the monetary policy. Institutions, like the savings and loan, became regulated by the Federal Reserve. This act was put in place to control the interest rates by controlling the amount of reserve requirements. The reserve requirements are based on the amount of the institution has in deposits. This act also phased out the restrictions that existed on interest rates that depository institutions could offer on their deposits. All parts of this act were put in place to encourage the public to save with banks, deregulate depository institutions and gain more control over the monetary policy.

Following the substantial decay of the savings and loan industry in the late 1970s early 1980s, the savings and loan industry almost doubled between 1982 and 1985 due to all the new regulations enacted. These insolvent savings and loan institutions engaged in what is called a “go for broke” strategy where they invested in riskier projects in hopes of getting higher returns that would help them out of insolvency. Texas was the home to the savings and loan industry meltdown. In 1988 more than forty percent of all the savings and loan failures occurred in Texas.

In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. This act abolished the savings and loan regulator, the Federal Home Loan Bank Board and the FSLIC, and replaced it with the Office of Thrift Supervision and the FDIC now provided the insurance coverage. This act created the Resolution Trust Corporation (RTC) that was funded to resolve the troubled savings and loan institutions that were still operating. The RTC closed over 700 savings and loan institutions that had assets over \$407 billion. The thrift crisis ended in 1995 with the closing of the RTC. Ultimately, taxpayers were used to cover the cost that totaled over \$124 billion (Robinson, n.d.) This act provided a pathway of stability and profitability, along with the other regulations put in place during the time, up until the crash of 2008.

In December of 1994, Orange County filed for bankruptcy after suffering major losses due to subprime lending. Orange County's bankruptcy began the large municipality to file for bankruptcy in the United States. The treasurer for the county, Robert Citron, used public funds to gamble with by putting those funds into risky investments. These risky investments included the savings and loan industry. He participated in these investments to hopefully market the interest rates against themselves as he would buy long-term investments and sell short-term investments believing that he could take advantage of the rate to make money. However, this time period proved to be a time of high interest rates which caused Orange County to have significant losses. Citron lost \$1.69 billion and forced the county to file for bankruptcy in December of 1994.

Merrill Lynch settled with Orange County for \$400 million for the risky investments that were sold to Citron. Citron had control over the county's investment pool and would offer high interest rates that encouraged public agencies to join in the pool. Citron would use those deposits to borrow money to invest in derivatives, inverse floaters, and long-term bonds that paid high yields. He would then borrow more money by using the borrowed money as the collateral. As interest rates rose, Citron's investments lost money causing the bankruptcy. Citron was asked to resign, and the county filed for bankruptcy. Just 18 months later, the bankruptcy ended due to \$880 million in bonds being sold in June of 1996.

## **V. WorldCom and Enron**

Some of the most notorious scandals in U.S. history took place in the early 2000's. The WorldCom and Enron scandals paved the way to new legislation and significantly changed American financial reporting. WorldCom was one of the world's largest telecommunication companies, while Enron was one of the largest energy companies. WorldCom and Enron produced some of the largest scandals to date through manipulation of financial reporting. The Enron scandal was found in 2001 and then shortly after in 2002 WorldCom's scandal was released.

Prior to Enron's infamous fraud scandal, Forbes had named Enron as America's Most Innovative Company for six years in a row. Some might agree that Enron really was innovative in how they ended up reporting their financials. Enron was able to increase their revenues from \$13.3 billion in 1996 to \$100.8 billion in 2000 (Paul, 2009). Enron's stock prices peaked in 2000 at ninety dollars a share. Enron spent the late 1990s into 2000 as one of the most admired companies in the world. However, despite the significant increase in revenues, stock price, and market share, Enron filed for Chapter 11 bankruptcy in 2001. This led to investigations being conducted on Enron and its leadership. A team was put together specifically to investigate Enron called the Enron Task Force that was made up of individuals from the FBI, IRS, SEC, and prosecutors from the Department of Justice. More than 1,800 interviews were conducted and 3000 boxes of evidence along with four terabytes of data were collected in this case (Enron, 2016).

The Enron scandal caused shareholders to lose \$74 billion while employees and investors lost their retirement accounts. Over two dozen of Enron's officers and executives were charged for fraudulent behavior. Enron used special purpose entities (SPEs) to help raise capital for all of their projects or acquisitions and found a way to avoid recording any of the assets or liabilities from those SPEs. By keeping at least three percent of the SPE ownership in an outsider investor, Enron was able to avoid reporting the SPE on their books. Using SPEs were common practice at the time and were legal. However, Enron abused the accounting rules by having the outside investor be a related party. Enron agreed to bare the risk associated with those SPEs, but that risk was not included on Enron's financial statements. Enron received permission from the SEC to use mark-to-market accounting, which allowed Enron to account for future profits in this

year's financial statements. Through all of Enron's abuse of the accounting rules, they were able to inflate their financial statements and stock price.

An inside whistleblower led to the fall of Enron. On October 16, 2001 Enron declared a \$638 million loss for the quarter (Paul, 2009). As news surfaced of Enron's losses and potential fraud by the executives, stock prices plummeted. Executives were charged with conspiracy to commit fraud, securities fraud, and covering up Enron's financial downfall.

Worldcom is known as the largest accounting fraud in U.S. history. WorldCom is a telecommunications company who is now named MCI, Inc. WorldCom manipulated their financial data that it included on many different forms and statements in an attempt to inflate their earnings. They accomplished this through capitalizing expenses that normally would not be capitalized. Capital expenses, with the accrual method of accounting, allows a company to expense their capital purchase over its useful life. This is how a company can better represent the revenues that are associated with the costs necessary to generate those revenues.

WorldCom took operating expenses and would allocate them to other property expenses that could be capitalized in order to avoid reporting expenses on this year's statements. This meant that they were able to spread their operating expenses over a longer period of time instead of expensing them in the year they occurred. This led to WorldCom reporting a \$1.4 billion profit for 2001, but had the expenses been recorded properly, WorldCom would have lost money in 2001 (Kennon, 2019). They were able to inflate assets by \$11 million and caused investors to lose over \$180 billion (Writers, 2019). From this fraud WorldCom went bankrupt but reemerged as the MCI, who is now a subsidiary of Verizon.

The collapse of WorldCom began after the acquisition deal with Sprint was blocked by the U.S. Department of Justice, since it was the second and third largest telecommunications companies. WorldCom profits began to stagnate in 2000 and led to the fraudulent reporting of expenses. WorldCom accountants also used adjusting entries to attempt to close the gap between the actual revenues for the quarter and the forecasted revenues for the quarter. Betty Vinson, who worked in the general accounting department for WorldCom, ended up going to the FBI to report that she had helped prepare more than \$3.7 billion of improper journal entries (Paul, 2009). The SEC also requested more information from WorldCom in 2002, due to their success while other telecommunication companies were suffered from losses.

The Public Company Accounting Reform and Investor Protection Act, otherwise known as the Sarbanes-Oxley Act of 2002, was passed in response to the Enron and WorldCom scandals. This act limited the services that an auditor can provide to its clients. Auditors should be limited in the nonaudit services that accountants can provide to their audit clients. Keeping auditors from performing too many duties in one company represented the need for auditors to stay independent from their client. This act also established the Public Company Accounting Oversight Board (PCAOB) to regulate these public accounting firms.

The PCAOB was given four main responsibilities. To begin with, they are in charge of registering accounting firms that can audit public companies in the U.S. securities market. Their next responsibility is to inspect those registered accounting firms. The PCAOB must also establish auditing, quality control, and ethics standards for registered accounting firms. Lastly, they must investigate and discipline those registered accounting firms for any violations of their professional standards or the law. Relatedly, the Auditing Standards Board added new standards for auditors to set up procedures to help detect potential fraud. In addition, the Financial Accounting Standards Board tightened rules for SPEs and the SEC required more extensive disclosures of off-balance sheet financing.

The WorldCom fraud case expedited the Sarbanes-Oxley Act of 2002 and was passed with a 97-0 vote (Paul, 2009). This act was the most dramatic change in the nation's financial reporting system since the Securities Acts of 1933 and 1934. Audit committees are held to higher standards to ensure their company is fairly presenting their financial information and that internal controls are designed to prevent fraud. The Schedule M-3 Form 1120 is created and requires corporations, with over \$10 million in assets, to reconcile their book income to their tax income and provide more clear financial information. This schedule helps corporations become more transparent with their financials and allows them to show why their book income may differ from their tax income. A huge part of the Sarbanes-Oxley Act of 2002 was Title II where it requires the corporate officers to certify the annual and quarterly reports generated by the company. This made the corporate officers more liable for any fraud committed by the accounting departments that work below them. This provision was added in hopes of making corporate officers more responsible for their subordinates' actions. The Sarbanes-Oxley Act of 2002 introduced a lot of changes to the business world and helped to limit fraudulent behavior.

## **VI. Financial Crisis of 2008**

The financial crisis of 2008 was the worst recession that the United States suffered since the Great Depression in 1929. The Great Recession in 2008 was due mainly in part to the collapse of the subprime mortgage market and mortgage backed securities. This crash led to financial institutions collapsing, credit markets seizing up, and stock markets plunging. This devastating time called for government intervention where new regulations were put into place in order to prevent another recession like this from occurring. The focus of the financial crisis of 2008 was the crash of the housing market. This idea of 'too big to fail' became prominent but was proven untrue as the government handed out lots of bailouts to large companies. Unemployment rates reached above nine percent and some of the largest investment banks collapsed. Many blame the recession on the lack of oversight and regulations on the financial institutions.

Leading up to the financial crisis of 2008, the government was pushing the housing industry and encouraging banks and mortgage companies to issue subprime loans and mortgages to low income areas. These pushes by the government led more

investment banks to use subprime mortgages and lend them to individuals who can not afford those mortgages. Because these homeowners could not afford the subprime mortgages, there were a lot of defaults on those mortgages.

In the year 2000, subprime mortgages made up 5.6 percent of the mortgage market and by 2005 they made up 50.5 percent of the mortgage market (Financial, 2016). Investment banks would purchase those subprime mortgages from the banks and the banks roles were basically eliminated. The bank lends the mortgages to more people and lowering their standard for who can receive the mortgage, then sells the rights to the mortgage payments to investment banks. The commercial banks lose most of the risk, while the investment banks take on a lot of risk. So why would investment banks purchase those mortgage rights? Investment banks purchased those mortgages to use for mortgage backed securities. These MBSs offered higher returns and were considered safe at the time due to the assets tied to them. The demand for MBSs increased and this led commercial banks to lower their credit standards for who they loaned to in order to sell more to the investment banks.

The housing market boomed since demand for houses increased now that more people were obtaining those mortgages to buy a house. In 2007-2008 the supply of houses was greater than the demand as people started to default on those subprime mortgages that had high interest rates. This started the collapse of the housing market. As the housing market decreased and houses lost value more people purposefully defaulted on their mortgages since their mortgage was worth more than the house they owned. That only caused the housing market to crash even more due to the increase in foreclosures. These crashes is what led to the bankruptcy of investment banks, such as Lehman Brothers, and the government bailouts.

In 2008, George W. Bush passed the Emergency Economic Stabilization Act which is also considered the bank bailout bill. The government purchased preferred stock in eight of the leading banks costing \$105 billion (Dodd, 2018). This bailout also targeted other companies and industries. Auto companies, insurance agencies, and to homeowners who need help refinancing their mortgages. \

The Dodd-Frank Wall Street Reform Act was also enacted due to the financial crisis of 2008. The Dodd-Frank Act was put in place to put regulations on lenders and banks in order to protect consumers and prevent another recession. The main provisions of this act were for banks to come up plans for when they approach bankruptcy, increase the reserves in banks to prepare for future recessions, annual stress test by the Federal Reserve if they have more than \$50 billion in assets, and the FSOC to identify risks that affect the financial industry and keep large banks in check. The office of credit ratings was put in place to help ensure that agencies provide reliable credit ratings. This act also helped to encourage and protect whistleblowing in order to keep fair practices at all levels. Included in the Dodd-Frank is the Volcker Rule. The Volcker Rule prevents banks from investing their funds, with some exceptions.

## **VII. Recent Fraud Cases**

### **A. Wells Fargo**

Wells Fargo represented one of the leading banks in America and was found for creating fraudulent acts in 2016. Employees opened almost 1.5 million bank accounts and applied for 565,000 credit cards that were not authorized by their customers (Corkery, 2016). Employees also created fake emails in order to sign up for online banking while also setting up fake accounts that were only found out about by the customers after the fees had accumulated. Wells Fargo was fined \$185 million that included a \$100 million penalty from the Consumer Financial Protection Bureau. That is the largest penalty that they have ever issued to a company. The importance in this fraudulent behavior by Wells Fargo shows that their internal controls were weak and did not help employees act with good intention. Internal controls are set up in order to eliminate some of the opportunities for fraud to occur. Internal controls are an important part of any company, especially a big company like Wells Fargo. Employees were driven to commit fraud through the motivation factor of the fraud triangle. Wells Fargo set up sales quota for all employees, but the quotas were too far out of reach. Employees felt an obligation to reach these quotas in order to keep their jobs and would then commit fraud by creating fake accounts in order to make their quotas. Wells Fargo implemented these sales quotas along with rewards for meeting those quotas and those rewards give employees even more motivation.

### **B. Valeant Pharmaceuticals**

Valeant Pharmaceuticals was once one of Canada's most valuable companies. As a drug company they have been under a lot of scrutiny for the high rise in drug prices. Valeant executive had created secret shell companies, secret email accounts, and kickback schemes to get rich at the expense of Valeant and their investors. A mail order pharmacy, Philidor Rx Services, worked with Valeant executive Tanner in order to pocket cash through a large acquisition with a large kickback. Davenport was the CEO of Philidor.

Davenport and Tanner exchanged emails under an alias name to discuss their get rich scheme. Tanner would steer Valeant business to Philidor and would purposefully block Valeant's efforts to diversify their pharmacy relationships. Tanner had financial interest in Philidor and with the help of Davenport, they concocted a \$300 million acquisition of Philidor in 2014 (Egan, 2016). From this acquisition, Davenport was able to pocket more than \$40 million while he allegedly kicked back almost \$10 million to Tanner (Egan, 2016). Tanner had created a Philidor email with the alias name of "Brian Wilson" in order to communicate with Davenport. The emails would say that they would both "ride into the sunset, like in the famous robbery film Butch Cassidy and the Sundance Kid," (Egan, 2016).

It is easy to see that Davenport and Tanner conspired with each other in order to rob Valeant and their investors in order to make a personal profit. Tanner, as an executive of Valeant, failed to withhold his fiduciary duties by conducting such a scheme with

Davenport. Since the discover of the Philidor and Valeant scandal, Valeant's stock crashed by nearly ninety percent. The Valeant scandal is considered to be the pharmaceutical version of Enron due to its large fraud scandal with Philidor.

### C. Heinz

Heinz is a ketchup company that was recently found as having issues relating their procurement process. Heinz received a subpoena from the SEC in October of 2018 where an investigation took place. The investigation found that employees were recording incorrect timing of certain costs and rebate elements as part of supplier contracts. The ending result was an increase in the cost of products sold for the last few years. Experts suggest that the cause of this fraud was due to inexperienced employees given too much control.

Heinz had also set up a bonus structure that would reward cost-cutting above anything else. This bonus reward program gave the employees incentive to cut cost and report the cost of products sold incorrectly. The overall affect of the funds was a small percentage, however Heinz had to adjust their 2016, 2017, and first quarter of 2018's financial statements. The total understatement represented \$208 million and represented less than one percent of their net income (Cosgrove, 2019). This scandal showed weaknesses in Heinz's internal controls and their procurement process. Although senior management was not found to have been a part of the fraud, Heinz hired a new CEO. Under the new CEO they established more internal controls and set up a stricter punishment program for employees. They have also set up more appropriate training programs for employees. New checkpoints were set up to help ensure that management's goals are attainable. Overall, this fraud case showed how weaknesses in internal controls leads to fraud. By increasing their internal controls and providing more security on their procurement and finance departments Heinz hoped to restore faith and turn around the company.

### D. Under Armour

The SEC has requested more information and began to probe into Under Armour's accounting practices in 2019. Under Armour is a sports wear company that competes with Adidas and Nike. In the recent years they have been making less money and losing market share. Allegations have been made that Under Armour is illegally shifting money from quarter to quarter in order to appear more financially healthy (Riley, 2019). Under Armour has since replaced their CEO and has been complying to all of the SEC's request. Other scandals regarding Under Armour were released in 2019 that dealt with business trips to strip clubs and inappropriate workplace behavior. Under Armour was said to have created a frat house culture. The public release of these scandals led to the drop in stock prices along with a four percent drop in sales in North America. Under Armour needs to improve their corporate culture and enhance their internal controls in order to avoid similar scandals in the future. By improving their internal controls, Under Armour will be able to analyze and ensure their accounting principles are appropriate.



## **VIII. Lasting Impact**

Fraud has led the way for new regulations and policies to be enacted in order to protect consumers, investors, and companies. As discussed, there have been a lot of major corporate fraud cases that have revolutionized American businesses. When we compare what corporate structure and regulation was before the Great Depression to what it is today, we can see why all these changes occurred. The Securities Act of 1933 and 1934 were the most monumental acts in affecting businesses for that time. Since the 1930s, we have seen a cycle of scandal and reform constantly repeating itself. Regulations enacted in almost every decade in order to help prevent more scandals and economic recessions from occurring. Up until the Securities Acts of 1933 and 1934 were passed, U.S. companies were not obligated to publish their financial states. However, we saw British Corporations beginning to publish audited financial statement in the 1840s (Paul, 2009). The Securities Acts helped to make public corporations transparent to their shareholders and the public. The 1933 act required registration statements before offering public securities, while the 1934 act required the period release of financial information. The 1934 act also established the SEC which proves to be an important to this day as they were given the authority to write financial accounting standards for public companies. This was the beginning of the generally accepted accounting principles being created. The SEC oversees all securities transaction on public markets in order to protect investors and consumers.

The enactment of the Securities Acts introduced huge changes into the business world and the next step was improving the accounting and auditing world that was in charge of producing and reviewing those financial statements. After the Enron and WorldCom scandals the next most extensive act was established that impacted businesses and their financial reporting. The Sarbanes-Oxley Act of 2002 established the PCAOB to help regulate public accounting firms. This act not also helped to establish more extensive punishments to corporate officers who were involved with fraudulent behavior. Corporate executives are also now required to sign off on all financial statements in order to prevent the use of negligence in a suit for fraud. Other organizations strengthened their rules and policies to help prevent or deter future fraud. The Sarbanes-Oxley Act of 2002 also strengthened the notion that auditors must remain independent of their clients. This meant the limiting of nonaudit accounting services that are performed with the audit client. The act also raised standards for audit committees and how they should oversee their company's accounting principles. This act made auditor establish an opinion on the fairness of the financial statements that they reviewed and to release to their client and the public their opinion. They should inform their client of where their weaknesses are and how to strengthen them.

Since the early 1900s, the United States has gone through multiple recessions on the economy. A significant cause of these economic depressions is due to securities fraud and false valuations due to companies fraudulent reporting. Speculations of securities offered by companies is what drives the stock market. As a company reports earnings and positive growth, investors speculate the continuing growth and cause stock prices to be

inflated. Once more information is released or discovered these inflated prices drop significantly and lead to a stock market crash.

There are a lot of factors that played into all of the crashes the United States has experienced since the 1900s, but this paper highlights the role that fraud played in those crashes. Each stock market crash and recession brought about new regulations to put trust back into the markets and into companies. The FDIC was established after the stock market crash of 1929 in order to provide security for the funds that the public puts into banks. The government regulation was in attempt to bring the economy out of the Great Depression and provide for more regulations on banks. The next recession in 1987 was brought about again through the overvaluations of stock. Derivatives played a large role in this crash since their value was based on the underlying assets, in this case stocks. The illiquidity of the market played an issue as well, so the Federal Reserve stepped in and offered assurance by stating their new policy of being a lender of last resort. Companies offering these derivatives were given a safety net and the public was able to restore their faith in the market. This stock market crash was short lived due to the quick actions of the government. Many the acts and regulations have been enacted since the 1900s in order prevent more opportunities to commit fraud and to increase the public's trust.

The business world has gone through periods of strict regulations to laize faire economies and throughout all periods fraud scandals still occurred. No matter the number of regulations or policies that are put into place, loopholes will occur and fraud will be attempted. When we look back at the fraud triangle that consist of opportunity, motivation, and rationalization, one can see that it is not possible for the government or corporations to fully prevent fraud. However, throughout history there have been many attempts to deter fraud and to keep companies transparent. Regulations have been able to curve the opportunity to commit fraud with requiring companies to publish financial statement and setting up accountnign standards that must be followed. These attempts to curtail fraud have helped to change the accounting reporting world.

The business environment is always changing and as companies commit more fraud and find more loopholes, more regulations will be enacted. This on-going cycle will continue to occur as fraud can never be eliminated. It is unlikely that any regulations or corporate control can eliminate all three factors of the fraud triangle. It is important to understand that it is the company's accountant's job to prepare fairly presented financial statements and that the auditors are reviewing those financial statements to issue an opinion. It is not necessarily the auditor's job to find fraud, but to state an opinion on the financial statements. Their opinion can lead to further investigations to find fraudulent behavior. Public trust in corporations is always fluctuating, however the regulations put in place have helped to build the public's trust and enable the markets to continue.

Fraud has shaped American businesses by forcing transparency and enabling civil and criminal actions to be taken on corporate leaders who are involved with fraudulent behavior. It has created new organizations that oversee the actions of companies and their accounting practices while also setting stricter rules for corporate tax filings. The

business world will continue to be shaped by fraud and will evolve even more as time passes.

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