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**Greed at the Top:  
Fraud and the Failure of Oversight at  
Adelphia Communications Corporation  
and Tyco International Ltd**

By

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**This thesis was written as a part of the masterprogram at NHH. Neither the institution, the advisor, nor the sensors are - through the approval of this thesis - responsible for neither the theories and methods used, nor results and conclusions drawn in this work.**

## **PREFACE**

This paper is a part of our “masterstudiet” on the Norwegian School of Economics and Business Administration. In the paper we examine the concept of fraud in relation to two contemporary business scandals. We focus on the scandals in Adelphia and Tyco to explore the concept of fraud. Accounting scandals like these have received major publicity in recent years. Because fraud persists as a threat to modern businesses it is important to study particular cases and explore how futures scandals may be prevented. We found this theme very interesting, and we chose to write our master thesis on these two major scandals. As we both start our careers in the same big audit firm, we chose to look at fraud from the auditor’s perspective. Many people may believe that the auditor has all the responsibility in discovering business fraud, but is this really the case? We ask: “What is the responsibility of the auditor, and who else shares the responsibility?” In writing our paper we have gathered information using several different sources including books, articles and the Internet.

We thank our supervisor, Iris Stuart, for helping us with this paper. She has been a great help both in giving us ideas and giving us inspiration. We also thank Bruce Stuart for his help with this paper, especially with the English language.

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## **ABSTRACT**

In this paper we have taken a good look at the concept of fraud, using theory and examining frauds that have happened in two large companies. The main purpose of this paper was to gain insight on the concept of fraud, to see why fraud is committed and who has responsibility to prevent fraud. We have seriously considered the auditor's job, to see what part he plays in preventing fraud. We have found that fraud is somewhat common in the business world and think it probably will continue to be a serious problem. In the beginning of this century several major accounting scandals were revealed. This publicity has prompted increased focus on the problem of business fraud. In response, a new regulatory framework is developed, we think that this framework is good, but it will likely not be sufficient to prevent fraud entirely. In this paper we have looked at fraud that involves management, thinking this kind of fraud is more difficult to prevent than fraud committed by employees. When management commits fraud, it is often committed by strong personalities. These persons are often very hard to stop with rules. If they have the desire to commit fraud, they can often find ways to break rules. The auditor has a certain responsibility to prevent fraud, but we have come to think that he can not be held responsible if he is doing his job properly. There are always many other people in position to detect fraud, employees and the Board of Directors. They can be good resources in the fight against fraud. We think that these parties can find support for their effort to prevent fraud, not only through formal structures of regulations but also from increased awareness of how to recognize circumstances that give opportunity for fraudulent actions.

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## INTRODUCTION

In this paper we are going to take a close look at the concept of fraud. The paper concentrates on two major accounting scandals that involved white collar crimes which took place in the beginning of this century. One of the scandals happened in Adelphia, a family run cable company, and the other in Tyco, a conglomerate doing business in several areas from healthcare to electronics. Both the companies are American. In both scandals the executives stole money from their companies; in effect, they lived by their own rules. In each case, the fraud continued several years before it was discovered. We think that getting a greater insight into the concept of fraud is important because it affects more people than one may think. Everyone can be affected by fraud. Changes in the regulatory framework are important, but fraud will remain a problem. Even if there are many new rules, we are not sure that frauds like those in Adelphia and Tyco will not happen in the future. Determined people we believe, will always find ways to commit fraud.

In the first part of the paper we are going to give an insight into the basic nature of fraud. To better understand what was going on in the two companies we have written a section about the concept of fraud wherein we carefully consider a theory with several key aspects. We will try to give the reader a clear idea about what fraud is, the common kinds of fraud, and why some people choose to commit such frauds. This brings us to what we call “the fraud triangle”, an important characterization of fraud. We then use the “fraud triangle” to analyze the fraud committed in the two companies, Adelphia and Tyco.

In both the scandals high profiled men are behind the frauds, and we take a close look at these men. These men were the CEOs of their company; in Adelphia, John Rigas, and in Tyco, Dennis Kozlowski. We look at their personalities and try to figure out why these two successful men ruined their careers and risked going to prison because of their actions.

An important part of our paper is the auditor’s place in the discovery of fraud. We have the impression that there is a common perception that it is the auditor’s responsibility to detect and prevent fraud. We are going to look closer, to see whether this perception is true or not. We look at the auditor’s responsibilities using International Standards on Auditing and General Accepted Auditing Standards. It is also interesting to consider the auditors’ role in the fraud at Adelphia and Tyco. We are not going to draw any major conclusions about whether

they did their job, but we will see what they did and make some remarks that emerge from the official investigations.

Even if the main perpetrators in these scandals were Rigas and Kozlowski, there were also others in the companies who participated in the fraud and some who could have detected the fraud or even prevented the fraud. In this paper we also look at additional people: some employees in the company, the Board of Directors, and the auditor. We offer comments on their responsibilities and consider why they did not do anything about the frauds in Adelphia and Tyco.

In the second part in the paper we address important issues when talking about the risk of fraud and how to detect and prevent it, we discuss conflict of interest and internal control. One good thing that comes out of scandals like these is that publicity prompts reform. In several areas, new and improved rules have been developed to prevent future fraud. The U.S. Government has developed a new directive called the Sarbanes-Oxley Act. But it is not only the U.S. Government that has developed new rules to fight fraud. Many companies have become more focused on how to prevent fraud, and the audit firms themselves have also developed new directions to fight against fraud. In the paper we look at a number of steps that have been taken by the different parties.

In the last section we give our opinion on whether the new and improved framework might have prevented the fraud in Adelphia and Tyco. We comment also on the new regulatory framework, including some of the new prescriptions for auditors.

## **ABOUT THE FRAUDS**

The scandals in Adelphia and Tyco are among the biggest in modern business history. They occurred at a time when the business world was harmed by many other frauds. The Adelphia and Tyco scandals hit the news in 2002, the period after Enron's<sup>1</sup> collapse, when investigation of major frauds were given high priority by the U.S. Government. Several committees were developed and the US General Accepted Auditing Standards was revised to include a fraud paragraph. This paper will describe and analyze the Adelphia and Tyco scandals. In the first part of the paper we will describe the scandals as presented in the SEC reports.

The Securities and Exchange Commission reports provide information gathered by an investigation conducted by the Commission. The SEC was established in the early 1930's as a result of the depression that followed the Great Crash of 1929. The idea behind its creation was that for the economy to recover, the faith in the capital markets had to be restored. With the newly established commission came securities laws designed to create stability in the markets and protect investors. The SEC describes its mission as: "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation". Because securities can lose their value, it is important for the investors to have as much information about the company as possible so they can consider the risk of investing in the company. The SEC thinks it important that the public receives the proper and correct information about a company so investors are able to make the right decisions. So the SEC "requires public companies to disclose meaningful financial and other information to the public". To see that important market-related information is disclosed, that fair dealing is upheld and to protect against fraud, the SEC oversees key participants in the securities world. The SEC brings hundreds of civil enforcement actions each year against both individuals and companies for breaking the securities laws. The SEC has the responsibility to

- Interpret federal securities laws;
- Issue new rules and amend existing rules;
- Oversee the inspection of securities firms, brokers, investment advisers, and rating agencies;
- Oversee private regulatory organizations in the securities, accounting and auditing fields; and
- Coordinate U.S. securities regulation with federal, state, and foreign authorities

([www.sec.gov](http://www.sec.gov)).

If the SEC suspects that a company is not making the reports pursuant to the rules, they start an investigation of the company. This is to reveal why the financial reports have misstatement and if there is any fraud in the company.

The SEC has to have a solid reason to begin investigating companies. There are millions of public companies, and the SEC can not investigate all of them. The SEC can decide to investigate a company for several reasons: due to insider trading, accounting fraud, for giving false or misleading information both about securities and the companies that issue them ([www.sec.gov](http://www.sec.gov)). At the time it started to investigate Adelphia and Tyco, concern for major fraud was a high priority. This was due, in part, because of the Enron scandal. In this context, the SEC had stepped up its investigations and was investigating many companies. In the first two months of 2002, the SEC opened an unprecedented 49 new financial-reporting cases. The inquiries were a part of a push by the SEC to crack down on potential financial-reporting abuses following the collapse of Enron, and a focus by Congress on the accounting abuses that contributed to Enron's demise (Pulliam 2002). On March 27 Adelphia announced that they had kept \$2.3 billion of debt off its books. This caused the SEC to start an informal investigation. On April 1 Adelphia first filed with the SEC for a 15-day extension of its 10-K financial report. Adelphia did not manage to meet this 15-day extension, and they filed for a second delay. After this second delay, the SEC opened a formal investigation into Adelphia's accounting practice ([www.sec.gov](http://www.sec.gov)). With Tyco, the SEC started their investigation based on a tip they got about a finder's fee that the CEO of Tyco had given to one of the board members. Tyco had also been investigated by the SEC previously. In 1999 they had been investigated, but at the time the SEC decided to take no further action ([money.howstuffworks.com](http://money.howstuffworks.com)).

## ***Adelphia Communications Corporation***

### **About the company**

Adelphia Communications Company was a large cable company founded by John Rigas and his brother Gus in 1972 in Coudersport, Pennsylvania. “Adelphia” is Greek and means “brothers”. At the time of the scandal, in 2002, Adelphia was the sixth largest cable company in the USA. Through numerous consolidated subsidiaries, they provided cable television and local telephone service to \$5.7 million subscribers in twenty-nine states and Puerto Rico (AICPA 2003, 2005).

Adelphia was a family run company where most of the executives were family members:

- John Rigas, Founder and Chairman (Father)
- Timothy Rigas, CFO and Board member. Between December 1992 and June 2001 he was chairman of the Audit Committee of Adelphia's Board of Directors. (Son)
- Michael Rigas, Executive vice president and Board member (Son)
- James Rigas, Executive vice president and Board member (Son)
- Peter Venetis, Board member (Son-in-law)
- James R. Brown Adelphia's Vice President of Finance

(AICPA 2003, 2005).

On June 25, 2002, Adelphia filed for bankruptcy. Adelphia and its subsidiaries operated under the protection of Chapter 11 of the U.S. Bankruptcy Code (SEC Litigation Release No. 17627 2002), until 2006 when it was purchased by Time Warner NY Cable LLC and Comcast Corporation ([www.timewarnercable.com](http://www.timewarnercable.com)).

The Adelphia subsidiaries consisted of approximately 63 various partnerships, corporations, or limited liability companies exclusively owned or controlled by members of the Rigas family. Fourteen of the Rigas entities were engaged in the ownership and operation of cable television systems and other related ventures (the “Rigas Cable Entities”). Approximately forty-nine of the Rigas Entities were involved in businesses completely unrelated to cable television (the “Rigas Non-Cable Entities”). Adelphia managed and maintained virtually every aspect of the Rigas Cable Entities, including maintaining their books and records on a

general ledger system shared with Adelphia and its subsidiaries. Adelphia and the Rigas Entities participated jointly in a cash management system (CMS) operated by Adelphia. This resulted in the commingling of funds among the Adelphia CMS participants, including Adelphia subsidiaries and the Rigas Entities. The sharing by Adelphia and the Rigas Entities of the same management, general ledger system, and cash management system greatly facilitated the fraud at Adelphia (SEC Litigation Release No. 17627 2002).

### **About the fraud**

The Adelphia fraud involves two types of fraud, one carried out by the executives on behalf of the company, and the other done against the company by the Rigas family. In a short summary, the charges dealt with overstating income and hiding loans off balance sheet. The U.S. Government also claimed that the Rigas family used the company as a “personal ATM,” using company money as if it were their own.

John Rigas and his family were known for their luxurious lifestyle. They had several vacation homes and luxury apartments on Manhattan. They also owned several private jets and spent a lot of money on a golf course. To support this life style the family used company money (AICPA 2003, 2005).

The Securities and Exchange Commission investigated the possibility of misstatements in the financial statements, and on 24 July 2002 they filed a suit charging Adelphia Communications Corporation, its founder John J. Rigas, his three sons, Timothy J. Rigas, Michael J. Rigas, and James P. Rigas, and two senior executives at Adelphia, James R. Brown and Michael C. Mulcahey, in one of the most extensive financial frauds ever to take place at a public company. The SEC report gives many details about the alleged fraud. The main points are summarized below. The SEC has divided the principal components of the fraud into three categories:

- (1) Between mid-1999 and the end of 2001, Adelphia fraudulently excluded from the Company's annual and quarterly consolidated financial statements over \$2.3 billion in its bank debt by systematically recording those liabilities on the books of unconsolidated affiliates. Not only did the exclusion of these liabilities violate Generally Accepted Accounting Principles ("GAAP"), but Adelphia and other

Defendants actively misled the public about these liabilities in Commission filings and other public statements. In some instances, the Defendants created sham transactions backed by fictitious documents to give the false appearance that Adelphia had actually repaid debts when, in truth, it had simply shifted them to unconsolidated Rigas-controlled entities.

(2) During about the same period, Adelphia and the other Defendants regularly misstated in press releases, including earnings reports, and Commission filings. Adelphia's reported performance in three aspects that are crucial to the "metrics" used by Wall Street to evaluate cable companies: (i) the number of its "basic cable subscribers," (ii) the extent of its cable plant "rebuild," or upgrade, and (iii) its earnings, including its net income and earnings before interest, taxes, depreciation, and amortization ("EBITDA").

(3) Since at least 1998, Adelphia used fraudulent misrepresentations and omissions of material fact to conceal rampant self-dealing by the Rigas Family. For example, Defendants forced the public company to pay for vacation properties and New York City apartments used personally by the Rigas Family, develop a golf course on land mostly owned by the Rigas Family, and issued over \$772 million of Adelphia shares of common stock and over \$563 million of Adelphia notes for the benefit of the Rigas Family.

(SEC Litigation Release No. 17627 2002)

The fraud turned Adelphia from a well functioning company to bankruptcy in just a few months. On March 27, 2002 Adelphia disclosed that they had borrowed \$2.3 billion through various family-owned partnerships off of its balance sheet. With this announcement the Adelphia stock dropped 18%. On March 27 the Adelphia stock was trading at \$16.72, but after this announcement it was downhill for Adelphia. Throughout the spring of 2002 the price of Adelphia stock collapsed. On April 1, 2002, Adelphia said in an SEC filing that it needed more time to review its accounting and would not be able to meet the deadline for filing its annual financial statement. They got a 15-day extension. They also failed to meet this extended delay and had to file for another one. Right after filing for the second delay Adelphia revealed that the SEC had opened a formal investigation into its accounting practices. In the period to come, several lawsuits were filed against Adelphia, the stock

continued to drop and several executives stepped down. On May 30 the National Association of Securities Dealers Automated Quotation System (NASDAQ) said it was going to delist Adelphia's stock on June 3. Through the spring the Adelphia stock had fallen from a closing price of \$20.39 per share on March 26, 2002 to a closing price of \$0.70 on June 2. (Table 1) NASDAQ did as they said, and on June 3 they delisted the Adelphia stock. After that Adelphia had no future, and on June 25 they filed for bankruptcy (SEC Litigation Release No. 17627 2002).

The fraud in Adelphia included several acts of fraudulent behavior. All the defendants in the complaint were investigated by the SEC. John Rigas and his son, Timothy Rigas, were tried and convicted in the case; they were sentenced to 15 and 20 years respectively. They got the harshest penalties of all the defendants. Both John and Timothy appealed their sentences, but the conviction was upheld in each case. John Rigas is now 84 years old, and is for all practical terms in prison for life.

Throughout the trial, John Rigas claimed his innocence, and for that reason he would not agree in a plea-bargain with the government, even if that might have given him a much lighter sentence. In an interview he said that he could not admit to a crime he did not do, and that he would rather spend time in prison than hurt his reputation ([www.charlirose.com](http://www.charlirose.com)). One of the executives, James Brown, did not share John Rigas' point of view, and he agreed to a plea-bargain and got a lighter sentence. In the trial Brown testified against the Rigas's, claiming that John Rigas and others knew about the false numbers. Brown only got a few years in prison (Wall Street Journal *Adelphia executives' conviction upheld* 2007).

One of the other sons, Michael Rigas, only got a light sentence; he was sentenced to 10 months of "house arrest". Prior to the sentencing, U.S. District Judge Jed Rakoff said that Michael Rigas seemed to be a person "who found himself in the wrong place at the wrong time" and was "on a totally different footing" from his father and his brother Timothy ([www.cfo.com](http://www.cfo.com)). The reason for this light sentence was that the prosecutor did not think he was as involved as the others. He agreed to plead guilty to the charges the SEC had against him, and that this helped him to avoid a retrial on 15 counts of securities fraud (Bray 2006).

## *Tyco International Ltd*

### **About the company**

Tyco was originally founded in 1960 as a laboratory that worked for the government. It went public quickly, in 1964, and from 1965 on it acquired other companies. With the acquisitions, Tyco went from being a research to a manufacturing company. Tyco continued to grow with acquisitions, and in 1974 Tyco's stock was listed on the New York Stock Exchange. The company grew larger, and in 1986 Tyco divided its subsidiaries into four segments, Electrical and Electronic Components, Healthcare and Specialty Products, Fire and Security Services and Flow Control. This was done to strengthen the company from the inside. In 1993 it changed its name from Tyco Laboratories to Tyco International Ltd since it had grown into a large multinational company. In the following years, Tyco continued to grow through acquisitions. This, in addition to growth in the already existing operations, meant that Tyco took a leading market share in all of its four segments ([www.tyco.com](http://www.tyco.com)).

This paper focuses on the major scandal in Tyco in 2002. The following executives were involved in the scandal<sup>2</sup>:

- L. Dennis Kozlowski, CEO
- Mark Swartz, CFO
- Frank E. Walsh Jr, Director and Tyco Board Member
- Mark Belnick, Chief Corporate Counsel and Executive Vice President

In 2002 the company employed more than 250 000 people in over 100 countries ([media.www.michigandaily.com](http://media.www.michigandaily.com)). Tyco was based in Bermuda and had annual revenue of about \$36 billion around the time of the scandal (Maremont & Cohen 2002). At the time of the scandal Tyco was one of the leading conglomerates in the world (Maremont & Reigber 2003). The CEO, Dennis Kozlowski, was one of the highest-paid CEOs in the world (Maremont 2003).

Unlike what happened in Adelphia, Tyco is still a functioning company. In 2006 Tyco decided to divide the company into three different companies, which would also be traded publicly. The idea originally came when Kozlowski still was the CEO, but they changed their

minds about it after a couple of months. The three companies were: Tyco Healthcare, Tyco Electronics and a combination of Tyco Fire & Security and Engineered Products & Services ([www.tyco.com](http://www.tyco.com)). The split did not happen before the middle of 2007. Tyco Healthcare is now operating under the new name Covidien, and Tyco Fire & Security became ADT Worldwide ([proquest.umi.com](http://proquest.umi.com)). Today Tyco operates throughout the U.S. and in 60 other countries.

### **About the fraud**

The fraud in Tyco was committed by the executives against the company. By using different methods they managed to steal about \$600 million. The U.S. Security and Exchange Commission filed a complaint against: L. Dennis Kozlowski, Mark H. Swartz, Mark A. Belnick, Frank E. Walsh Jr. and Tyco's auditor, Richard P. Scalzo from PricewaterhouseCoopers LLP.

The scandal in Tyco broke after the SEC started their investigation of Tyco in 2002. At this time the CEO, Kozlowski, had become interested in buying art and sat on the board of the Whitney Museum. At the same time the Manhattan District Attorney's Office investigated galleries that had helped customers avoid sales tax. Kozlowski had bought several expensive pieces himself, and they indicted him for evading over \$1 million in sales taxes on these purchases ([www.cbsnews.com](http://www.cbsnews.com)). The SEC cooperates with the Manhattan District Attorney, and it also got a tip about a finder's fee to one of Tyco's Directors, Walsh, which prompted the SEC to start their investigation. Tyco had also been investigated by the SEC in 1999. The SEC investigated Tyco's accounting principles because of an analyst's report. They were especially concerned with how Tyco accounted their acquisitions, but that time the SEC decided to take no action ([money.howstuffworks.com](http://money.howstuffworks.com)). Since the SEC had more information in 2002 than they had in 1999, they decided to reopen their investigation.

Using the SEC reports, we give an overview of the fraud. Tyco had different programs to take care of their employees. To encourage executives and key employees to own Tyco stocks, the company had a Key Employee Corporate Loan Program (KELP). KELP provided the employees with loans at low interest so that they could pay taxes for owning company stocks. KELP was established in 1983. Tyco also provided relocation loans to all employees. These were given to help their employees relocate when Tyco moved offices from New Hampshire

to New York and Florida. The loans were interest-free and were to be provided only to those that had to move when the offices were relocated. They were not supposed to be given if an employee moved somewhere else or for other purposes. The program was established in 1995 (SEC Litigation Release No. 17722 2002).

Because of the low interest, the KELP loans were a favorable deal for the employees. But Kozlowski and Swartz also took advantage of these loans, using them for other things than the stated purpose of the loans. The SEC report states that these executives granted themselves hundreds of millions of dollars from the KELP program. They took the money in a five-year period, from 1997 to 2002. The report states that Kozlowski received KELP loans from the company of about \$270 million. Out of this sum only \$29 million was used to cover the taxes from owning Tyco shares. With the remaining money Kozlowski bought expensive art, jewellery, an apartment on Park Avenue that cost millions of dollars, an estate in Nantucket and many luxury items. Of course, none of these things falls under the stated category for which the KELP loans were intended. In the same period, Swartz stole about \$85 million, most of which he also gained from KELP loans. Out of this money only \$13 million was used to pay taxes. Swartz used the rest of the money for own pleasure and business investments (SEC Litigation Release No. 17722 2002).

Tyco used a Director & Officer (D&O) Questionnaire that the executives had to fill out. These questionnaires required Kozlowski and Swartz to disclose their KELP loans, but they did not make these disclosures even though they knew that this was wrong. They did not disclose their loans to investors in any other ways (SEC Litigation Release No. 17722 2002). Each man claimed their innocence, but they had to have known that this was wrong. They knew the purpose of the loan program, and when they did not report all the money they had “borrowed”, they deliberately did something wrong. As the report from the SEC says: “Kozlowski and Swartz knew, or were reckless in not knowing, that they were obligated to disclose their improper KELP loans to investors in Tyco’s annual reports on Form 10-K and proxy statements...” (SEC Litigation Release No. 17722 2002). Because of this failure to report, the shareholders did not know about the improper loans that the two executives got from the KELP accounts.

Kozlowski and Swartz did more than abuse the KELP loans. An even more attractive loan was the relocation loan that was given without any interest charges. In the period between

1996 and 2002 Kozlowski received approximately \$46 million in relocation loans. Out of this money only \$18 million was used to buy a home near the new Tyco office in Boca Raton, Florida. Of the remainder, about \$21 million was used to buy properties in other places. These actions did not meet the requirements of the loan because the purchases were not in the areas of the new Tyco offices. Kozlowski used the remaining \$7 million to buy an apartment on Park Avenue for his separated wife. From the same program Swartz received loans of more than \$32 million. He bought a waterfront compound in Boca Raton for about \$17 million, a \$6.5 million New York apartment and spent the remaining money on a yacht and several real estate investments. In this way, he used \$15 million on things that were not a part of the program. The executives reclassified the loans from KERP to relocation loans several times. But they did not show any regard for the stated purposes of the loan fund. They did not disclose these loans on the D&O Questionnaires either, so the shareholders did not get any information on them, and therefore did not know about the misuse of the programs (SEC Litigation Release No. 17722 2002).

It was not enough for the two men to get loans with good terms. They also oversaw and authorized other transactions that caused tens of millions of dollars of loans to be forgiven and be written off Tyco's books. In 1999 Kozlowski received loan forgiveness to his KERP account of \$25 million, and Swartz got a loan forgiveness of \$12.5 million. In 2000 Kozlowski received loan forgiveness of almost \$33 million and Swartz received over \$16.6 million. This forgiveness was credited to their relocation loan account. Relocation loan forgiveness was also given to others who had these loans. To get this forgiveness these executives had to sign an agreement that they promised not to disclose the loan forgiveness "to anyone other than their financial, tax or legal advisors." Kozlowski and Swartz wanted to hide what they themselves had done, so they made others falsify the records. According to the SEC, they did this by "offsetting the cost of the relocation loan forgiveness program against the gain from an unrelated initial public offering of a Tyco subsidiary" (SEC Litigation Release No. 17722 2002).

As you can see, the main persons behind the fraud were Kozlowski and Swartz. They were the two executives on top of the corporate ladder, and they had the power to do as they wanted. But also several other people were involved in this fraud. Tyco's Chief Corporate Counsel and Executive Vice President, Mark A. Belnick, also received over \$14 million in relocation loans. He did not fulfill the requirements for the loan program because he began

working in Tyco after they had moved, and he already lived near New York City. He used \$4 million on an apartment in New York City, and the remaining \$10 million he used on a real estate in Utah. Belnick already owned a home there, and Tyco did not even have operations in Utah. The SEC report also says that he got an annual allowance from Tyco for the “dedicated Tyco office in his Utah home.” Belnick also should have answered the D&O Questionnaires, but he did not disclose these loans even though Tyco required it (SEC Litigation Release No. 17722 2002).

The loans were not enough for Swartz and Kozlowski. In 2000 they came up with a company bonus program. This program allowed Tyco to pay the two executives and several other employees cash bonuses, award them Tyco common stock, and grant forgiveness of relocation loans. Kozlowski and Swartz received over \$25 million plus stocks with this program. This was also hidden from the records by offsetting the cost against “an unrelated gain realized on the disposal of a Tyco subsidiary.” In 2001 Kozlowski and Swartz “directed the acceleration of the vesting of Tyco common stock”. This also led to a \$12 million profit for the two. Several other employees also benefited. Again the chief executives made others falsify the records (SEC Litigation Release No. 17722 2002).

Kozlowski also made transactions between the subsidiaries and Tyco that were related-party transactions. These transactions dated back to 1996. These transactions started with a trust in which Kozlowski was the only beneficiary. The trust bought a house from one member of Tyco’s Board of Directors. The purchase price was paid through a Tyco subsidiary. It was charged to Kozlowski’s KELP account; then it was later paid by Tyco. Kozlowski sold a house to TME, a Tyco subsidiary, for three times the market value, and he bought an apartment from Tyco at the same price that Tyco had paid eighteen months earlier, even though this was a period with great value-growth for these apartments. Swartz also made some of these undisclosed related-party transactions. He started with the first transactions that the SEC discovered, as early as 1995. He sold a real estate to a subsidiary which cost Tyco money when they sold it less than two years later. The D&O Questionnaire required the executives to disclose transactions with Tyco’s subsidiaries, but Kozlowski and Swartz did not make these disclosures. As the SEC report says: They “knew, or were reckless in not knowing” that these transactions were not disclosed (SEC Litigation Release No. 17722 2002).

The two executives also had Tyco buy two apartments in New York in their own names, and they then lived in the apartments rent-free. Kozlowski used Tyco funds to give millions of dollars to charity and made these contributions in his own name. For little or no cost, they both used the company aircraft. None of the transactions were disclosed to shareholders, and the perquisites that they received were not disclosed as executive compensation (SEC Litigation Release No. 17722 2002).

In the years from 1998 to 2001 Kozlowski and Swartz signed letters to the auditor, stating that there had been no “fraud involving management or employees who have significant roles in the company’s internal control” (SEC Litigation Release No. 17722 2002). As we now have learned, frauds were committed in all of these years, and even in the years before 1998.

In August 2005 both Kozlowski and Swartz were sentenced to 8 1/3 years to 25 years in state prison (Wall Street Journal Tyco Convictions Upheld 2007).

A fourth person, Frank E. Walsh, has also been investigated by the SEC. Walsh was a Director and a Tyco board member. Walsh was involved with one of Tyco’s many acquisitions. He recommended the acquisition of a company called CIT. He arranged meetings between Kozlowski and the CEO of CIT. Kozlowski let Walsh know that if the acquisition took place, Walsh would get a finder’s fee. When the board voted whether to go through with the acquisition, Walsh, of course, voted for the acquisition without telling the others that he would receive this fee. When the merger came together in 2001, Walsh received a finder’s fee of \$20 million. \$10 million was given in cash, and the other \$10 million was given to a charity which Walsh chose. The finder’s fee was paid to Walsh even though in the merger agreement Tyco said that “there is no investment banker, broker, finder or other intermediary that has been retained by or is authorized to act on behalf of Tyco who might be entitled to any fee or commission from Tyco...” (SEC Litigation Release No. 17896 2002). In 2002 Walsh pleaded guilty to the charges relating to the undisclosed finder’s fee (Forelle 2007).

With the many things we have listed in the previous section, anyone can see that there was much fraudulent activity in Tyco. The executives were able to do what they wanted for several years without anyone stopping them. In the years from 1996 to 2002, because of this

fraudulent activity, Tyco gave false and misleading annual reports (and proxy statements with the SEC). This means that anyone who made financial decisions on basis of these reports may have drawn other conclusions than they would have made if the reports had been correct.

We have now sketched account of the frauds in the two companies. We have shown which persons were involved in each company and the charges against them. In the next sections we discuss a theory that describes fraud, and then use this theoretical construct to analyze the frauds we have just described in Adelphia and Tyco.

## **FRAUD**

In recent years we have seen many different types of fraud. Some of the frauds have a greater scope than others. The Adelphia and Tyco scandals are two examples of highly-publicized, major scandals that involve management fraud. Before we analyze the fraud that was committed in Adelphia and Tyco, we present a sketch of fraud a characterization of the phenomenon. In the next sections we show what fraud involves, and discuss why it happens. We will comment the effect fraud has on various groups, and finally we will suggest effective ways to prevent fraud. To give shape to our treatment, we use the International Standards on Auditing and two chapters of Albrecht, Albrecht, and Albrecht, *Fraud Examination*.

### ***Why study fraud***

First we wish to clarify why the study of fraud should be interesting for everyone. In the recent past scandals in Tyco and Adelphia got much media publicity. Many now know them as huge financial fraud. But why does the public find this topic interesting? The majority of the public does not have any connection with Tyco or Adelphia, most people do not have stock in the companies therefore they will not be financially affected by the frauds. Yet the publicity shows that people care. There can be a number of reasons for this: one reason is curiosity and entertainment. The frauds are characterized as scandals, and “everyone loves a good scandal,” whether the scandal is a Hollywood couple breaking up after only a year of marriage, or if it is Kozlowski’s \$2 million birthday party for his wife. These things give us “ordinary” people something to think about, besides our own not so interesting life, and we like this. A second reason has to do with ethical judgment. Fraud is wrong and the public has a strong negative feeling about the whole concept. It makes people upset that others can commit fraud. We get involved because we believe right and wrong, we take ethics seriously, and hope to see the perpetrators convicted for what they have done.

A third reason, that not many think about, is that fraud like that in Adelphia and Tyco does affect the public in a more serious way than to inspire just curiosity and remind people about ethics. Even if someone does not have any stock in companies damaged by fraud, they are still affected in an economical way. Many people are, in fact, the company’s stakeholders, not just the stockholders of the company but everyone that has an interest in the company. The

company's customers, its employees and suppliers are stakeholders that we easily can see will be affected. Stakeholders like the government and some members of local society are not that obvious, but they will also be affected. When fraud is committed, the government uses a lot of resources in investigating the crime; these resources are based on your tax-money and because of this the fraud affects everyone in the country. Local society can be affected if the firm is a big part of a particular community. If a fraudulent company has to close down or reduce its size, this can cause many people in the area to lose their jobs, and this can also have side effects on other companies in the area.

A study done by the Association of Certified Fraud Examiners (ACFE) in 2002 shows that approximately 6 percent of revenues is lost because of fraud. In the U.S. this is about \$600 billion, or about \$4,500 per employee. Therefore fraud committed by just a few people can have a major impact on others. Fraud also has other effects. Investors tend to invest less in companies in countries that have more fraud than other countries. In some countries, especially underdeveloped ones, the government might be corrupt and there may be much fraud among the nation's companies. When the investors know that the companies in that specific country are more likely to have fraud, they lose faith in the companies, and are suspicious about risk, and are not willing to put their money at stake. This can harm the country by getting in the way of economic growth. If there is a chance that management in a company will use their money to pay for private things and for illegal activity, then investors will put their money in a company that will make good and proper use of their investment. Frauds use a lot of resources that could have been invested in building the economy, so by preventing fraud billions of dollars can be saved (Albrecht et al. 2006).

Because fraud affects many people, and not just company shareholders, it is important to study fraud, so that in the future one might prevent new frauds. In the next section we will show the different characteristics of fraud using Albrecht and the International Standards on Auditing (ISA).

### ***The International Standards on Auditing's definition of fraud***

The ISAs are developed by the International Auditing and Assurance Standards Board (IAASB). The IAASB is a board under the International Federation of Accountants (IFAC). The IAASB serves the public interest by:

- setting, independently and under its own authority, high quality standards dealing with auditing, review, other assurance, quality control and related services, and
- facilitating the convergence of national and international standards.

(www.ifac.org)

The ISA is the standard that the IAASB makes to give guidelines to the auditors all over the world. The ISA has this definition of fraud:

*An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.*

(www.ifac.org)

### ***Different types of fraud***

Using Albrecht, let us examine fraud in a more detail way. The book divides fraud into two categories, fraud committed against the company and fraud committed on behalf of the company. A person commits fraud on behalf of the company when he makes the financial statement look better than it is; a person commits fraud against the company when, for example, they steal from it. The book further divides fraud into types of fraud. These are:

1. Employee embezzlement
2. Management fraud
3. Investment scams
4. Vendor fraud
5. Customer fraud
6. Miscellaneous fraud

(Albrecht et al. 2006)

The fraud is called employee embezzlement when an employee steals from the company. This fraud can vary in scale, from the employee stealing a pen to stealing millions of dollars.

Internal control is important for preventing employee embezzlement. We will discuss internal control later in the paper.

In Tyco and Adelphia we have what is called management fraud. This means that the fraud is committed by the executives in the company. The victims in these cases were everyone who relied on the financial statement, stockholders, lenders and other interested parties (stakeholders). We can have either of the two types of fraud, frauds committed against the company and frauds committed on behalf of the company. In Adelphia we have both types of fraud, but in Tyco the fraud was only committed against the company. Management fraud can be more difficult to detect than fraud by employees. This is because internal controls do not always cover the activities of the executives, and management can more easily override the controls than other employees can. It is easier for them to do as they like without anyone finding out. This means that they can more easily manipulate accounting records and present misstatements.

An investment scam is when someone is tricked into investing in something that does not exist or that the investments are not as they were described to investors. Investment scams also include fraudulent sale of mutual funds and late trading on the stock market. We have vendor fraud when the customers do not get the goods they have purchased, they get overcharged or the goods are inferior. When customer fraud is committed, it might be that the customer does not pay the full price, that they get something for free or that they get something they should not have by deceiving the company. Frauds that do not belong in the first five categories are labeled miscellaneous fraud. None of these frauds have relevance to Adelphia or Tyco, we have just introduced these kinds of frauds here so the reader will recognize that there are many different kinds of fraud.

### ***“The fraud triangle”***

We have now seen how we can divide fraud into different categories based on who commits the fraud and what the intentions behind the fraud are. Many have labeled fraud as the fastest-growing crime; therefore it is important to focus on fraud and try to prevent new frauds from happening. To do this, it is important to have a clear idea about why these things happen, and what can be done to reduce the possibility of new frauds. There are components that have to

be present in order for fraud to occur. They can be called the “fraud triangle” because there are three things that have to be in place for a fraud to happen:

1. perceived pressure
2. rationalization
3. perceived opportunity

(Albrecht et al. 2006)

In each kind of fraud these three things have to be present, but they can be present in varying degree. If the perceived pressure is large, then the rationalization does not have to be that elaborate. For example, if you have a lot of pressure to come up with money in a short period of time, this perceived pressure can be quite great. If a person decides to steal money from the company because of this perceived pressure, then he does not have to rationalize it very much to himself. In another example, if the perceived pressure comes merely from wanting a new and expensive car, then the pressure is not quite so great. Accordingly he would have to rationalize it a little more. He can come up with excuses that he is poorly paid, that the chief treats him badly or the company owes it to him, and so on.

We will examine the three components in the “fraud triangle” and give examples on how they can be present in frauds. Later in the paper we analyze the fraud in Adelphia and Tyco using the “fraud triangle”.

### **Perceived pressure**

The first component in the “fraud triangle” is perceived pressure. The perceived pressure can take place in different ways, even in ways that we do not always understand and just consider to be “greed.” We can more easily understand pressure that involves saving the company and preventing many people from losing their jobs, than the pressure of some person driving a new car. The different kinds of pressure can be divided into four types:

1. financial pressure
2. vices
3. work-related pressure
4. other pressures

(Albrecht et al. 2006)

Financial pressure can be present both when the fraud is committed on behalf of the company and when it is committed against the company. Often when fraud is committed on behalf of the company, the financial pressure is such that the managers feel that they have to meet expectations from the people outside the company. For example, it can be the pressure from the banks to meet covenants. If a company fails to meet them, they have to repay the entire loan. Say, for example, one covenant is to keep the company's equity ratio above 30%. Dropping the equity ratio to 29% is in itself not that dangerous, but when it means that the company has to repay a big loan early, then it can have a big effect on the company. If the company is in danger of failing to meet such a covenant, the executives can be tempted to fake the numbers in the financial statement so the bank thinks that everything is as it should be, and the business can continue as before.

All stakeholders have some expectations for the company, and for different reasons it are important for the company to be able to meet these expectations. It can be that investors are not willing to invest in the company if it is not making as much money as expected, or it can be vendors who are not willing to do business with the company if it is not selling as much as expected. In these cases, management feels pressure to falsify the financial reports, so when the company is not able to meet expectations, the false financial statements show that it did.

As we know, some frauds are committed against the company. The financial pressure may then be of a more personal nature. Common financial pressures associated with fraud that benefits the perpetrators directly include the following:

1. High bills or personal debt
2. Personal financial losses
3. Poor credit
4. Unexpected financial losses
5. Living beyond one's means
6. Greed

(Albrecht et al. 2006)

The financial pressure that comes with high bills or personal debt is easy to understand. Maybe an employee has a mortgage payment due, and does not have the money. Or an executive has taken up too much debt. The financial pressure can also come from personal financial losses as an investment that has gone wrong. Your investment has lost, rather than

made, money for you. In some cases, people can have a hard time getting loans because they have had loans which they could not repay. They are back on their feet and can now manage a loan, but because of their earlier mistakes the bank will not lend them any money. In all these cases it can be tempting to just “borrow a little money” from the company they work for, for a short time. But even if their intention is to repay, if they take the money without anybody about it, it is theft. For other people the financial pressure can come as an unexpected financial loss. They become very sick, and cannot work or have a large hospital bill. All this financial pressure can be understood, and we can, to a certain extent, understand why these people commit fraud.

There are other financial pressures that do not come from the fact that you “need” the money, but for a variety of reasons, you just want more money; you are just greedy. Often these pressures can come when you originally have a lot of money, and you then adapt a lifestyle where you need even more. Many commit fraud to support such a luxurious lifestyle or because they are greedy. They have a lot of money, but they always want more. This kind of financial pressure can be hard for many of us to relate to, and more difficult for outsiders to understand. As we will later see, in the paper, much of the pressure that the perpetrators in Adelphia and Tyco experienced came from living beyond one’s means and from greed.

To this point we have spoken a lot about financial pressure, but there are also other kinds of pressure. One of them is “vice”. This kind of pressure comes from some kind of addiction that one needs money to support. It can be drugs, gambling, and alcohol, or even expensive extramarital relationships. When you see what drugs can do to people, it is easy to understand how they are able to commit fraud to support their habit. Vices are the worst kind of pressure that pushes toward fraud. Often fraud is not the only thing people do wrong when the vices are driving them. They often steal from others, lie to the people close to them and do many things that are irrational. Albrecht gives example of what someone who has a drug addiction are capable of doing. This confession is from a former addicted drug user:

*My wife and I literally whooped for joy at the sight of our newborn son: a 7-pound baby with big eyes and rosy cheeks - normal and healthy looking. But we both knew the moment we had been dreading was now just hours away. The baby would be going into withdrawal. We didn't want him to suffer because of our awful habit. And we had to keep the doctors from finding out he had drugs in his system, or he would be taken from us and placed in foster care. We felt we have no choice. When the nurses left the*

*room, I cradled our baby in my arms and clipped a thin piece of heroin under his tongue.*

Someone who will clip a piece of heroin under a newborn baby's tongue will surely look for ways to embezzle from employers or commit other types of fraud to support their habit (Albrecht et al. 2006).

The financial pressure and the vices we have described are pressures that come from outside the job, but there is also pressure that is work-related. This kind of pressure can come from reward systems that are connected with the performance of an employee. Let us say you get a bonus if you reach a certain sales number, it can then be tempting to falsify the sales number to get the bonus even though you do not have the sales number. Some commit fraud to earn recognition from their boss or get the promotion that they think they deserve. Some also commit fraud by stealing money from their own company because they think they deserve it, that they have worked hard, and the company owes them. These are many examples of personal pressure that is work-related.

We also have pressures that do not fall under any of the mentioned categories. Such other pressures may not occur that often, but once in a while fraud is committed for other reasons than financial pressure, vice or work-related pressure. This can be the pressure from having the desire to beat the system or committing the "perfect crime." The pressure can come from the need to prove to oneself that one has the ability or the power to beat the system. As we shall see later, the perpetrators, especially in Tyco, most certainly were driven from some kind of pressure to beat the system and prove the power they had.

Some of the pressure discussed can be easy for everyone to relate to and some is more difficult to understand. Everyone experiences pressure in their life at some point, but they are able to distinguish between right and wrong. Money has for many in our society a strong connection to happiness and success. If you think you have success, there is a big possibility that you make a lot of money. So the pressure is always there and even if most people never commit fraud, there are some situations that can tempt the most honest person. Psychologists tell us that most people have a price at which they will be dishonest. If you were starving and in your work environment the cash was abundant and not accounted for, or you really believed that you would repay the money you take to feed yourself, you may commit fraud

(Albrecht et al. 2006). That shows the aspect of the “fraud triangle”, all three components have to be present for fraud to occur, pressure, opportunity and rationalization.

### **Rationalization**

Whenever a fraud is committed in addition to perceived pressure one has to be able to rationalize the act to themselves, otherwise they are not able to do it. Think of a person that needs money and decides to “borrow” from the company. He rationalizes by saying that he will pay it back next month. But the month goes by, and he does not have the money. No one in the company has discovered what he has done, so he takes more. Along with “I am just borrowing the money and will pay it back,” there are a number of other rationalizations that are used by fraud perpetrators. Often we hear that the reason he took the money from the company was because the company owed it to him. All the hours that he spent working for the company and never got paid for. He takes the money because in his mind he deserved it. Some rationalize the act by telling themselves that nobody will get hurt by their act. It may be that the amount they steal is so small in the big picture. If taking a little money will not affect the company or the other employees, it will be okay to take the money (Albrecht et al. 2006).

In some cases one can rationalize the fraudulent act by claiming to themselves that it is for a good purpose, as Robin Hood did when he rationalized stealing with the fact that he was giving the money to the poor. In the Adelphia fraud the perpetrators rationalized falsifying the books, telling themselves that their intention was to straighten the books as soon as they got through the financial difficulty. In the case of choosing between reputation and integrity, some rationalize the fraud by convincing themselves that when choosing between integrity and reputation, integrity has to suffer. For example: If I do not embezzle to cover my inability to pay, people will know I can not meet my obligations and that will be embarrassing because I am a professional (Albrecht et al. 2006).

These are common rationalizations used by fraud perpetrators, but those who commit fraud are not the only ones who rationalize their actions. Almost everybody rationalizes things to themselves in the daily life. It can be small things like rationalizing that we are overweight and do exercise enough. Most of us even rationalize being dishonest, as we say to ourselves

that the truth hurts, therefore to tell a lie can sometimes be the best. But in fact dishonesty is a bad thing regardless of how we rationalize it (Albrecht et al. 2006).

## **Opportunity**

Opportunity is the third element that has to be present for fraud. If you do not have the opportunity to commit fraud, you simply can not do it. Opportunity can be present in a more or less degree. Sometimes perpetrators have to work very hard to get the opportunity to commit fraud; they have to override the rules and trick other people. Other times the rules are so poorly made that they do not prevent the opportunity from being present. Opportunity is not just that fraud is easy to commit, opportunity also consists of easily being able to conceal an act or avoid punishment.

The most effective way to prevent fraud is internal control. Most internal controls that the companies set up are to reduce the opportunity to commit fraud. In this context, it is also important to remember the aspects of pressure and rationalization when one tries to reduce the probability of fraud (Albrecht et al 2006). Let us now consider the concept of internal control and how this can reduce the opportunity element.

Internal control is the best way to detect frauds done by the employees, and the best way to stop them from happening. The Committee of Sponsoring Organizations (COSO) has identified five elements of an organization's internal control framework:

1. control environment
2. risk assessment
3. control activities
4. information and communication
5. monitoring

(Albrecht et al 2006)

The first thing that has to be in place for the internal control to be effective is a good control environment. The most important thing in establishing a control environment is for the management to set a good example. In both Adelphia and Tyco it was the management that acted improperly, so why should the employees act correctly? If the management sets rules

and standards for example, but do not follow the rules themselves, then others will also break the company rules and violate the standards. If the management follows the rules, and makes others follow them, then it will not be easy for others to rationalize breaking them. The old saying “you shall do as I say and not as I do” is a good example of a control environment that does not work. Another important element is a clear organizational structure. It is important that everyone knows what his responsibilities are. That way it is harder to do something wrong and not get caught because it is easier to identify wrongdoing and missing assets. To be able to track things that have been done, it is important to have a good accounting system. If the company has an effective accounting system, it will give a trail that makes it easier to discover fraud, and make it more difficult to conceal particular wrongdoing. To cover up fraud here, one would have to alter or misplace the accounting records, or make them fraudulent. The difficulty in this component is to distinguish between fraud and unintentional errors. When the company is large, like Tyco and Adelphia, a crucial element will be an effective internal auditing department. Studies show that internal auditors detect about 20% of all employee frauds (Albrecht et al. 2006).

Risk assessment is important for identifying where the risk is highest and to reduce the appearance of risk. It is much easier to have a functioning internal control when you know where it is most likely to fail. For example it is important to have appropriate hiring. It is important to check references to see if an applicant has a record of honesty. One can also check for a criminal record. It is important to match qualifications to the particular job, so the employee has a reasonable chance of success. It is very important for a company to trust their employees and hire people who are qualified for the job. Doing this the company has already reduced the possibility of new frauds and eliminates some of the risk (Albrecht et al. 2006).

Another important component for a functional internal control is control activities. Of course, this is more important the bigger the company. In a small company it is easier for the manager to see what goes on, and to perform “control activities” himself. For example, if someone steals from the company the manager would probably detect it quickly. Yet small companies may have some unique control problems. For example small companies often do not have the resources available. If the company only has 5 employees, it is not that easy to perform controls like segregation of duties. However, in a large company it is important to initiate control activities. These activities make it easier to detect frauds, and minimize the opportunity to commit frauds or make it difficult to conceal wrongdoing (Albrecht et al 2006).

There are five control activities that are primarily needed for the internal control to function well:

1. segregation of duties, or dual custody
2. system of authorizations
3. independent checks
4. physical safeguards
5. documents and records

(Albrecht et al. 2006)

Segregation of duties means that one person does not have complete control of a specific task, that the internal control requires at least two people to perform it. This means that for a fraud to happen the two would have to commit the fraud together which is less likely than if one person performs the task. System of authorizations means that only a few people get access to certain things, or that others need their signature to gain access. Some companies have rules that every investment over a certain amount has to be approved by the board. If the employees know that the chance of being caught is great, then they may not commit fraud. As another form of control the company should perform independent checks. This might include things like periodic job rotations, cash counts or certification, supervisor reviews and “mandatory vacation”. If you take money from the company but have to go on vacation, then it is quite possible that the substitute will find out what you are doing. If you are allowed to work all the time on the same tasks, then the chance of someone else finding out is much smaller. Physical safeguards can be things like vaults, safes, fences, locks and keys to physically prevent the company’s assets from being stolen. Documents and records will leave a trail. In that way documents make it a lot easier to detect frauds than there were no accountability. It is also important to use the documents and records appropriately. It does not help to have a form for all employees to sign when they are taking a delivery if no one actually signs (Albrecht et al. 2006).

It is also crucial for internal control that the management communicates what is right and what is wrong. If they do not establish standards for their employees, how will they know what is acceptable? Giving them a thick book about ethics does not help. No one will read it. There have to be clear guidelines that are easy to understand. The company can have codes of conduct, orientation meetings, training, supervisor/employee discussions, and other means to communicate what is acceptable and what is not. The right information has to be given to the

right people so that they can complete their responsibilities and make the correct decisions. The information system has to give reports about relevant information, and not just information generated from inside the company but also external information. It is also important to have effective communication with customers, suppliers and shareholders about company standards (Albrecht et al. 2006).

Monitoring of controls is important to ensure that the internal controls are functioning as they should. If a specific signature is required to get goods out of inventory, it is important to check if this really happens. You need to be sure that employees who work with the inventories check this signature every time, and this will make it easier to reduce fraud which involve stealing company assets. In our paper, the frauds are mostly about stealing company money and falsifying the financial statements. If these companies had implemented controls to detect these kinds of things, then it would have been important to see if the controls were followed. One can ask questions; is every investment over a certain amount run by the board? Or are the accounting principles followed? If no one checks to see whether the controls work, then the point of having them is undermined (Albrecht et al. 2006).

A functional internal control is the best way to reduce opportunity. As we have seen, many things have to be in place for the internal controls to work effectively, and this can be costly. Consider segregation of duties: when it takes two people to do the task of one person it is easy to understand that this is more costly. But fraud can be much more expensive. When a fraud is committed, the company experience both the direct costs, for example the things that are being stolen, and indirect cost, losing customers from the publicity. Fraud will discourage investors. Investors are not that eager to buy stock in a company where there is a chance that they are going to lose their money through dishonesty. Even if internal controls cost much, the alternative is worse.

The one thing that is the hardest in internal control is to prevent fraud done by the management. The internal controls are easily made so that it prevents the employees from committing fraud, but when it comes to the management it is hard to make an internal control that reduces the opportunity to commit the fraud. We have spoken about control environment and standards that have to work for the internal control to be effective. But when the management is committing the fraud they can easily override the standards they themselves have made.

We have now discussed the “fraud triangle” and shown how the three components have to be present for fraud. We can look at the “fraud triangle” like a bonfire, for it to burn you have to have heat, oxygen and wood. If you remove any of the three, the fire will run out. There will be no fire without heat as there will be no fraud without pressure and so on.

### ***People who commit fraud***

In the previous section we have not talked much about what characterize the people who commit fraud. In this section we are going to take a look at the people behind the frauds. Research shows that anyone can commit fraud. When finding what characterize people who commit fraud, one finds that they are ordinary people like you and me. In a study summarized in Albrecht, they compare fraud perpetrators with two different groups. One group consists of prisoners incarcerated for property offences, the other of non-criminal college students. In comparison with the criminals, the fraud perpetrators are distinguished from other criminals in that they are less likely to get caught, turned in, arrested, convicted and incarcerated. Fraud perpetrators are older, there are more female perpetrators, and they are better educated, more religious, and less likely to have criminal records. They are less likely to have abused alcohol, and considerably less likely to have used drugs. They were also in better psychological health. They enjoyed more optimism, self-esteem, self-sufficiency, achievement, motivation, and family harmony than other property offenders. Fraud perpetrators also seemed to express more social conformity, self-control, kindness, and empathy. When compared to the college students, they were quite similar, even if there were differences between these two groups, they were often (or statistically) much more alike. These studies make the point that fraud perpetrators are just like ordinary people (Albrecht et al. 2006).

It is important to remember that people we trust sometimes commit fraud. Many have been surprised when people they never would have believed could do such a thing do commit fraud. In many cases, people react with denial when it comes to fraud. Victims can not believe that individuals who seem much like themselves and who were usually trustworthy can behave dishonestly (Albrecht et al. 2006). As we see later in the paper, the people behind the frauds in Adelphia and Tyco fits perfectly in the previous description, and many people around them also reacted with denial. We will now use the “fraud triangle” to analyze the fraud committed in Adelphia and Tyco.

## **THE FRAUD IN ADELPHIA AND TYCO**

We have now seen what characterizes fraud, how and when it occurs. We now take a look at the fraud in Adelphia and Tyco, and their main characteristics; the kinds of fraud, if they were done on behalf of the company or if they done against the company, the components from the “fraud triangle” that were present, the particular pressures, opportunities and rationalizations. In this section we analyze the fraud using the SEC reports and insight from the Albrecht theoretical framework that we have just introduced.

As explained above there are three necessary components of fraud. This “fraud triangle” includes:

- Perceived pressure
- Rationalization
- Perceived opportunity

(Albrecht et al 2006)

### ***The fraud in Adelphia***

We have also identified two types of fraud, that committed by the management on behalf of the company and fraud committed by management to benefit themselves. In Adelphia we have both kinds of fraud. In the two different kinds of fraud the components in the “fraud triangle” is present in a somewhat different ways.

#### **The fraud committed on behalf of the company**

Let us consider fraud that was committed on behalf of Adelphia as a company. Two fraudulent behaviors were done by the executives to benefit the company and can be explained with reference to industry pressure. The industry pressure on Adelphia and its management was very strong in the late 1990s. Adelphia failed to meet the expectations from those outside the company. Many different parties had interest in the company (we call them stakeholders) and these stakeholders have certain expectations towards the company. Most information that stakeholders have about the company are based on the financial reports. They rely on these reports to be correct. Banks were among the stakeholders that pressured

Adelphia. The banks had certain conditions to be upheld by the company for the company to receive loans, called covenants. The executives in Adelphia were under a lot of pressure to meet these covenants; if they failed to meet them they had to repay the loans. That would have affected the company in a negative way. To avoid this, the executives manipulated the financial statements, so it looked like the company was running well. They falsified the financial reports in order to “fool” the outsiders, and by doing that, whatever relationship the stakeholder had with the company was based on deception, on lies.

Executives manipulated the financial statements in several different ways. First they exaggerated the numbers of subscribers. Instead of calculating one household as one subscriber, they used the number of televisions in the household as the number of subscribers. This was a known practice in the industry, and it can not be characterized as wrong accounting, but it was a questionable method and was against the metrics Wall Street use to value cable companies. They also overstated earnings by using creative accounting behavior, including net income, earnings before taxes, depreciation and amortization. They also overstated the extent of the cable park and the extent of the cable lines (SEC Litigation Release No. 17627 2002).

They also excluded over \$2.3 billion in debt in their consolidated financial statements. Instead of repaying debt, they shifted the debt to unconsolidated Rigas-controlled entities. By doing this it seemed to the public that the debt was paid when it really was not. This is not only a violation of Generally Accepted Accounting Principles (GAAP), but it also misled the public into believing that the company was more profitable than it really was (SEC Litigation Release No. 17627 2002).

These two types of fraud are management fraud. The perpetrators are the top management and the victims are stockholders, lenders and other who rely on the financial statements (Albrecht et al. 2006).

We now analyze why these frauds took place using the “fraud triangle”. In this case, it seems best to focus first on perceived pressure. When the executives acted fraudulently on behalf of the company, the pressure was rather strong. There was pressure throughout the industry, and Adelphia was failing to meet the expectations from the stakeholders. John Rigas had built the company from scratch and he could not stand still watching his company struggle, but instead

of improving business, he only made it seem better. He knew that if the accurate accounting statements became public, Adelphia's stock would fall and the banks would demand their loans paid back. There was a strong pressure on John Rigas. He has throughout the whole trial claimed his innocence, in light of this pressure. One of the executives, James R. Brown, agreed in a bargain with the government to testify against the others and then get a light sentence himself. He testified that the financial statements were wrong and in his testimony he said that John Rigas once said to him *"he told me he felt sorry for Tim Rigas and me because the operating results were putting so much pressure on us . . . but he said, 'You have to do what you have to do,' "* (Nuzum2004).

This leads us to the next element in the "fraud triangle", rationalization. In this case it is very much present. John Rigas saw his company struggle and he thought that it was not wrong to manipulate the financial statements so the company could get back on its feet. He thought that if he revealed the accurate financial statements, it would cause more pain than good. It would mean that the stock would drop and that the company would have to pay back its loans to the bank. Thinking that he was doing the company and their shareholders a favor by hiding the true numbers, he rationalized his fraudulent act to himself. He convinced himself that what he was doing actually was a good thing.

For outsiders, it looks like John Rigas and his sons believed that they were not doing anything wrong. And if they did know that their actions were wrong they did a very good job making the public believe that they believed that they had done nothing wrong.

John Rigas and his son Timothy Rigas were sentenced to 15 and 20 years respectively (Wall Street Journal, *Adelphia executives' convictions upheld 2007*). The sentence could have been lighter if they had cooperated with the government. But instead they claimed their innocent the whole time and refused to testify in their own trial. By claiming their innocence, they got a much harder sentence than if they had agreed to a plea-bargain. Their decision not to agree to a plea - bargain indicates that they did not believe they had done anything wrong. There can be many reasons why they believed this, one of them can be arrogance. Another might be that no one was in the right place to tell them that the things they had done were wrong. "Me? I did not do it. How can you possible believe that I can do such a thing?" Or they simply justified the act to themselves with that they did not know the difference between a family run

company and a public company. That is they rationalized their actions as protecting their own property.

The last element in the “fraud triangle” is opportunity. In this fraud it was not only John Rigas and his son Timothy who were the perpetrators; but also John’s other sons and several executives. This makes the opportunity element easier to understand. It is hard to detect fraud when it is committed by the people on top and even harder when many people on top are in it together. This was the case here. The top executives were in on the fraud and they had ample opportunity. Even if the company had rules on how to do the financial reports, the rules were easily overridden by the management. The best way to reduce the opportunity is internal control, but it is hard to follow through when the fraud is committed by the people on top. Internal control only works if there are people to monitor and then make sure the internal control is followed up and work as it should. But when the management wants to override, internal controls fail and fraud can occur.

### **The fraud committed against the company**

The previous section discussed the fraud done by the executives on behalf of the company. But in the Adelphia scandal executive fraud benefited the executives, as well. The SEC accused several members of the Rigas family of using company money as if it was their own. The family founded the company, the Rigases used the company as their “personal ATM”. For example, they used the money on a luxury apartment on Manhattan and developed a 18 hole golf course with company money. They bought luxury condominiums in Colorado, Mexico and New York City. They issued over \$722 million of Adelphia’s shares of common stocks and over \$563 million of Adelphia’s notes to benefit their own family. To hide this self-dealing, Adelphia misrepresented or concealed a number of significant transactions by which the Rigases used Adelphia resources with no reimbursement or other compensation to Adelphia (SEC Litigation Release No. 17627 2002).

We can examine this kind of fraud, fraud done against the company, and see how the components in the “fraud triangle” are present. As you remember, the first component in the “fraud triangle” is perceived pressure. In this kind of fraud perceived pressure can be difficult to explain. Financial pressure is the most common pressure to commit fraud. Often when we

think of executives or employees who embezzle from the company, we think they do this because they need money. They steal from the company to help themselves out of an economic crisis of some kind. This economic crisis can be present for a number of reasons. For example, you can be in an unexpected need of money because you or someone in your family is sick so you need the money for the hospital bill. Nothing like this is fraud in the case of the Rigases: they had a lot of money and were not in any actual need of money. But financial pressure not necessarily means that you need money as everyone else sees it. It can be that you need the money because you are living beyond your means or that you just are greedy. This kind of financial pressure seems a more fit description of pressure that is likely the Rigases were experiencing. They adopted a lifestyle that was somewhat out of their means. In the SEC report you can read that they built an 18 hole golf course with the company money, and bought several luxury apartments and vacation homes. One can argue that this is not financial pressure, but for the Rigases it was. They wanted to spend money they did not have.

Financial pressure is not the only pressure one can experience when committing fraud. Pressure from vice is often why people commit fraud. Work related pressure may also be the reason why some people commit this crime. Work related pressure can be the reason why none of the employees in the company said anything about the Rigas' fraud. They did as their boss told them so that they would not get on the wrong foot with him. We will look more closely at the employees' place in the fraud in a later section. But vices and work related pressure are not very good explanations to the pressure that the Rigases experienced.

We also have another kind of pressure that does not fall neatly into a category. That is the kind of pressure that is driven by the power or the desire to beat the system. We can say that this kind of pressure is somewhat present in this case. John Rigas was a powerful man, he had built Adelpia with his "bare hands" and he could beat the system. He could take the money and no one would say anything. This might have been a proof to him of how powerful he was. He felt the pressure to keep beating the system so he could at all times prove his power.

When we try to understand why this fraud was committed, the next element in the "fraud triangle", rationalization, is very important. Adelpia was founded as a family company, run and owned by the Rigas family. John Rigas built the company and had a much stronger connection to the company than just a job. This company was in his heart and soul. When the

company went public, John Rigas still thought of the company as his own and still had the board meetings around the family table. At all times, the Rigas family held the voting control of Adelphia's shares, holding 5 out of 9 Board of Directors positions; so even when the company went public, the Rigases had control.

When the company went public John Rigas had a hard time adjusting to the fact that the company's money no longer was his own money. In a public company, shareholders own the company and the company's money is also their money. Even if John Rigas had built the company, he became just an employee, employed by the shareholders when the company went public. There was now a line between the company and John Rigas' money, but he did not see or chose not to see this line. He seemed not to understand why he could not use this money when it was his company. One of the cases that fascinated the media was when John Rigas flew a Christmas tree in the company jet. The tree was for the local community where Rigas lived. This trip cost the company a lot of money, but John Rigas did not think that this was wrong because he was doing it for the people in his neighborhood ([www.charlierose.com](http://www.charlierose.com)).

Throughout the trial he claimed his innocence. Maybe this was a play for the gallery, but it also reflects the view that Rigas had, an attitude the rest of the family seemed to have. Rigas rationalized his act to himself to the extent that he truly believed that what he did was not wrong, that he had deserved it and he did it for the neighborhood. When committing fraud, one has to some extent rationalize the fraudulent act to themselves. Not many people can commit a crime and then not rationalize the act in some way, even if the rationalization makes no sense to anyone else. For example, one who commits murder may rationalize to themselves that the person they killed deserved it. The case can be that not anyone deserves to die, but the murderer has to come up with reasons why what he did was not wrong. This was a really harsh example hard for most of us to relate to, but rationalization is present for many of us in the daily life. Just imagine one day that you are lying on your couch and there are chores you should do, I suggest you can come up with "good" reasons to let the chores wait and just lie on the couch. By doing this you rationalize the act to yourself so that you can lie on the couch with a clean conscience.

If we go back to the fraud in Adelphia, John Rigas' rationalization works the same way. He told himself that he deserved the money, because he had worked so hard for the company.

And giving money to charity could not be wrong. He could also rationalize the fraudulent act to himself by saying he could take the money so why should he not. That brings us to the next element in the “fraud triangle”, opportunity.

Opportunity has to be present in order for someone to commit any crime; embezzling money from your own company is no exception. As we discussed earlier when analyzing the fraud committed on behalf of the company, the opportunity element is always present when the fraud is committed by the people on top. John Rigas had a great opportunity to take the money from the company because he had so much power and no one else had the courage or interest to stop him. As discussed, internal control does not work when the crimes are committed by the people with the most power in the company. And the risk of fraud is especially high when the company is controlled by a small group of people with much power, as the Rigases were. In such cases the opportunity element is always present, and in most cases internal controls usually fail to prevent fraud.

As we have gone through the “fraud triangle” in the frauds, both the fraud committed on behalf of Adelphia and the fraud committed against the company, we have seen that the three components in the “fraud triangle” were present. There are some differences in the two frauds on what component that is the most important. In the fraud committed on behalf of the company the pressure is quite strong. The executives struggle with the financial pressure that their company is not meeting the expectations of the outsiders. In the fraud committed against the company the rationalization element is very strong as John Rigas and the others rationalize the fraudulent activity to the extent that when hearing their arguments you almost believe they are innocent. But as the analysis show, all the components are present in both frauds.

## *The fraud in Tyco*

Two types of fraud happened in Adelphia. In Tyco the fraud were committed only against the company. We will now analyze the fraud which the management committed against their company. As in the previous sections we examine what happened in light of the “fraud triangle”.

The executives stole money for their personal use, and the fraud was not intended to help the company. Even though the company did not go bankrupt because of the fraud, the executives stole over \$600 million. The executives used their position to bend the rules and do as they liked. They misused the company’s assets, and they exploited the good loan programs that Tyco provided for their employees. The only reason they did this was to enrich themselves, and they used much of the money for luxury. The executives did not disclose their loans or the perquisites they received (or gave themselves). Because of this, Tyco’s records were false and misleading. For example, the executives ordered others to hide the scam by offsetting the costs against things that had nothing to do with forgiveness of the loans.

Because the executives committed the fraud, this kind of fraud falls under the category of management fraud. By not disclosing their actions, they fooled the company’s shareholders. People who were supposed to make important decisions by taking the financial statements into consideration may have concluded differently than they would have if the statements were correct. The executives who stole were some of the people who made the most money in the company. When they stole even more money, received perquisites and used company assets that no one else had access to, they deceived the rest of the employees who worked hard, were honest in their work, and who did not make the same kind of money.

We have written about three things common to all fraud, pressure, rationalization and opportunity. As in Adelphia, it is not easy to see what pressure the executives were under in this case. They did not act on behalf of the company so the pressure was of a personal nature. They stole a lot of money and spent it on luxury items so the pressure was not about paying the next bill. As discussed, financial pressure can be more than the pressure one feels when in a financial crises. Financial pressure can also be the pressure of living high, having multiple homes, arriving in a private jet and owning expensive art. Kozlowski was a powerful man, and he earned more money than most of us can imagine. It is pretty clear that he did not need

the money, but he developed a lifestyle where he felt he needed it. By spending money as he did, he showed the world that he was a powerful man. The pressure did not only come from the fact that he was living beyond his means but also that he was greedy. He had a lot of money, but always wanted more.

In this case there are other pressures than financial pressure that can explain the act. Kozlowski has said that he took the money because he could, that he did not need it, so as long as no one stopped him he kept on taking. In other words he felt the pressure to beat the system, and he had to do it. Kozlowski had a desire to become a powerful man and by beating the system he felt even more powerful.

It is hard to sympathize with Kozlowski and the others' rationalizations, but they convinced themselves that they were not doing anything wrong. They convinced themselves that it was acceptable to commit fraud as long as no one told them not to. They have said that the bonuses given to them were early payouts of money that the company owed them (lawprofessors.typepad.com). Kozlowski also said that he deserved it after his success with the company (www.cbsnews.com). By telling himself that he was not stealing and that he deserved it, he managed to convince himself that the act was acceptable. He rationalized the act: he was not really committing a fraud.

The opportunity was obviously there because it was the management that committed the fraud. The executives continued the fraud for years before they were discovered. Internal controls are hard to introduce at this level, and easy for the executives to avoid discovery. For example, Tyco had the D&O Questionnaires that the executives were supposed to fill out. But it was easy for them not to disclose all of their loans and other perquisites from Tyco. In this case, they did not disclose the loans, and no one discovered it for years. The executives set up their own rules and did as they wanted. Even though the loan programs had special purposes, the executives did not care and gave themselves loans they were not qualified to get. Even though Tyco, in the case of the acquisition of CIT, said no one in Tyco had the right to receive any finder's fee, Kozlowski gave a fee to Walsh. It seemed like the executives could make up their own "rules", giving financial benefits only to themselves. There were no controls in the company to stop them.

In every company it is important to establish a control environment. By doing this, the management sets a good example, which they clearly did not do in the Tyco case. They did what they could to receive millions of dollars just for their personal enrichment. And when the CEO steals so much from the company, then why should not the rest of the employees? After all, others do not earn as much as their chief. If employees think like this, we might see fraud spreading throughout the company. We do not know if the executives told the employees what was right or wrong; but if they did, they certainly did not follow it themselves. We see that internal controls did not work. The management easily overrode them, just with Adelphia. The internal controls could be avoided because the fraud was done by the people on top, and because Kozlowski got others in the company to go along with the crime.

As in Adelphia, we can see the three elements of the “fraud triangle”. The frauds committed against the company are somewhat similar in the two companies. The pressure, the rationalization, and the opportunity element all have similar features.

## **THE PEOPLE BEHIND THE FRAUDS**

White collar crimes are often committed by people that no one can imagine doing them. People respond to it by denial: they will not believe that this person could do such a crime; therefore it is interesting to look at the people behind such fraud. Looking at the people helps us to understand why the fraud happened. In both Adelphia and Tyco successful, admired men perpetrated the frauds.

### ***John Rigas***

John Rigas was born in the little town of Wellsville, New York on November 14, 1924. He was the son of a Greek immigrant who ran a hotdog stand. Rigas' story has been characterized as both the American dream and a human tragedy. John Rigas was a hard working man: at the age of nine he worked busing tables. Through his whole life he worked hard to achieve. He went to Wellsville high school where he was a standout scholar / athlete. He earned recognition on the Wellsville High School sports hall of fame in football, basketball, baseball and track ([www.livingprimetime.com](http://www.livingprimetime.com)). But he ended up a fraud perpetrator sentenced to live the rest of his life in prison.

John Rigas has been a person well liked by others. "Johnny" ran errands for his hard-working parents, while helping neighbors and friends. It was the beginning of a tradition he has never abandoned, according to the many Coudersport and Wellsville townspeople who witnessed his generosity ([www.livingprimetime.com](http://www.livingprimetime.com)).

After he finished high school, he joined the military. His business carrier began when he bought a theatre. The theatre was never a big money maker, but the experience helped him when he later founded Adelphia. John Rigas built Adelphia with his brother Gus, and with clever decisions and hard work he managed to turn Adelphia into one of the biggest cable company in the U.S. ([www.livingprimetime.com](http://www.livingprimetime.com)).

Adelphia became a big part of the community in Wellsville, giving the community many jobs. John Rigas was a big part of the community too. Adelphia and the Rigas family supported almost every activity in the community. Rigas encouraged his employees to involve

themselves in the community, in everything from sports to churches. He was a role model by always being involved, serving as a volunteer baseball coach, Chamber of Commerce president and active Rotarian for many years. All this shows the dedication and devotion John Rigas had to other people ([www.livingprimetime.com](http://www.livingprimetime.com)). The people around him picked up on that, and many people have only nice things to say about him. John Snyder from his old town once said: *“He (Jon Rigas) is one of the finest individuals I have ever known, and I'm a better person for having had the opportunity to know him.”* (Scanlon 2002).

Bob Smith, a man from Coudersport who worked for Adelpia in its Marketing Department, said: *“John Rigas improves everything he touches”. “We’ve seen it with the properties he’s purchased in Coudersport, where he has restored Victorian homes, with the cable systems he’s acquired, and I’m sure we’ll see it with the Buffalo Sabres. The man is truly one in a million.”* ([www.livingprime.com](http://www.livingprime.com)). With quotes like: “the man is truly one in a million”, it is clear that John was a beloved, respected man.

There are many examples that John Rigas was a beloved man and that he always treated people decently, so many people do not believe that he has done what he is accused of. Even those who believe that the accusations are true do not think that he deserves to spend time in prison, because he has done so much good in his life.

What puzzles us the most is how he could do what he did, knowing that he was throwing all he ever worked for out the window. For us, it is very hard to understand how he was willing to risk all that he had done. And for what? He had no need of money, yet he grabbed the company’s money as if he were living on the edge of hunger. We find it fascinating that someone can become that greedy, especially when this is a person that had worked so hard and accomplished so much.

The story of Adelpia is not only the story about John Rigas, but also the story about his family. Adelpia was a family run company where John Rigas worked with his children. He and his wife, Doris, had four children, Timothy, James, Michael and Ellen. He was proud to have them go to the finest colleges in the country and then have them return to their hometown to work for their company ([www.livingprime.com](http://www.livingprime.com)).



*John Rigas and his sons*

Timothy and Michael were the children with the biggest roles in the company. Michael, John's eldest son, was Executive Vice President of Operations. He pleaded guilty on making false financial reports, but almost all the charges against him were dropped. He was sentenced to 10 months of home arrest.

Timothy, John's middle son, was a big part of the company and the fraud. He was the Chief Financial Officer and pleaded, as his father, not guilty on all charges. He was convicted on one count of conspiracy, 15 counts of securities fraud and two counts of bank

fraud, and got 20 years in prison. James, John's youngest son, was the chief of Strategic Planning. He was not charged in the criminal fraud, but is named in the SEC civil case.

In an interview after the conviction, John Rigas tells that he can not understand what happened. He claims his innocence and thinks he did nothing wrong, that all he did was for the community and the people who worked in Adelphia. He believed that he did not get a fair trial. He thinks both he and the company were victims of the focus on fraud that the Enron scandal had started. He thinks that the verdict he got was too harsh especially when people who commit murder get lighter sentences than he got. He does not think that what he did was a crime, and certainly that he does not deserve to spend the rest of his life in prison ([www.charlierose.com](http://www.charlierose.com)). Rigas is not ready to admit that he did anything wrong. We think that he, at some point, did know that he has committed a crime and that it was wrong. But we also believe that when he committed the crime, he did not understand its consequences. He did not consider that the act was going to put him in prison for life. In his mind the things he did were not crimes, at least not crimes of a "20 years in prison" scale.

## *Dennis Kozlowski*



*Dennis Kozlowski*

Dennis Kozlowski was born November 16, 1946 in Newark, New Jersey. He went to West Side High School, Newark, NJ (1964), he did not join the army as John Rigas, and after high school he went to BS Finance and Accounting, Seton Hall University (1968) ([www.nndb.com](http://www.nndb.com)). In high school Kozlowski was popular both in the neighborhood and at school. He did well in school and was elected “class politician” by his graduating class at West Side High in 1964. He was, like John Rigas, a well liked person and not anyone you would think of as a criminal (Bianco et al. 2002).

Kozlowski, like Rigas, was not born into a wealthy family. Both men were born poor and had to work themselves to the top. Kozlowski had a dream to be the most acknowledged and admired CEO ever. His biggest idol was Jack Welch<sup>3</sup> and he dreamed that he one day would overdo him. As the story ends Kozlowski surpassed Welch in many ways, sadly it is not the right things that will be remembered ([www.cbsnews.com](http://www.cbsnews.com)).

After going to the university, Kozlowski took an auditing job in New York City with the conglomerate SCM Corp. In 1975 he was headhunted to Tyco. He made an impression on the management in Tyco as president of Tyco's largest division, Grinnell Fire Protection Systems Co. He made the division more profitable than it had ever been. Cutting overhead expenses is one example of how he did this (Bianco et al. 2002).

On the way up the ladder in Tyco, Kozlowski changed. The guy who everyone liked from his neighborhood and high school slowly vanished. As he got more and more powerful in Tyco, he became more and more feared. But he was good at what he was doing and had great respect in the business world. In 1987 Kozlowski became a member of the Tyco Board and in 1989 he was promoted to President and Chief Operating Officer (Bianco et al. 2002).

It was a disagreement with the existing CEO that made Kozlowski CEO in Tyco. They disagreed on how to run the company, and the board could not have the CEO and the most powerful executive in the company running in separate directions. The board believed in the vision that Kozlowski had, so in 1991 they made him CEO (Bianco et al. 2002).

Kozlowski was a good CEO, and with him at the helm Tyco became the most profitable it had ever been. Tyco grew and Kozlowski made money. In 1995 Tyco earnings nearly doubled to \$244 million. Kozlowski was highly recognized and the board gave him a raise of salary to \$2.1 million. In the years to come, his compensation rose, as did Tyco's profitability. From 1997 through 2001, Tyco's revenues rose by 48.7% a year, five times faster than General Electric's, while its pre-tax operating margins improved to 22.1%, easily topping GE's 16.4%. The compensation Kozlowski got was \$8.8 million in 1997, \$67 million in 1998, and \$170 million in 1999, ranking him second among all CEOs and far ahead of his idol, Jack Welch. He managed to overdo his idol both in succeeding with his company and money made for himself (Bianco et al. 2002).

On this journey to becoming a well paid man and a great CEO, he also started spending money, a lot of money. His spending was publicized in the tabloids and some of how he used money are well known to the public: his \$6,000 shower curtain, the 40th birthday party for his wife Karen on Sardinia with the vodka-spewing, full-size ice replica of Michelangelo's David. He lived a luxurious life style. There are many examples:

Kozlowski laid out \$29.8 million to build a mansion in Boca and an additional \$30.8 million to buy and furnish an apartment on Fifth Avenue in Manhattan. He topped off his collection of airplanes and speedboats by shelling out \$15 million for Endeavor, a rare 1930s-vintage yacht. He spent upwards of \$20 million on fine art, including \$3.9 million on a middling Renoir that he pretended to ship to Tyco's office in New Hampshire, which has no sales tax. He gave Karen \$1.5 million to start a restaurant in Boca Raton, and the 40th birthday party he threw for his new wife in 2001 on the Mediterranean island of Sardinia cost \$2.1 million. According to Tyco, Kozlowski misappropriated \$43 million in corporate funds to make philanthropic contributions in his own name, including \$5 million to Seton Hall, which named its new business-school building Kozlowski Hall (Bianco et al. 2002).

Kozlowski's story is much like Rigas's story, a dream that went wrong. Kozlowski achieved what he had worked so hard for all his life; but when he got the money he deserved, he thought he deserved more. With that he lost all the things he had accomplished in his life.

Even though Kozlowski thinks he is innocent, he was sentenced to 8 1/3 years to 25 years in state prison. In an interview with 60 minutes he says that the verdicts were wrong. He means that he did nothing wrong, everything the prosecutors used as evidence they took straight from Tyco's books, nothing was hidden and no one was fooled. He thinks that what he did was not wrong because no one stopped him. He admits that he used the company's money and that he took loans from the company, but he still thinks that what he did was not wrong ([www.cbsnews.com](http://www.cbsnews.com)). Kozlowski's defense lawyers have said that paying taxes was not the only purpose of the KEMP, and that it was no secret how much money Kozlowski had borrowed ([www.nytimes.com](http://www.nytimes.com)). Kozlowski has also said that he does not regret what he has done because he does not think that it was wrong ([www.soxfirst.com](http://www.soxfirst.com)).

Even if he does not admit any wrongdoing, he admits that he got "a little wild" with his spending at times. When he saw the tape of the birthday party he threw for his wife, he admitted that he got embarrassed and that the whole thing was too much. He also bought many paintings to his Manhattan apartment, expensive art that he says in the interview that he had no joy from. He only bought it because he had the money to do so ([www.cbsnews.com](http://www.cbsnews.com)). This illustrates how Kozlowski adopted a lifestyle that required a lot of money. At one time, the spending got out of control and he lived a life that he not even wanted himself. But when he had started using money he "went with the flow", and the need for money got bigger and bigger. Kozlowski admits afterwards that he gets embarrassed over his spending. He seems now to think things got out of control for him.

Just like John Rigas in Adelphia, Kozlowski thinks that he got the harsh sentence because of the big scandals newly revealed. After the scandals in Enron and WorldCom<sup>4</sup> shock the financial world, the U.S. Government announced that such crimes were to be prevented. One step in preventing frauds was harsh punishment for perpetrators. Kozlowski thinks he became a victim of this, that the government needed someone to make their point, that he was punished harshly because they needed a scapegoat, someone to show to the world that they had taken white collar crime seriously ([www.cbsnews.com](http://www.cbsnews.com)).

Kozlowski also thinks that Tyco was scrutinized because of what happened in other companies, like Enron, and that the rating agencies downgraded them because of that ([www.soxfirst.com](http://www.soxfirst.com)). He means that what happened in Tyco was blown out of proportion by everyone, especially the media. The fall in Tyco stock and the bad discussion was much worse than it could have been because of the widespread publicity.

His second wife filed for divorce right after he got the verdict, and many of his friends abandoned him when he did not have any more money. He tells in the interview that 90 percent of his friends, he had because of the money, and now that the money is gone so are they ([www.cbsnews.com](http://www.cbsnews.com)). This is the major difference between Rigas' story and Kozlowski's. While Rigas was loved by everyone all the way to the end, the people's confidence to Kozlowski was lost somewhere along the way. So hearing about Rigas, the people around him reacted with denial and were determined to stand beside him no matter what, but the people around Kozlowski abandoned him. The local newspaper in Rigas's home town, "The Buffalo News" makes a clear stand in the case. When writing about the fraud, you can clearly see, the newspaper thinks that the Rigases are innocent and that the whole thing is just terrible. Their attitude is "what a shame" and not the "let's lynch them" attitude that sometimes meets criminals. On June 2, 2002 the reporter Fred Williams wrote that "The idea of anyone accusing kindly, white-haired John J. Rigas of white-collar crime is unthinkable to many" ([www.buffalobeast.com](http://www.buffalobeast.com)).

As we can see, Rigas and Kozlowski are similar persons in many ways. The strangest similarity is that both worked hard and it paid off in great success. In both cases the public wonders why they did the fraudulent behavior. They had worked hard for everything they had, just to throw it all away. In both cases it is clear that they did what they did because they truly believed that they deserved the money.

Rigas and Kozlowski have been interviewed after their verdicts, and when you hear them talk you see they still believe that they did nothing wrong, and that everything is a conspiracy against them. At this time, we do not believe that either of them thinks that they are actually going to prison, and at least not for the full sentences.

We have looked at the scandals in both Adelphia and Tyco. We analyzed the frauds in both companies. We have also taken a look at the main perpetrators. Now we will take a closer

look at other persons that were a part of the scandals. This includes people in the two companies, the employees, board of directors, other executives, and also people outside the companies, other stakeholders and the auditors.

## THE AUDITORS' PLACE IN THE FRAUDS

Often the auditor's job is taken into consideration when talking about a fraud. Many think that it is the auditor's job to prevent fraud. The main purpose for an auditor is to be an independent third party who is going to make sure the financial statements are correct. The management can have reasons for not reporting correct financial statements and the stockholders can have reasons for not trusting the financial statements. This we call asymmetric information and it makes for a lot of unnecessary "noise" between the management and the stockholders. By having an auditor to make sure that the financial statements are correct, one can reduce this asymmetry. In the next two sections we discuss the auditor's responsibility and describe the auditors' place in the frauds in the two companies, Adelphia and Tyco.

### *The auditor's responsibility*

The auditor's responsibility in the fraud cases is directed in the International Standards on Auditing 240 – *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. In this ISA, the responsibilities are pointed out and there are guidelines to the auditor on how to do his job. We are going to use this ISA to describe the auditor's responsibility when it comes to fraud. The ISA 240 has recently been redrafted, and the new version will be effective for audits of financial statements for periods beginning on or after December 15, 2008 (ISA 240).

We use Generally Accepted Auditing Standards (GAAS) which are developed by the American Institute of Certified Public Accountants (AICPA). The AICPA is a national and professional organization for all Certified Public Accountants. The organization's mission is "to provide members with resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit public as well as employers and clients". The standards were developed as early as 1947, and they have not changed much since. The standards give a measure of audit quality and the objectives that should be achieved in the audit. GAAS consists of general standards, standards on field work and standards on reporting. The auditor should "plan, conduct and report the results of the audit in accordance with GAAS" ([www.aicpa.org](http://www.aicpa.org)). The standards should be followed so that the probability of missing material information will be minimized.

The ISA are the rules meant to be a guideline to all the countries in the world, but not all of them use the ISA. Auditors operating in the U.S. are not required to follow the international standards, they use GAAS. So the auditors in Adelphia and Tyco were not required to follow the ISA standards when the fraud was committed. But these standards give a good insight in what an auditor's responsibility should be, so we think that it is important to also look at them here. The fraud standard in GAAS that we use did not exist when the fraud was committed in Adelphia and Tyco. In fact, the GAAS did not have any standard on fraud, until 2002. Before that the auditor was not required to think of fraud at all, and the rules did not instruct him to look for fraud. This means that the auditors who were in Adelphia and Tyco not were required to follow either the ISAs or the today's version of GAAS. But we think that the standards should have been common practice for the auditors, even before 2002. We also believe that the ISAs and GAAS should be as similar as possible; after all, there are not any differences in fraud committed in the U.S. and fraud committed in the rest of the world. Therefore we use both the ISAs and GAAS here to see what should have been the auditors' responsibilities (even if these were not the rules the auditors in Adelphia and Tyco operated under).

### **International Standards on Auditing 240**

There are two types of fraud relevant to the auditor, misstatements from fraudulent financial reporting and misstatements that are a result from misappropriation of assets. The auditor is only concerned with fraud that results in a material misstatement in the financial statements.

Despite what many may think, it is not primarily the auditor's responsibility to prevent fraud. That, together with the detection of frauds, is the responsibility of those charged with governance of the entity and the management. The auditor's responsibility is to give an opinion on the financial statements (Eilifsen et al. 2006).

The auditor's responsibility is to give a "reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error". Even though the auditor should detect both intentional and unintentional errors, the risk of not detecting misstatements because of frauds is higher than detecting misstatements because of unintentional errors. The risk is greater also of not detecting material misstatement from fraud done by the management than fraud done by employees (ISA 240).

It is important for the auditor to remember that controls set up to discover errors may not be that effective for detecting fraud. Therefore the auditor is “responsible for maintaining an attitude of professional skepticism throughout the audit.” This includes asking the company many different questions and critically assessing the audit evidence. The auditor can not always believe everything the management says, so they have to investigate to determine whether what they are saying is true and whether they perform all the controls they claim. The auditor should actually assume that there is a risk of material misstatements because of fraud and should keep this in mind until it has been proven that it is not. This approach should be taken even though the management has been honest in the past. Further, the management may override the controls, and they may tell the auditor about the good things that they do, but in reality management may do something totally different (ISA 240) (Eilifsen et al. 2006).

The objectives of the auditor are:

1. To identify and assess the risks of material misstatement of the financial statements due to fraud;
2. To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses
3. To respond appropriately to identified or suspected fraud

(ISA 240)

The auditor should perform different risk assessment procedures to obtain an understanding of the company. The auditor should make inquiries of management about their assessment of the risk that the financial statements can be material misstated because of fraud. Auditors should ask management what they do to identify and respond to such risks and find out whether the management already has identified such risks. The auditor should also find out if the management communicates these things to those charged with governance. The auditor should converse with the management and others in the company to see if any of them have knowledge of “any actual, suspected or alleged fraud affecting the entity.” They should also speak to the internal auditor about the same thing (ISA 240).

If the company is big, like Adelphia and Tyco, those charged with governance are often not involved in managing the company. In these cases the auditor should obtain an understanding of how they oversee what the management does to identify and respond to risks of fraud. To

corroborate the responses of the management, the auditor should find out if those charged with governance also have knowledge of “any actual, suspected or alleged fraud affecting the entity” (ISA 240).

When the auditor performs the analytical procedures, they should evaluate whether they discovered any unusual or unexpected relationships. They should also evaluate if they have received any other information that indicates risk of fraud that leads to material misstatement. The auditor should also evaluate the information from the other risk assessment procedures and activities related to this. Do any of these procedures indicate any fraud risk factors? (ISA 240)

As we have described in previous pages, the frauds committed in Adelphia and Tyco were performed by the executives. The ISA 240 has a section about “audit procedures responsive to risks related to management override of controls”. As we discussed in the fraud-section, this can be a big problem. It is much easier for the management to override the controls and in that way to commit fraud that is not easily detected.

As stated in the ISA, this can be a problem because the management is in a “unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.” The auditor should design and perform audit procedures to:

1. “Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.” To do this the auditor should inquire employees who are involved in the making of the financial statements, and consider the need to test.
2. “Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.” The auditor should evaluate if the judgments and the decisions that the management has made when it comes to estimates can represent a risk of material misstatement.
3. And for transactions that are significant and outside what the business normally do, or otherwise unusual, the auditor should “evaluate whether the business rationale ... of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets”.

(ISA 240)

When the auditor finds a misstatement, he should evaluate if this is because of fraud. If discovering that a misstatement comes from fraud, the auditor has to consider the possibility that other misstatements in the financial reports also are due to fraud. The auditor should relate this fraudulent behavior to other things that the management has told him. He should think about the possibility of fraudulent activity involving others, for example other employees, management or third parties. Discovering that management, and especially senior management as in Adelphia and Tyco, is involved is very serious, and the auditor should “reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks” (ISA 240).

If the auditor has found out that fraud exists or that it may exist, then the auditor should communicate this to the appropriate level of management. If the fraud involves, for example, the management, then the auditor should communicate these matters on a timely basis to those charged with governance. Because of client information confidentiality, the auditor has no legal duty to tell someone outside the company what is going on. But in some circumstances when the fraud is severe, the auditor’s legal responsibility may override client information confidentiality, and he should report it to someone outside the company. If the auditor detects fraud, and the company is not willing to change their ways, then the auditor sometimes will choose not to continue as the company’s auditor (ISA 240).

We have now looked at the things an auditor should do and his responsibilities. To prove that he has done what is required of him, he should document every step in his work.

Documentation is a very important part of the auditor’s job. If he does not document, there is no evidence of the work he has done. This is so important that there is a whole standard on it – ISA 230, but the ISA 240 also has some paragraphs on documentation. By documenting everything he does, he has proof of the work done. If he then comes up on a situation where someone doubts his work, he can show them step by step what he has done. In the cases of Adelphia and Tyco, the auditors were also investigated. If they had done their jobs properly, then they could have shown the court their working papers. The working papers include audit evidence which documents that the auditor has done his job in compliance with the auditing standards. The auditor can not be convicted for not detecting fraud if he has followed the rules, so the only thing an auditor can be convicted for is not following the rules that are set for him. If they have documented that they have done everything correctly, then they can not

be convicted. The auditor can only be convicted for not following the auditing standards (Eilifsen et al 2006). In the Adelphia and Tyco cases, we see in the SEC reports that they use the auditors' working papers as evidence.

The documentation is a record of the work that the auditor has done, and all the documentation is the basis for the conclusion that the auditor gives in his report. The documentation contains the planning of the audit, the performance and the supervision. For example, if anyone wonders why the auditor has given a modified opinion in his audit report he can look at the auditor's working papers to see why the auditor concluded as he did. In the documentation it should be easy to understand "the issues and risks, the assertions tested, the audit procedures performed to gather evidence, the findings and the conclusion" (Eilifsen et al. 2006).

The documentation should include what the audit team has discussed among themselves about weakness of the company's financial statements to material misstatement because of fraud. The auditor should also document the identified and assessed risks of material misstatement both at the financial statement level and at the assertion level. The auditor should document the responses to these risks and "nature, timing and extent of audit procedures". He should also document the link between the procedures they have done and the assessed risk, and, of course, it is important to document the results of these procedures (ISA 240).

The auditor also has to document communications with management about fraud and with those charged with governance. If he concludes that there is a risk of material misstatement because of fraud "related to revenue recognition is not applicable in the circumstances of the engagement, the auditor shall document the reasons for that conclusion" (ISA 240).

If the auditor meets some problems during the audit, these problems should also be documented. For example this can be problems with the management, if they refuse to give the auditor access to something. This has to be documented and in some cases may even be the reason to give a modified opinion. In such a case, the auditor should think that they deny him for a reason and that it might be because they have something to hide (Eilifsen et al. 2006).

## **General Accepted Auditing Standards**

The SEC reports also give us a listing of the auditor's responsibilities. They list the requirements of the Generally Accepted Auditing Standards. The main points in the U.S. GAAS are the same as in the International Standards on Auditing. The audit should be planned to give reasonable assurance about whether there are material misstatements in the financial statements or not. The risk of material misstatement because of fraudulent activity should be assessed throughout the audit. As the audit develops there may be some evidence which causes the auditor to "modify the nature, timing and extent of other planned procedures" (SEC Litigation Release No. 48328 2003). So as we can see, the planned audit sometimes has an unexpected outcome. If the auditor finds something that seems suspicious, then he may have to perform other procedures than the ones first planned. One has to adjust the procedures after the risk assessment. The auditor may change the audit procedures to get more reliable evidence.

One important risk factor for the auditor is the characteristics of management and its influence over the control environment. Both in Adelphia and Tyco the management had significant control over the control environment, something the auditors should have considered when performing their audits. As we have seen from the ISAs, the auditor should operate with professional skepticism and should not believe everything the management tells him, but get proof that what they say is the truth (SEC Litigation Release No. 48328 2003).

At the end of the audit, the auditor should evaluate whether the results of the audit procedures has affected the risk level he assessed when he planned the audit. Is there any need for additional audit procedures? The auditor should also take a closer look at whether the misstatements are due to fraud or are unintentional errors or poor routines. One should also remember that if the misstatement is not material, but it involves senior management, it can be an indication of a more serious problem which the auditor should take very seriously (SEC Litigation Release No. 48328 2003).

GAAS also states that some conditions should be communicated to the audit committee. These conditions can represent "significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial

statements". The SEC report mentions undisclosed related party transactions as an example of this (SEC Litigation Release No. 48328 2003). As we saw, in Tyco there were undisclosed related party transactions. Both Kozlowski and Swartz made such transactions between Tyco and its subsidiaries. One example was a trust in which Kozlowski was the beneficiary. The trust bought a house from one of Tyco's board members, through a Tyco subsidiary, and was charged to Kozlowski's KELP account. As we now know, parts of the KELP loans were forgiven, and therefore this purchase was later paid by Tyco.

We have seen what the International Standards on Auditing and the Generally Accepted Auditing Standards have to say about the auditor's responsibility. We will now look at the auditors who were in charge of the audits in Adelphia and Tyco. It is hard to say if the auditor did their job as they should, so we will not evaluate what the auditors did or did not do. We will briefly describe the part they had in the companies and the frauds. We use the SEC reports to see the government's charges against the auditors, starting with Adelphia's auditor, Deloitte & Touche.

### ***Adelphia and Deloitte & Touche***

Deloitte & Touche was the auditor of Adelphia Communications Corporation's fiscal year 2000 financial statement. Deloitte agreed with SEC in June 2005 to pay \$50 million in settlement. At the time this was the largest settlement ever been done with the SEC. The money was put in a fund to benefit the victims in the fraud, for example, the stockholders and the banks. Deloitte settled with SEC without admitting or denying any wrongdoing. By doing that, the case did not go to court, and Deloitte was not convicted in the case. Deloitte simply agreed to pay the settlement (SEC Immediate release 2005-65).

The SEC concluded that Deloitte did not act in the accordance with GAAS and they failed to detect a massive fraud perpetrated by Adelphia and the Rigases. The SEC's charges against Deloitte are contained in an administrative order issued by the SEC and a complaint filed by the SEC in federal court in Manhattan. The SEC order found that the auditor did not do his job as he should have. It finds that Deloitte engaged in improper professional acts when they failed to detect the massive fraud being committed in Adelphia. Deloitte recognized Adelphia as a high risk company, but it failed to do the necessary auditing procedures (SEC Immediate release 2005-65).

The investigation by SEC concludes that Deloitte knew or should have known that Adelphia's failure to include all co-borrowing debt on its balance sheet, or to otherwise disclose that a portion had been excluded, did not comply with GAAP, and that Deloitte improperly failed to object to Adelphia's netting of related party payables and receivables. Deloitte had a risk management program, but they failed to address each risk factor identified by this program (SEC Immediate release 2005-65).

The SEC report states that:

Deloitte issued an audit report containing an unqualified opinion on Adelphia's financial statements for fiscal year 2000 while Deloitte knew or should have known that Adelphia: (a) failed to record all co-borrowing debt on its balance sheet or otherwise failed to disclose that it had improperly excluded \$1.6 billion in debt from its balance sheet; (b) failed to disclose significant related party transactions by improperly netting related party payables and receivables; and (c) overstated its stockholders' equity by \$375 million. In the federal court complaint, the SEC charged Deloitte with failing to implement audit procedures designed to detect the illegal acts at Adelphia.

(SEC Immediate release 2005-65)

It was not only the audit firm that was charged by the SEC, individuals in the firm were also charged. Gregory M. Dearlove was the engagement partner on the 2000 audit of Adelphia. He took over the Adelphia audit from Don Cottrill, the engagement partner who had conducted Adelphia's audits from 1993 to 1999. The switch was made because in 1999 and 2000, the American Institute of Certified Public Accountants (AICPA) required that member firms rotate an engagement partner of the audit of a public company after seven years to bring a fresh perspective and maintain auditor independence. Dearlove was accused of numerous of violations including improperly allowing Adelphia to keep \$ 1.6 billion of co-borrowed debt off its balance sheet. The SEC denied him the privilege of appearing or practicing before the Commission as an accountant for four years. After four years he can ask the SEC to reinstate him (SEC Release No. 51606 2005)

William E. Caswell who directed the Adelphia audit, was also charged. He joined the Deloitte's engagement team at Adelphia in 1994 as a Senior Manager. The next year he was promoted to Director – the most senior, non partner position on Deloitte's Adelphia

engagement – and held that position through Deloitte’s dismissal by Adelphia in June 2002. Caswell did not serve as the audit partner on the Adelphia engagement. The charges against him was that he did improper professional conduct within the meaning of several rules of the Commission’s Rules of Practice by the Respondent in connection with the audit of the financial statements of Adelphia for the year ending December 31, 2000. He settled without admitting or denying any wrongdoing and accepted a ban of at least two years from practicing as an accountant (SEC Release No. 51606 2005).

Even though Deloitte agreed not to deny or admit any wrongdoing, after the settlement they expressed in the media that they were deceived by the executives in the company. After Deloitte settled and agreed to pay \$50 million, they issued a statement that they could not be blamed for the scandal. They claimed they were deliberately misled by John Rigas and others. This statement shifts blame to Adelphia and its executives, and this goes against their agreement, as one of the conditions of the settlement was that Deloitte should not deny any wrongdoing in the fraud. This statement does indicate how the auditor feels. Even if the SEC later officially viewed the statement as a denial of liability and forced Deloitte to rescind it, the statement still shows that the auditor feels that he was deceived by the executives in Adelphia (Solomon 2005).

### ***Tyco and PricewaterhouseCoopers***

It was PricewaterhouseCoopers which audited Tyco in the years of the fraud. They agreed to settle in a class action lawsuit which was brought by the shareholders. In the settlement PwC agreed to one of the biggest payouts ever by an auditor; they agreed to pay \$225 million ([www.washingtonpost.com](http://www.washingtonpost.com)).

From 1997 through the fiscal year 2002, the PwC engagement partner for the audits in Tyco was Richard P. Scalzo. He was the engagement partner in all the years that the fraud was committed. The SEC has investigated Scalzo and the work he did on the audit of Tyco. They conclude that he did not do his job in a proper way and violated several sections of the Exchange Act. Based on this conclusion, Scalzo was denied the privilege of appearing or practicing before the Commission as an accountant ever again. This means that he was dismissed from the profession (SEC Litigation Release No. 48328 2003). As we can see,

Scalzo got a much harsher punishment than the auditors in the Adelphia scandal. When we read the SEC report, we see that the SEC thinks that he personally was more responsible for not detecting the fraud in Tyco than the auditors were in the Adelphia case. We will summarize the SEC report, its findings and opinion.

In the SEC report there are listed several reasons why the auditor should have questioned the integrity of Tyco management. The SEC also found several things in the auditor's working papers that should have made him reassess the risk level in Tyco and perform extended audit procedures. As we have learned from ISA 240, the auditor sometimes has to do additional steps in the audit. For example, the information Scalzo had about the loans should have prompted him to perform additional actions. The biggest mistake of the Tyco audit was that Scalzo did not change his audit procedures or risk assessment even though he discovered things that should have made him question the integrity of Tyco management. Several things were found in his working papers that tell us he should have performed more audit procedures to gain more information. "At no point during the course of his work as engagement partner for the Tyco audits did Scalzo reassess the level of audit risk with regard to executive compensation or related party transactions" (SEC Litigation Release No. 48328 2003).

As described earlier in the paper, the executives had to fill out forms to disclose their KEMP loans. In the auditor's working paper for the fiscal year 1997 the SEC found lists of the activities in these KEMP accounts. For those regarding Kozlowski the description included: "Wine Cellar", "BMW Reg/Tax", "Waldorf" and many other notes. As we can easily see, these activities do not meet the goals of the KEMP accounts. In the following years the working papers have schedules for the KEMP accounts. Even if they do not include descriptions like the ones mentioned, the auditor should have seen that the executives took out much more money from these accounts than they needed to pay in taxes on their Tyco stocks. The SEC report states that PwC should have investigated this to see how they got authorizations for these loans, but Scalzo; "did not inform the audit committee of Tyco's Board of Directors that Tyco's most senior officers had used KEMP loans for non-program purposes." (SEC Litigation Release No. 48328 2003).

The Tyco executives also used relocation loans as they wanted. Scalzo apparently knew about these loans that came to millions of dollars. The loans were recorded in Tyco's books, and were therefore reviewed during the audit. In this case PwC recommended that Tyco should

disclose those loans, but the response from Tyco was that the loans were not material to Tyco's statements and it did not have to be disclosed. Again one could question the integrity of Tyco's executives, but Scalzo did not re-evaluate the audit risks in this area and took no additional audit steps. There are several other incidents that should have made the auditor question the management. The audit team also found transactions from 1998 that showed three of Tyco's executives exercised Tyco stock options (SEC Litigation Release No. 48328 2003).

When the previously wholly-owned subsidiary TyCom Ltd went public, bonuses were given to 51 of Tyco's employees. The bonuses were given as cash, forgiveness of relocation loans and/or Tyco stock. Scalzo's working papers from 2000 show "that Scalzo was aware of and focused on off-sets to the IPO," but when discussing this with Swartz he was told that "the bonuses were not material." The SEC report states that Scalzo did not re-evaluate audit risk. "He did not insist that the bonuses be separately disclosed in the financial statements, and he did not report to the audit committee that Kozlowski and Swartz received the bonuses" (SEC Litigation Release No. 48328 2003).

When Walsh received his finder's fee for the CIT, Scalzo was given false information from the management. When he inquired of the management about related party transactions, they told him that there were no such transactions. Later the Tyco Capital Corporation audit team told Scalzo about the fee, so yet again Scalzo had reason to question the management's integrity. The SEC report says that "when the matter involves higher level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem" (SEC Litigation Release No. 48328 2003).

All these reasons suggest that Scalzo should have known that the financial statements in Tyco were misleading and that the executives in the company were committing fraud. Even when all the evidence was there, with so many red flags, Scalzo still issued an unmodified audit report, an audit report which states that PwC had conducted an audit on Tyco's financial statements "in accordance with auditing standards generally accepted in the United States of America". As the engagement partner, Scalzo was responsible for those statements. Therefore the SEC states that; "Scalzo was reckless in not knowing that the Tyco audit had not been conducted in accordance with GAAS" (SEC Litigation Release No. 48328 2003).

We have now discussed the auditor's place in the Adelphia and Tyco frauds, and we have treated the auditor's responsibilities when it comes to fraud. The auditor has some responsibility to detect fraud, but all that is required of him is that he follows the framework. He can not be blamed for not detecting fraud, if he has done his job according to the rules.

## **OTHER PEOPLE IN THE COMPANY**

Even if Kozlowski and Swartz in Tyco and Tim Rigas and John Rigas in Adelphia are in the spotlight the most, they had to have help to commit fraud. In both the trials, other people in the company were on trial or testified on behalf of the government. In both cases the auditor was investigated by the SEC, and in both cases the audit firm agreed to pay a settlement. Our point is that in both the cases there were other people who knew what was going on. The top executives could not have run the company and committed the frauds they did with no one else knowing about it. The question that pops in to our minds: Why did not anyone say something, what were the motives for quietly accepting the fraud?

In this section we first look in a general way at why other people in the companies do not say anything when fraud is committed. Then we will look at some individuals in Adelphia and Tyco and discuss their possible motivations for not telling on their chiefs.

The first thing you can say is that no one wants to be “a whistle blower”, a concept with a negative sense to it. But often this motive is not the reason why people do not tell. The motivation for not telling might be fear, especially if the fraud is committed by the top executives. If they are dominating people, the employees can simply be afraid to blow the whistle because they are afraid of their bosses. Another fear is that of losing your job. You can lose your job for a number of reasons: if you tell and the company then goes bankrupt you lose your job. If you tell on your boss, he may fire you. There are motivations other than fear to consider. If you are in a company that is running well because of the fraud that the executives commit, you may not tell because you want a good resume whenever you leave this job. It looks much better when applying for a new job that your last job was in a company running well, rather than in a company that was harmed by a financial scandal.

In Tyco the executives directed others to falsify the books. So, of course, someone had to have known some of the things that were taking place. Maybe these people did not know the whole story or maybe they did not know what was right and what was wrong. They listened to their supervisors, and it can be very difficult to question them. There can be pressure on these employees. It is not always easy to stand up against management pressure. You do not want to be unpopular; you want to keep your job. For example, it would take a lot of courage to stand up against Kozlowski if he told you to do something. Kozlowski even tried to get a brokerage

firm to hire a “friendlier” stock analyst so that he could get his way ([query.nytimes.com](http://query.nytimes.com)). He gave this analyst and other employees gifts, a thing that probably made it hard for them to stand up and say that what he was doing was wrong. Of course, they liked the gifts. Maybe it was nice to show the things they received to their friends and brag about what a nice place they worked at.

As the CEO of a huge company like Tyco, Kozlowski was a powerful authority for his employees. And certainly for those who worked closely with him. He was a powerful man, with a good education and much work-experience. Who would have the courage to question or stand up against a man like that? If anyone could, it probably would have been some executives who also had significant power and the possibility of seeing what was wrong. The top executives knew more about what Kozlowski was doing than other employees; likely they did not have to fear losing their jobs in the same way as “insignificant” employees. Other executives could have stood up against him; they could have told the board and made sure that Kozlowski did not have the opportunity to continue. But the problem here was that the other executives also were in on the fraud. This was also true at Adelphia; many executives were in on the fraud, as were family members. If others in the company wanted to say anything, they had to face the entire senior management and several of the board members. The safety of having a good job is worth much to people, so much that they do not risk it by telling on their boss. It would have been easy for Kozlowski to fire some employees if they were too critical about his way of doing business. (And when he gives gifts, who would go through all the trouble?)

As you can see it would not be easy for employees to say anything when the executives in the company commit fraud. For anyone to tell it has to benefit themselves, and as long as the employees do not get anything out of being a whistle blower they may not have any motivation to do it.

## ***The Board of Directors***

Up to this point we have just considered some people who were near to the managerial perpetrators, other executives and some employees. But there are others that could have stopped the fraud, for example the Board of Directors. As mentioned, many people think that it is the auditor's responsibility to prevent frauds and discover ongoing frauds. But the auditor's responsibility is only to give an opinion on the financial statements and conclude whether or not there are material misstatements. Actually the Board of Directors has as much responsibility when it comes to check on the management. There are two different ways to look at why the boards did not say anything; either they simply did not know or they knew but it was in their own best interest not to tell. Either way, the boards did not do their job. In this section we look at the boards of Adelphia and Tyco and analyze what they did and did not do and explain what they should have done.

### **The Board of Directors in Adelphia**

The Board of Directors in Adelphia consisted most of the time of the Rigas's family members. As mentioned before, the Rigases made sure that they had the controlling vote in the board, holding 5 of 9 board member seats. The people in the fraud at the time of the scandal were:

- Pete J. Metros - President, managing director and member of the board of directors of Siemens Dematic AG.
- Dennis P. Coyle - General counsel and secretary of FPL Group and Florida Power & Light
- Leslie J. Gelber - President and COO of Caithness Corp.
- Erland E. Kailbourne - Chairman and president of Foundation the John R. Oishei

#### Family Directors

- John J. Rigas - Founder, chairman, president and CEO of Adelphia
- Michael J. Rigas - Executives Vice President-operations and secretary of Adelphia and vice president of its subsidiaries
- Timothy J. Rigas - Executives Vice President, CFO, chief accounting officer and treasurer of Adelphia

- James P. Rigas – Executive Vice President-strategic planning of Adelphia and a VP of its subsidiaries
- Peter L. Venetis (Son-in-law) - Managing partner of Praxis Capital Ventures, L.P., a private equity investment firm and a subsidiary of Adelphia

(Scanlon, 2002)

Most board members were family members, and surely they knew what was going on. Since most of the executives also were a part of the board this complicates things even further. The board cannot see if the executives do their jobs properly when the board and the executives are the same persons. In addition, as the old expression says: “blood is thicker than water” - family members hold together. In the case where some of the members of the family are involved in a fraud, there is a real possibility that the other family members will not tell on their family members. After the scandal and the convictions the Rigas family still says the relationship they have between themselves is strong. After his father and brother were convicted to serve a long term, James Rigas said that the family strings are stronger than ever; “We’ve always had a close family, and hard times draw you closer together” (www.buffalobeast.com). When he feels that strong of a relationship with his family after the scandal has been known, one can easily understand why none of the family members said anything before the fraud was revealed.

The Board of Directors’ job is to monitor the management and make sure that the stockholders’ best interests always are the main goal of the management’s actions. To make this happen it is important that the board be independent, so that they do not experience any conflict of interest. As for the conditions in Adelphia, where the family held five of nine positions in the board, this conflict of interest was hard to avoid. The situation in Adelphia was very special when it came to the board. We can almost say that the whole board was a part of the fraud. The fraud benefited the Rigas family directly; therefore the fraud benefited the majority of the board members. The way this board was put together it could not take care of the stockholders’ best interest the way it was supposed to. The family members who were not convicted in the fraud did know what was going on; some of them testified in the trial. But we can see why they did not go to the authorities with what they knew; surely they did not want to tell on their own family.

Even if the majority of the board in Adelphia was Rigases, there were also other independent persons on the board. There is a little possibility that those persons did not know what was going on and that the Rigases managed to deceive them. An even bigger possibility is that they did know, but it was not in their own best interest to tell anyone. Often it is beneficial for board members to be on boards of well running companies. And when you are a member of a board that consists mainly of family members, it can be hard to go against all of them or to ask questions.

### **The Board of Directors in Tyco**

In Tyco, the board members were not family members like the board in Adelphia. They were supposed to be independent, and their job to oversee the management should not have been a problem. When the scandal broke in 2002 and Kozlowski left Tyco, the work of building up the trust in Tyco began. One of the steps in doing this was to replace all of the members of the board. Clearly, the board did not do their job in the case of Tyco and people outside had lost their trust in them. The old board were defendants in a number of private complaints, one example is; in the complaint *Evans v. Kozlowski et al.* on June 12, 2003. All the members of the old board are defendants. Several people on the board had been on the board for several previous years, including the years of the fraud. In 2001 Mark H. Swartz also became a member of the board. The people that sat on the board in 2001 were:

- L. Dennis Kozlowski, Chairman of the Board and Chief Executive Officer
- Lord Ashcroft KCMG, Chairman Carlisle Holdings Limited
- Joshua M. Berman
- Richard S. Bodman, Managing General Partner Venture Management Services Group
- John F. Fort
- Stephen W. Foss, Chairman and CEO, Foss Manufacturing Company, Inc.
- Wendy E. Lane, Chairman, Lane Holdings, Inc.
- James S. Pasman, Jr.
- W. Peter Slusser, President Slusser Associates, Inc.
- Mark H. Swartz, Executive Vice President and Chief Financial Officer
- Frank E. Walsh Jr., Chairman, Sandy Hill Foundation
- Joseph F. Welch, Chairman and Chief Executive Officer, The Bachman Company

(media.corporate-ir.net)

The purpose of having a board is to control what the management does on behalf of the company's shareholders. The shareholders themselves do not have the power or possibility to check out the management even though the management works for them. Therefore third parties like the auditor and the Board of Directors play an important part for the shareholders of public companies. In the Tyco guidelines it says that the board should set an ethical tone at the top. During the years from the late 1990s to 2002, the ethics in Tyco were not as they should have. The executives had the power to do what they wanted without the board coming to question their actions as they should have. According to the guidelines, the board is supposed to provide the management "with strategic guidance, and also ensure that management adopts and implements procedures designed to promote both legal compliance and the highest standards of honesty, integrity and ethics throughout the organization" (www.tyco.com).

After the scandal broke in 2002, Tyco did not only replace board members, Tyco also made new rules about the board to help keep the stockholders' best interest in mind. The fact that all of the board members were defendants as individuals shows that there was much dissatisfaction with the job they did. In many of the things done in Tyco; with the management stealing money from the company, the stockholders' best interest was not upheld. One can claim that the board did not know and that there are no way they could have gone through the financial reports to ensure they were correct. But we think that in this case they did not have had to go through all the financial reports. The fraud that was committed was more obvious than that. For example, the board had to sign forms that approved use of the KERP loans; they could easily have seen that the loans were not used in the proper way.

Once again we have people in the company who did not tell when they knew that something was wrong. The board's job was to make sure the management did not do anything to harm the stockholders, but that was exactly what the executives did. So the board did not do their job. Why they did not say anything is hard to understand. In some fraud cases, the excuse of the board is often that they did not have the time to do their job as well as they should, because they had other jobs that took their time. This could be the reason that the board members of Tyco did not see what was going. Yet this is no excuse for not protecting stockholders. If the reason that they did not do their job was that they had no time, this was still a major fault, very harmful to shareholders. It could also be that the board members did know what was going on but chose not to see it. Kozlowski was known for giving presents

and money to employees, and we think that it could have been many positive sides for the members of the board personally for not saying anything on Kozlowski's actions. By not questioning the things that Kozlowski did, both Kozlowski and the board benefited. He could commit his fraud in peace and quiet, and the members could continue at a well run, money making company. As mentioned earlier, Mark Swartz was put on the board in 2001. He was the next most powerful executive in the company and very much involved in the fraud. With such people on the board, it is easy to understand why the board did not say anything.

After the scandal Tyco has formed what they call Board Governance Principles. There should be no doubt about board responsibilities. The Board which sat during Kozlowski's time as a CEO of Tyco should have followed such principles. The principles involve an active board, that shall at all times keep themselves informed of the company and strongly oversee the management. The board has the responsibility of reviewing and approving plans and objectives of management, and should approve their actions. They shall overview the carrying out of the plans and objectives, advise the management in significant decisions and approve major transactions. The board has the responsibility of evaluating the major risks of the company and to check that control procedures are in place. It is their responsibility to select and compensate the Chairman/CEO and other senior executives. They shall monitor and evaluate them, and, if necessary, replace them. The board shall see that the necessary procedures are present to support compliance with laws and regulations. They shall determine "that procedures are in place designed to promote integrity and candor in the audit of the company's financial statements and operations, and in all financial reporting and disclosure" ([www.tyco.com](http://www.tyco.com)).

There is a section in the new guidelines about director independence. The majority of the board should consist of independent directors in order that the board to have an objective oversight of the management. For the members to be independent, they cannot have worked in Tyco or any of its subsidiaries (in the last five years). Apart from their board membership, they should not have a material relationship with Tyco nor should they have had it before they joined the board. They should not have worked for someone or be in the immediate family of someone who receives anything of substantial value from Tyco. This also includes family members working in Tyco ([www.tyco.com](http://www.tyco.com)).

When the people on top commit fraud we can see that it is hard for others to say anything, mostly because of the position the perpetrators have. Many people in both the companies knew what was going on, but we can see there were many reasons why they chose not to say anything. Conflict of interest is the key issue. If they tell anyone what they know, it may not have been in their own best interest, thus they choose to do what is best for themselves and not the company and its shareholders. As with some employees, the board members had no clear motivation to “blow the whistle.”

The conflict of interest is a term that is used much in the auditing profession. In the next section we are going to see what this expression means for auditors and what risks auditors face when doing their job.

## **RISK AND THE CONFLICT OF INTEREST**

### ***Risk***

A big part of an auditor's job is to identify risk. There are several forms of risk, economic, family and industry risk. The main point of identifying risk is to find the probability of fraud happening. The auditor uses an audit risk model, where the audit risk is the sum of inherent risk, control risk and detection risk. In this section we see what the concept of risk includes for an auditor and how the auditors in Adelphia and Tyco handled the risks in the two companies.

Risk is a very important aspect to consider when planning an auditing process. The auditor faces an auditing risk. This is the risk that the auditor issues an unmodified opinion when in fact there are material misstatements in the financial statements. The auditor should reduce the risk level to such a point that he has reasonable assurance that the result he finds is the right one. He can not be 100% sure that fraud has not occurred, but reasonable assurance means that there is little probability that he gives an unmodified opinion when in fact fraud has occurred. It is some level of risk that the auditor did not detect all material misstatements (Eilifsen et al. 2006). The biggest risk is often related to the control environment. Often when fraud occurs, it involves the management overriding the internal control. This is exactly what happened in both Adelphia and Tyco. To help the auditor be aware of that risk and help him to know how to do the audit, he uses the audit risk model.

### **The audit risk model**

This is a model intended to give the auditor a guideline when he is planning his audit. Planning an audit requires careful consideration by the auditor. The procedures he is doing are not always written down exactly, but he must use his own judgment on what to do. The audit risk model is a help to the auditor to decide the scope of auditing procedures. The model is specified as:

$$AR=IR \times CR \times DR$$

where AR is auditing risk, IR is inherent risk, CR is control risk and DR is detection risk.

Inherent risk and control risk the auditor has to assess. He has to take a good look and then determine a level of risk that he thinks is appropriate. Control risk is the risk that material misstatements are not detected or were not prevented by the internal control. This means that in order for him to set the right level of control risk, the auditor has to evaluate the internal controls of the company. The auditor has to know which factors can have a negative impact on the effectiveness of the internal control. Such factors can be lack of segregation of duties, meaning that one person is doing assignments that give him the opportunity to commit fraud. Or it can be that the internal control easily can be overridden by the management (Eilifsen et al. 2006).

The auditors use the model to determine the appropriate level of detection risk. If both inherent risk and control risk are high, it requires more auditing procedures in the areas where the risks are high (Eilifsen et al. 2006).

We have seen how important it is to identify risk; now we are going to use the SEC reports to see how the auditors in Adelphia and Tyco handled the risks in these companies.

### **The risk procedures that Deloitte did in the Adelphia audit**

The SEC reported that Deloitte did its job when it came to identifying the level of audit risk in Adelphia. They concluded that Adelphia presented a much larger risk than normal. This was the largest risk level that Deloitte operated with. Some of the identified risk Deloitte found in Adelphia in 2000 was:

- Management is dominated by one strong personality or concentrated in a small group without compensating controls.
- Management appears willing to accept unusually high levels of risk.
- Management tends to interpret accounting standards aggressively.
- The organizational [and/or reporting] structures are unduly complex.
- There is substantial debt from unusual sources (e.g., related parties) or on unusual terms.
- There are significant affiliated entities or other related parties that we will not audit and with whom significant transactions might have occurred.

- [Adelphia] engages in unique, highly complex and material transactions that pose difficult “substance over form” questions.
- [Adelphia] is under significant pressure to obtain additional capital necessary to stay competitive, and is growing and is near the limit of its financial resources.
- There have been frequent disputes with Deloitte on accounting, auditing, or reporting matters.

(SEC Release No. 51606 2005)

As you can see, Deloitte was well aware of the risk that fraud could happen and that they had identified the large risks in many of the things that did happen. One identified risk was that the management was dominated by one strong personality or concentrated in a small group without compensating controls. We see that Deloitte was aware that the fraud could happen but they still failed to detect the fraud. In the fraud in Adelphia, the management did the fraudulent behavior, and they could do this because the Rigases had all the control in the firm. This was exactly the risk that was identified by the auditors, and still they did not look enough in the audit to detect what was going on. We can see that they identified risk with the fact that Adelphia had several affiliated entities that Deloitte did not audit. One part of the fraud was that the debt in Adelphia was moved over to the Adelphia-owned entities. Once again Deloitte identified the risk, but still they did not manage to prevent the fraud. If Deloitte had taken all the identified risk seriously maybe they could have detected the fraud at an earlier stage, and not given a clean report but rather a modified one.

Level of inherent risk and control risk are functions of the entity and its environment and are not affected by the auditor’s actions. This risk appears independent of the audit. It is important to identify these risks, in order to determine detection risk.

One of the things that Deloitte should have questioned was the \$1.6 billion in debt that Adelphia in 2000 removed from their balance sheet. The management had many explanations why this debt should not be included in the balance sheet. Deloitte should have recognized how this did not comply with GAAP. The SEC reports: “Deloitte knew or should have known that the \$1.6 Billion was Adelphia’s liabilities and should have been reflected on its financial statements. Deloitte knew or should have known that that this practice was a violation on GAAP”. Deloitte also missed other red flags; most seriously they did not pay enough attention

to where money went. They should have conducted a more careful review of the relationship between the payables and receivables (SEC Release No. 51606 2005)

The SEC report states that Deloitte failed to address each risk factor identified by the risk management program. The auditor also had a program to identify the risk and they managed to identify it, but they did not do the audit procedures that the risk level required. When an auditor identifies that there is great risk involved in several aspects of a firm, and they still fail to look into this, they will likely miss the red flags that indicate fraud. An auditor's job is to do the audit in such a way that these red flags are discovered. Deloitte failed to do this in very many ways. Because of their failure, Deloitte was charged by the SEC (SEC Release No. 51606 2005).

### **The risk procedures that PricewaterhouseCoopers did in the Tyco audit**

During the relevant years PwC was the independent auditor for Tyco. Scalzo was the responsible auditor and he was largely responsible when it comes to the auditor not doing an appropriate job on the Tyco audit. Scalzo's biggest mistake on the Tyco audit was that he did not reassess the risk level. Even though several incidents occurred during the audit, the auditor never changed the risk level or performed other auditing procedures than the ones already planned. While the auditors in Deloitte set the risk level in Adelphia as high, the auditors in PwC failed to draw such conclusions about Tyco. As we know, there was significant risk in Tyco. The executives failed to disclose several of their loans, and the auditor found other things they knew were wrong. As we learned from the ISA 240, one should take it seriously when the management lies and this should be enough to reassess the risk level. For example, Scalzo's working papers show that KELP loans had been used to exercise stock options worth millions of dollars, not an acceptable use of loan funds. This should have made the auditor reevaluate the audit risk, but no audit steps were taken to find whether the loans had been used for their stated purpose (SEC Litigation Release No. 48328 2003).

When it came to the relocation loans, PwC actually recommended that these loans should be disclosed but that was rejected from Kozlowski and Swartz. The auditor should have insisted, and if the executives still had refused, he should have at least informed the audit committee

about this. The integrity of management is one important part of evaluating risk. When the two executives refused to disclose the loans, the auditor should have given this matter extra attention and considered this as a big risk factor (SEC Litigation Release No. 48328 2003).

By not assessing the right level of risk, Scalzo failed to do the proper auditing procedures later in the audit. He failed to address the right level of risk, and later in the auditing process he did not use the right procedures to determine the actual risk level. When one manages to assess the right level of risk, it is easier to know which auditing procedures to do; but when one fails to address the risk, as Scalzo did, this can mean that one will not perform necessary auditing procedures. As we have described, the SEC found that Scalzo did not do his job in a satisfactory way, mostly because he did not manage to assess the right level of risk.

In the matter of whether the auditors who audited Adelphia and Tyco did their jobs properly we can not agree either way. But as we see, the SEC reports indicate that they did not do their job as well as they should have. Maybe it would have been impossible for the auditor to prevent the fraud in either of the firms even if he had done his job well? That is not the question here, the question is did the auditor do his job as accurately and extensively as required? We have seen how they dealt with the risks in the companies, and it is our opinion that they did not do their job in the best possible way. Maybe the management deliberately tricked the auditors, but the signs were too obvious to miss. If they had handled the risk procedures in another way and taken the risk they found into consideration, they probably would have done their job in a more acceptable way.

### *The conflicts of interest rife in the auditing profession*

Identifying risk is not the only thing that is crucial for the auditor to do a good job. The auditors also have to struggle with what we call the conflict of interest. The purpose of the auditor is to be an independent third party who can reduce the asymmetric information between the management and the companies' stockholders. A big problem in the audit industry, at the time of the scandals in Adelphia and Tyco is that in many cases the auditor was not independent. In this section we are going to take a closer look at the concept we call the conflicts of interest as a key dimension in the analysis of fraud.

Many people think the biggest problem the auditor faces is that of independence. The rules say that the auditor shall be independent both in appearance and in mind. That means that he can not consult and audit the same company. He also is not supposed to have any personal relationship with the management whatsoever. An auditor shall have what we call a professional skepticism which means that he goes into the audit with a questioning mind and a critical assessment of audit evidence. Even if he knows the management well and he thinks that these people are not going to commit fraud, he has to go into the audit believing that they might have. Before the scandals in the beginning of this century, it had become more and more common that audit firms also consulted for the company they audited. It was a good use of resources because the auditor has knowledge of the business and may have had sound ideas on how to help the company. But consulting and auditing the same company means that you end up "auditing yourself" and that is not a good thing.

The best way to prevent this conflict of interest is to make the framework so that the auditor never is put in that position. The rules have to be established so that the auditor cannot choose if to be independent or not. If the rules open up possibilities that compromise independence, then the rules are not good enough. Every auditor knows that independence is important, but sometimes the temptation becomes too great, or they are so close to the case that they can not see that the independence is jeopardized. With a good framework we can prevent this from happening. Imagine that you tell a child not to eat candy, but you put the candy in front of him and tell him that nobody will ever know if he eats it. For many children this temptation is just too great to resist; but if the candy is not there, the child do not have opportunity to eat it. This should be stressed: if the opportunity to do something wrong is not present it will not happen. As the framework existed at the time of the scandals, temptation to compromise independence

was very much present, for the auditor. As long as the auditor has the incentive to satisfy his client he will always see the world in a biased way. And even the most honest auditor may do the wrong thing if he is not aware that he does so. The only way to reduce the problem is to eliminate the conflict of interest, so that the auditor never is tempted to act in the interest of the company when this is not the best interest of the environment (Moore 2002).

Maybe the best thing that comes from scandals like this is that everyone becomes more aware of the problem. After all the scandals in the beginning of this century the audit firms and the government have seen the consequences of the scandals and are working to prevent future fraud. In the next section, we look at things that have been done in the fight against fraud.

## **WHAT HAS BEEN DONE AFTER THE SCANDALS?**

After the major scandals at the beginning of the century many new rules and a regulatory framework has seen the light. The audit firms themselves have done some things, and so has the government. The firms have made more rules to govern themselves. For example, they cannot implement an accounting system in a company they audit. For the same firm to audit and consult for a company, approval must be given from the Governmental Audit Quality Center Executive Committee. After the scandals, firms are less likely to get an approval on auditing and consulting the same company than before. Now the firm has to disclose the companies they are auditing and consulting. By not doing both things for the same company, firms express what we call independence in appearance. All this helps to give the auditors the independence they need to do their job properly. The firms also made rules that the same individual auditor can not be in charge of the audit and the consulting for the same company at a given time. Most of the existing firms still offer consulting services, but not to the same companies they audit. In Norway, when you have big clients it is common practice that one of the big audit firms audits a company and another big firm is consulting for that company.

The profession has also taken steps. In 2000 the American Institute of Certified Public Accountants (AICPA) made a rule that after seven years on the same client the auditing firm has to change the auditor responsible for that audit. As we saw in Deloitte they switched the responsible auditor for the Adelphia audit to meet this requirement.

### ***Steps taken in Deloitte***

As you read in the SEC report, Deloitte has made much effort to improve their audit process so that they can be better prepared to detect fraud. For example, they now use a proprietary financial analysis tool to assist in its assessment of substantially all of its U.S. public company clients with publicly traded equity securities as to their potential for financial statement fraud or business failure. Deloitte has established the following to their auditing procedures to prevent fraud from not being detected in the future:

- a. Deloitte now notifies the Audit Committee about a client's placement in the Risk Management Program.

- b. Deloitte forensic specialists are now involved in the audit planning for certain clients in the Risk Management Program that are determined by Deloitte to be at a high risk of fraud. The Audit Engagement Partner also retains the discretion to have Deloitte forensic specialists involved in audit planning in other audits in the Risk Management Program.
- c. The Audit Engagement Partner now conducts a detailed review of the principal audit work papers and the Concurring Partner must do an overriding review.
- d. At the conclusion of the audit of clients in the Risk Management Program the engagement team must document its conclusions about the effectiveness of audit response to identified audit risks, and the Special Review Partner must concur.
- e. Deloitte now develops and documents circumstances specific to each particular. Client under which the client would be permitted by Deloitte to exit the Risk Management Program.

(SEC Release No. 51606 2005)

As you can see many steps have been taken to help the auditor detect and prevent fraud. It may be too soon to tell whether these steps are effective.

### ***Steps taken in PricewaterhouseCoopers***

From 2001 on, PwC has done surveys every other year to help them find out more about the concept of fraud. Their latest survey was in 2007, conducted in 40 countries with over 5,400 interviews.

By making these surveys, PwC can be more prepared to meet the challenges of fraud. They can see where fraud is most frequent, who commits fraud, and how others manage the risk of fraud. By doing these surveys PwC can see what others think about fraud, and by that get some idea on others' awareness of fraud. In the 2007 survey, they found that even though

companies have invested a lot of money and implemented several controls to prevent and detect fraud, this is not enough. Fraud is still a problem to the same degree as it was a few years ago. 11% of the companies in the survey think that it is likely that they will be victims of fraud in the next two years. In 2005 7% thought the same. Analyzing their survey, PwC talks a lot about the fact that controls are not enough, that company culture also plays an important part in preventing fraud (PricewaterhouseCoopers 2007).

PwC focuses on what they call the Fraud Control Paradox. This is based on the concept that if you do not know what you are looking for then you will not find it. If you on the other hand know what you are looking for and try to find it, then you are more likely to find it. So when controls are implemented, more frauds are detected. PwC has also done research that shows companies which have implemented more than five controls discover much more fraudulent activity than the companies which have fewer than five controls. It is important that the controls focus not only on delivering accurate financial reporting, but that they also see the risk of fraudulent behavior. Therefore it is important to upgrade controls, so that they do not go out of date. As the fraudsters learn new ways to commit fraud, controls must be updated to reveal these new kinds of fraud. The controls should reflect the corporate culture and the company's guidelines. By doing these surveys PwC gets a better view on which controls are working and how the controls have to be modified to prevent fraud (PricewaterhouseCoopers 2007).

With the help of surveys, PwC can more easily detect where there is high risk of fraud, what signs to look for that indicate high risk. In the last survey, they got a better view on how a company can develop and grow by taking risk, but at the same time handle this risk so that fraud will not occur. For a company to develop and grow, it has to take some risk to seek great opportunities, but by taking these risks the company also increases its possibility of fraud. Companies often make changes to survive; therefore, must they learn to control the negative side of changes. They can do this by implementing new controls, evaluating the old ones, assessing their vulnerability, and accommodating programs and systems to the new circumstances. The companies with more controls not only detect more fraud, but it is also easier for them to approximate the losses that come from fraud. If they do not have enough controls, then the companies will not know how vulnerable they are, and they may not learn from the particular frauds that have affected them (PricewaterhouseCoopers 2007).

In the survey PwC also finds that in many cases the controls do not work as well as they should. They find that in 2007 41% of frauds were detected by chance. The companies have a long way to go when it comes to detecting fraud. By being aware of this, PwC can do a better job of preparing their audit procedures. They know that many controls do not work, and they can identify risk more accurately (PricewaterhouseCoopers 2007).

The PwC Global Economic Crime Survey shows that when senior management is involved in fraud, it has a negative impact on staff morale. But in the cases where the fraudsters have been properly punished, the impact will not be as significant as when they get away with fraud. Some companies are afraid to punish their executives because they would prefer less publicity about the events. There are, of course, negative side effects to fraud committed in the company, but when the company stands up and shows that this is not acceptable they can gain a great deal. In fact, the survey shows that it can be more harmful if the public finds out that fraud was committed and nothing was done about it. It is important to show that the company takes a stand against fraud (PricewaterhouseCoopers 2007).

Trough these surveys PwC is able to get a better view on the concept of fraud. By better understanding they are able to improve their audit practice in detecting and preventing fraud. We can see both that the audit firms take fraud seriously and they have done important things to help in the battle against fraud.

### ***Steps taken by the U.S. Government***

We have now considered efforts that audit firms have taken, but the U.S. Government has also made new effort to prevent scandals. In 2002 the U.S. Congress passed the Sarbanes-Oxley Act. The Act establishes a new quasi-public agency, the Public Company Accounting Oversight Board (PCAOB) which is charged with overseeing, regulating, inspecting, and disciplining accounting firms in their roles as auditors of public companies. The Act also covers issues such as auditor independence, corporate governance, internal control assessment, and enhanced financial disclosure. The Sarbanes-Oxley Act consist of 11 titles that each take on different issues. Among other things, they focus on the independence of the auditor. The law also addresses the need for white collar crime to have harsher penalties ([www.sarbanes-oxley.com](http://www.sarbanes-oxley.com)). In both the Adelphia and Tyco fraud the perpetrators were

punished quite harshly. Adelphia's John Rigas was in all practical terms, sentenced to life, and Kozlowski will be a very old man when he gets out of prison. Maybe these harsh sentences are a consequence of previous scandals and the debate over Sarbanes-Oxley. Whether this is positive effect cannot be said yet. Few major scandals have been uncovered in the past few years, but if this is a result of the Act we do not know. We give here a short summary of the main content in each of the eleven titles:

**Title 1 Public Company Accounting Oversight Board (PCAOB):** This title establishes the PCAOB and describes the purpose of the Board.

**Title 2 Auditor Independence:** This title is about the independence of the auditor to limit the conflict of interest. It addresses new auditor approval requirements, audit partner rotation policy, conflict of interest issues and auditor reporting requirements. It says that an audit firm has to get approval from the Board before they can do non-auditing services for a company they audit. There are some non-auditing tasks they can never do: bookkeeping or other services related to the accounting records or financial statements of the audit client, financial information systems design and implementation and management functions or human resources.

**Title 3 Corporate Responsibility:** This title establishes that the executives in the company have individual responsibility for the accuracy and completeness of the financial reports. They are held responsible if the financial reports have any misstatements.

**Title 4 Enhanced Financial Disclosures:** This title describes the reporting requirements for financial transactions, including off-balance-sheet transactions, pro-forma figures and stock transactions of corporate officers. It also requires internal controls for assuring that all procedures in making the financial reports are reliable.

**Title 5 Analyst Conflicts of Interest:** This title consists of one section, which includes measures designed to help restore investor confidence in the reporting of securities analysts. It defines the codes of conduct for securities analysts and requires disclosure of knowable conflicts of interest.

Title 6 Commission Resources and Authority: This title defines practices to restore investor confidence in securities analysts. It also defines the SEC's authority to censure or bar securities professionals from practice and defines conditions under which a person can be barred from practicing as a broker, adviser or dealer.

Title 7 Studies and Reports: This title concerns the conduct of research for enforcing actions against violations by the SEC registrants (companies) and auditors. Studies and reports include the effects of consolidation of public accounting firms, the role of credit rating agencies in the operation of securities markets, securities violations and enforcement actions, and whether investment banks assisted Enron, Global Crossing and others to manipulate earnings and obfuscate true financial conditions.

Title 8 Corporate and Criminal Fraud Accountability: This title is also referred to as "Corporate and Criminal Fraud Act of 2002". It describes criminal penalties for fraud by manipulation, destruction or alteration of financial records or other interference with investigations. It also gives some protection for whistle blowers.

Title 9 White Collar Crime Penalty Enhancement: This title increases the penalties for white collar crimes, to make a statement that such crimes are not taken lightly. It recommends stronger sentencing guidelines and specifically adds failure to certify corporate financial reports as a criminal offense.

Title 10 Corporate Tax Returns: This title says that the financial executives officer is entitled to sign the company tax returns.

Title 11 Corporate Fraud Accountability: This title identifies corporate fraud and records tampering as criminal offenses and joins those offenses to specific penalties. It also revises sentencing guidelines and strengthens their penalties. This enables the SEC to temporarily freeze large or unusual payments.

([www.sarbanes-oxley.com](http://www.sarbanes-oxley.com))

By this legislation the government hopes that it can reduce the extent of white collar crimes. There is one title dedicated to the independence of the auditor. This rule is to help the auditor

be as independent as he needs to be to do a good job. With a better framework, it should be easier to follow the rules.

Other things have been done in the fight against fraud. In some regions, for example, North America, whistle-blowing systems have become a statutory requirement for listed companies. Whistle-blowing systems make it possible for employees to report tips on ongoing fraudulent behavior. PricewaterhouseCoopers' 2007 survey lists several examples of whistle-blowing systems, and what the practice should be. Companies can have help lines where employees can report things that happen even if they are not their immediate responsibility. Their identity is to be kept secret from their supervisors. They can also report to an e-mail address or a mail box. It is important that it is toll free and be available in several languages in the cases where the companies are international. It should be possible to report anonymously, and protection should be given to the ones that report fraud if they receive threats. It is important for the employees to know how to report wrongdoing and to train them well in company code of conduct, rules and regulations so that they know what is important to report. It should be possible to ask question and receive guidance. The survey also lists other things the company may do. The survey from PricewaterhouseCoopers shows that these systems have a great impact on detecting fraud. They find that in 8% of the cases it was such a system that detected the fraud, and when the company thought the system was effective, it detected 14% of the frauds (PricewaterhouseCoopers 2007).

The scandals in Adelphia and Tyco have in a way been good to the audit profession. Scandals set the profession in a bad light, but also remind us how much we need an auditor. To make the stock market work, the valuation of the stock has to be right. To give a right valuation of the stock, the financial statements have to be right. People have to trust that the numbers the company publishes are correct. All stakeholders depend on the credibility of the financial statements. Without an auditor, no one is going to trust anyone. A vicious cycle may appear: no one will invest, firms do not run as well as expected, they fake their numbers and so on.

We have now seen what the audit firms and the government have done to address fraud. Many of the things focus on the auditor and how conflicts of interests can be reduced. The auditors play a major part in the fight against fraud. The companies themselves can also do things to prevent fraud. We will look at some of the things that were done in Tyco after the 2002 scandal.

### *Steps taken by Tyco*

In Tyco's somewhat unusual, annual report from 2002 you can read of the things that the new management and new Board of Directors did to restore stockholders' confidence. Here are some of the points from the report:

- Replaced the Board of Directors;
- Created new Board charters;
- Created a new employee guide to ethical conduct and conducted worldwide employee meetings to train employees;
- Created new mission, values and goals statements;
- Instituted detailed operating reviews with the Chief Executive Officer and Chief Financial Officer and each business segment;
- Reviewed total incentive compensation spending with the Compensation Committee of the Board of Directors;
- Initiated a controllership assessment process to identify the status of key routines and controls;
- Conducted a thorough review of internal audit processes and procedures;
- Instituted a code of conduct for all financial executives;
- Continued to initiate a process of conducting intensified internal audits, detailed controls and operating reviews, and reported the results of such audits and reviews;
- Development of an accounting policy and procedures manual to ensure conformity with GAAP;
- Expanded the resources and responsibilities of the internal audit function, with a senior internal audit officer who reports directly to the Audit Committee of the Board of Directors; and
- Created disclosure committees that include senior personnel from the legal, finance and Human Resources departments throughout our businesses, and which are responsible for reviewing results of operations, evaluating compliance with policies and procedures and communicating material findings to the Company's CEO and CFO

([www.tyco.com](http://www.tyco.com))

As we see, many of these steps are taken to restore stockholders' confidence. By changing both the Board of Directors and the management, they got the "clean" start they wanted. Many of the actions involved establishing better routines in the internal control, especial

where internal controls involve the management. The hardest thing with developing a functional internal control is to involve the management because it is so easy for them to override it. By taking small steps to involve the management in the internal control, one can reduce the risk of management fraud. There are also some points about the internal auditor, by improving his performance, it is hoped they can reduce the risk of fraud.

All parties involved in a fraud have things they can improve so that the risk of new fraud is reduced. But, as with other crimes, it is impossible to eliminate the opportunity to commit fraud. Regardless of the steps taken to reduce opportunity, the risk will continue. As long as men like Kozlowski and Rigas exist, there are people who find a way to commit fraud. With that said, there is no doubt that the things done after these scandals are positive things. Even if not all the actions reduce fraud directly, they can have the good effect by bringing focus to fraud, and making people more aware. As the PwC Survey said; it is harder to find something you do not know you are looking for. Because of the new rules and regulations, more people focus on the possibility of fraud, and it is more likely that fraud will be discovered at an earlier stage.

## **INTERNAL CONTROL**

In both Adelphia and Tyco the opportunity element is kind of a puzzle. In both cases the fraud was a management fraud, the fraud done by the people on top. In most cases this makes the opportunity component in the “fraud triangle” easy to understand. In the previous sections we have mentioned that control environment and internal control is important to reduce the opportunity element. In this section we are going to look at why the internal control did not prevent this fraud from happening in Adelphia and Tyco.

The opportunity element in the fraud triangle depends on the extent of the internal control. To reduce opportunity one has to have an effective internal control. Internal control makes sure that company rules are followed by employees. Internal control can be very useful on the employees in the firm, and usually good internal controls reduce opportunity for committing fraud. In Adelphia and Tyco fraud took place, so the question is: Why did the internal control not prevent fraud here?

The question is somewhat easy to answer; internal control is easily developed to prevent fraud from happening among the employees, but when facing the management internal control can often be overridden. Internal control only works if people monitor and make sure the internal control is followed. However it is often easy for management to override internal control. It is hard to detect fraud committed by the people on top and even more difficult when all the people on top are in on the fraud. This was the case in Adelphia. In Adelphia and Tyco the internal control did not work for the management because there was no one to monitor them. The management had all the power so when fraud was committed no one else in the company was aware of what happened. (Or if they were aware, they did not have the courage or the power to stop the executives.)

As discussed earlier, we can see that it is not easy to establish control activities which involve the management. Management fraud is not easily avoided. It was especially true in this case when many executives took part in the fraud. When it comes to Tyco, if only Kozlowski had acted fraudulently, then maybe Swartz could have stood up and told the board or the authorities about what was going on. But when several more executives took part, then it became even harder for others to stop them. The management has the highest authority in the company so it is quite difficult for others lower in the corporate ladder to inform on them.

After all, there were only a few employees who actually worked with Kozlowski himself. Sometimes it can be hard even to find out if executives are doing something wrong, and who would check if the CEO of their company is committing fraud? The management often has the highest authority, and others have to come to them to get permission to take many actions. It is not very easy to segregate the duties of a CEO. Physical safeguards that work for other employees do not work well for management. As we can see, there are several reasons to why controlling management is much harder than controlling other employees.

The question that still remains is what could then have been done to reduce the opportunity? When every theory tells us that the best way to reduce opportunity is internal control, what can be done if internal control does not work? Maybe the answer is that in management fraud the only thing to do is to reduce the two other elements in the “fraud triangle”. This assumes that it is likely that little can be done to reduce the opportunity element when it comes to management fraud. In the last section we look at what could have prevented the frauds, as well as consider the many things that have been done since the scandals.

## **COULD THE FRAMEWORK HAVE PREVENTED THE FRAUD?**

In this last section we consider the scenario where the entire framework, which is now in place, existed at the time the frauds were committed. We try to answer the question: If we had the framework that is now in place, would this framework have prevented the fraud?

This question is difficult to answer, but we do think that some of the framework that has come about could have helped in the discovery of the fraud at an earlier stage. In the auditing profession one of the biggest challenges is the conflict of interest. Now there is much more focus on the independence of the auditor than it was when these frauds happened. We saw that the Sarbanes-Oxley Act has a title dedicated to this issue, and the rules have been improved. In the case of both Adelphia and Tyco, the auditor has been investigated and agreed to a settlement. If the rules and regulations had been what they are today, it may have made the auditor do his job another way.

Even though the auditor's independence has been the main focus in the auditing profession the recent years, the consulting has never been a bigger part of the auditing firms. In Norway there are four big audit firms and all of them have consulting services as a big part of their company. These firms have a philosophy that auditing means not only to look at the financial reports, but to be a part of the whole process, from developing internal control and making good routines for the numbers in the financial reports to be accurate and correct. By involving the auditor in the whole process he gets a better understanding, but it also makes the auditor a little less independent. By being a part of the process and maybe come up with some ideas to improve the procedures, this can make the conflict of interest rise even if the auditor do not think this himself.

We read in the SEC report that many steps have been taken in Deloitte after the Adelphia fraud. Emphasis focused on assessing risk and how to deal with it. The routines to follow up when a client is addressed with high risk are improved. In Adelphia the auditor managed to identify the risk but failed to take the proper action for that level of risk. If the rules and procedures had been improved before the fraud, fraud may have been prevented. But the biggest problem was that the auditor did not follow the procedures as he should. Even with the framework we have today, the auditor can choose not to do as he is supposed to do. It is hard to get rid of the problem just by increasing the penalties for the auditors who have not

done their job, especially when they are not aware that they did not do it. To reduce the problem one has to eliminate the conflict of interest in such a way that an auditor is not tempted to act in interest of the company when this is not the best interest of the environment (Moore 2002).

Another thing that has been done that affects the auditor is that the penalties have increased. This can help, making the statement that everyone takes fraud seriously and that when an auditor does not do his job properly there will be consequences. The penalties have not only increased for the auditor, but also for the perpetrators the penalties has become more harsh. In the past, many have had the impression that a white collar crime is not really a crime. By increasing the penalties, it may have an awakening effect on the whole society that this is really a crime. By focus on white collar crime, more people may think twice before they commit such crime. By increasing the penalties one can reduce the rationalization element in the fraud triangle. It can be harder for the perpetrators to rationalize the act to themselves when the main perception in the society is that they have committed a real crime. Often when talking of white collar crime, many think that this is not really a crime. This makes it easier for the perpetrators to think that what they are doing is okay. They do not see themselves as criminals. By comparing them to “real criminals,” like bank robbers, this can reduce the rationalization element.

We do not think that any of the rules or frameworks recently developed have helped enough with the issue of internal control when it comes to management. The Sarbanes-Oxley Act has made some rules and procedures that can help to develop an internal control that is better for preventing the management from committing fraud, by for example having rules that the CEO and CFO have to put their name on that the financial reports that they give from them are correct. These are steps in the right direction, but we still think that it is not enough. When the management is committing fraud, the rules have to be so solid and so difficult to override that it is almost impossible to make the rules that good. As long as the executives who commit fraud have such strong personalities (as Rigas and Kozłowski had,) no rule in the world will ever stop them. There have to be people who are able to stop them, like the auditor or the other employees. As we have seen, it is very hard for employees to say anything when the fraud is committed by the management. The company has to give the employees a motivation to be a whistle blower. If Adelphia and Tyco had implemented the whistle-blowing systems we described in a previous section, then the fraud might have been discovered at an earlier

stage. But it is hard to say. If some of the employees had reported fraudulent activity, who should take care of this when the executives was the ones doing the fraud? We have talked about the board in the companies, and it seems like they only watched with half an eye. The board in Adelphia consisted mostly of family members so they probably would not react to this. But the others on Adelphia's board and the board in Tyco should have taken these kinds of reports seriously. But even with the new framework, we do not think that they would have done it. They did not do anything when they clearly did know what was going on. That gives us no reason to believe that they would have taken any action if one of the employees had come to them with information on the fraudulent behavior. Once again, we see that the framework is good in theory, but as long as the fraud is committed by the management all the rules can be overridden.

We do not think that any of the framework and rules that have come up after the scandals could have prevented the frauds in Adelphia and Tyco. Even if the new framework had been there, Rigas and Kozlowski could still have acted the way they did. The board and the employees might still have not paid enough attention or cared enough to tell anyone what was going on. But with an improved framework, there was a bigger chance that someone might have seen what was going on and told at an earlier stage, or that the SEC might have had a suspicion at an earlier stage.

We think that a good framework could prevent some fraud. A good framework is needed so that the system can be trusted, like an auditor is needed for the same reason. But when it comes to men like Rigas and Kozlowski, it is likely they could not have been stopped by improved framework. With today's rules maybe it would be more difficult for Rigas and Kozlowski to commit the fraud, but even if the framework was better it still had to be someone who had to stop them. We can say that by improving the framework we can reduce the opportunity element in the fraud triangle. But opportunity will not disappear, and for people like Rigas and Kozlowski it will still be pretty big – even if reduced.

All the attention that fraud and white collar crimes have gotten after the scandals may be the main reason that fewer frauds that have been committed in recent years. New and improved framework has helped, so have harsher penalties, but the main reason is the public focus. The auditing business was in the spotlight and now everyone in the industry stepped up a notch so that the firm they worked for does not get in another scandal. All auditors have felt pressure

from both the society and the firm they work for to do their job a little bit better. We think that all the scandals in the beginning of this century were the wake up call that everyone needed so that people saw what will happen if someone does not do their job properly. If the framework had existed before the Adelphia and Tyco fraud, we do not think that this would have prevented the fraud; but now with the focus on fraud it may help prevent fraud in the future. In a way, we need scandals like this from time to time, so that everyone can be reminded that we have lost focus, and that it is now time to improve the framework again. It is like when you are driving on the same road every day with a speed limit of 30 miles per hour. If there have not been any accidents on that stretch, and there are no speed controls, you may see no reason why you should drive 30 miles per hour. Little by little, you increase your speed. You drive over the speed limit, until one day someone is killed by a speeder, and authorities enforce new controls. You wake up and see the consequence of speeding, and so you reduce your speed. The rules have been there all the time but people need to be reminded of what can happen, and the importance of following the rules.

In the light of the fraud triangle, the new framework can help reduce the opportunity element and with increased penalties reduce the rationalization. The last element in the fraud triangle, pressure, is hard to reduce by improved framework. And we do not think that any of the things that have been done have reduced this element in a way worth mentioning.

## CONCLUSION

In this paper we have taken a good look at the concept of fraud. We have analyzed the fraud in Adelphia and Tyco and considered the new rules and regulations that have come after all the scandals at the beginning of this century. We have tried to see if the fraud could have been prevented with the entire framework that exists today, if it had been in place before the fraud. We have come to the conclusion that fraud can never be completely eliminated. By taking all we have learned into consideration, we think that the frauds in Adelphia and Tyco would have happened no matter what rules had been in place at the time. When these kinds of actions are performed by such powerful men as Rigas and Kozlowski, then it is almost impossible to stop them. As long as the frauds are committed by human beings, they will always find a way to go around the rules. Do not misunderstand us, we think that most of the rules that have come are good, and they can help reduce the number of frauds. We think also that the most important thing the authorities can do is to make the rules as good as possible, and contribute to a focus on fraud. If companies and people are aware that these things go on, they may keep an eye open and discover such activity at a much earlier stage. The possibility to commit fraud does not necessarily get more difficult because of the rules themselves, but because the framework sets the focus on fraud. But to think that it is possible to develop a system of rules that can prevent fraud entirely is to believe in the impossible.

As we saw how Rigas and Kozlowski were allowed to behave without anyone bothering them, it shows that no rules in the world could have stopped them. With new rules they may simply have come up with new ways to evade them. With the focus and new rules, there have also come increased penalties for such crimes. With harsher punishment one hopes that fewer people will fall for the temptation to commit fraud. Harsh punishment is also helping making a stand that fraud is not acceptable in our society. By having perpetrators serve longer time in prison, it helps the public to see fraud as a real crime. This also helps to make people who commit fraud think twice before they do the crime; for it is harder to rationalize the act that he thinks is a real crime.

Because of the accounting scandals that took place, the public has lost their trust in the audit firms; therefore the most important job for the audit firms in these recent years has been to regain this trust in the work they do. The focus of the auditor's independence has become more important. Even if it is not the auditor's job to prevent fraud, it is important that they do

their job in the best possible way, and that the public think that they do it. Together with the Board of Directors and the employees of a company, the auditor can be a part of preventing fraud. But for this to happen, it has to be in everybody's best interest to detect the fraud. This means that the auditor has to get rid of the conflict of interest, and the board and the employees has to be motivated to do the right thing.

Fraud is a part of the business world, and we think that there will always be some fraud. By setting the focus on fraud one can reduce its threat. It is important always to have focus and to improve the framework. Doing these things, we are able to hold the situation in place. But as long as someone has the desire to commit fraud, we think that no one or nothing can stop them, just make it a little more difficult.

## FOOTNOTES

<sup>1</sup> Enron was an U.S. energy giant who had fraudulently overstated the company's profitability. The scandal was revealed in 2001, and Enron went bankrupt. The audit firm at the time, Arthur Andersen, had not been objective in its auditing, and it resulted in Arthur Andersen going out of business. They had lost their reputation and had to stop auditing companies. Enron was one of the first big accounting scandals this century which caused the authorities to reconsider the rules and regulations and the auditing companies to reconsider their working practice (Eilifsen et al 2006).

<sup>2</sup> In Tyco there were also three other executives who was charged by the SEC. These were Richard D. Power (Vice President - Special Projects), Edward Federman (Controller and CFO of Tyco Electronics) and Richard J. Heger (principal financial officer of the Fire & Security Services division). Power and Federman were charged for inflating Tyco's operating income by several hundred million dollars through the use of a sham transaction and improper acquisition accounting, and Heger for approving the financial results when he knew, or should have known, that they had been inflated by the sham transaction and improper accounting of the acquisition (SEC Litigation Release No. 19953 2006).

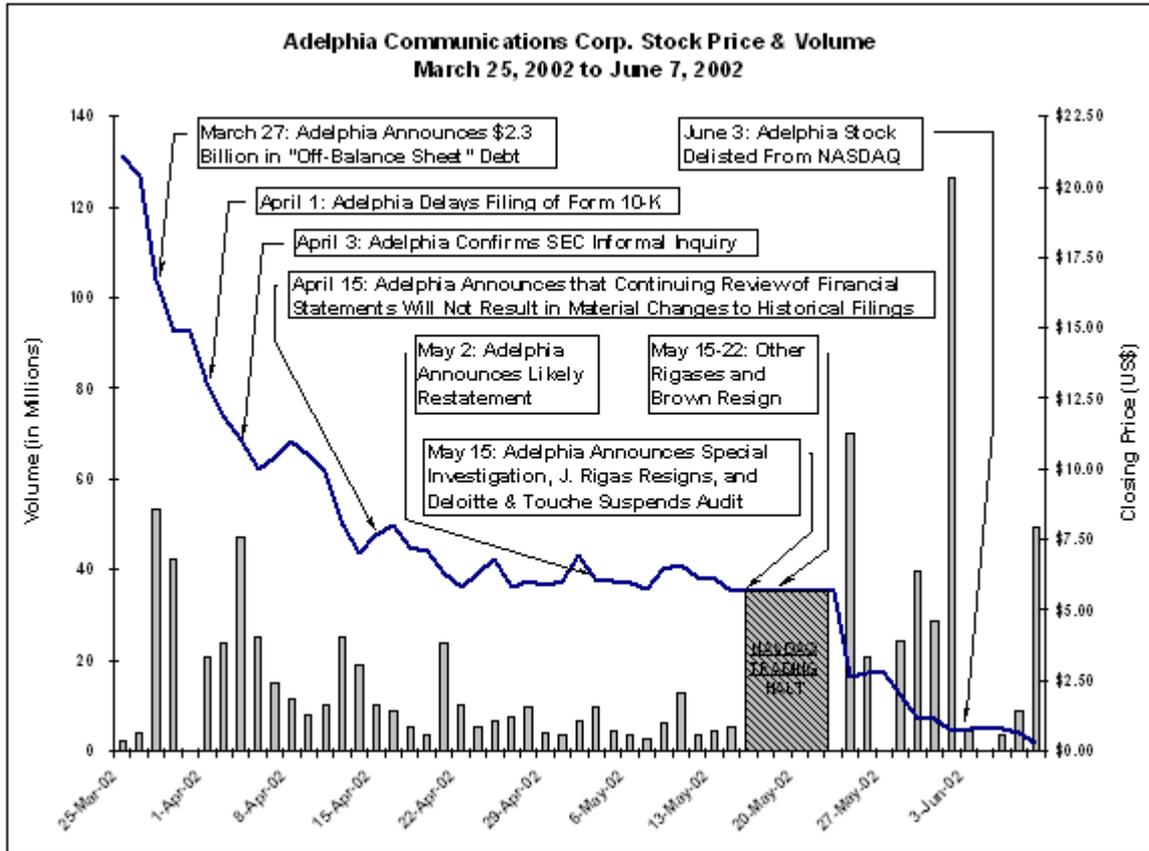
We have not looked at this part of the Tyco scandal in our paper. We have focused on the fraud that involved the CEO, Kozlowski, and those that committed the fraud with him.

<sup>3</sup> John Francis "Jack" Welch, Jr. was Chairman and CEO of General Electric between 1981 and 2001. Welch gained a solid reputation for uncanny business acumen and unique leadership strategies at GE. He remains a highly-regarded figure in business circles due to his innovative management strategies and leadership style (en.wikipedia.org).

<sup>4</sup> WorldCom was also a U.S. based company which was in the telecom business. WorldCom was caught overstating their net income by classifying operating costs as property, plant and equipment. Arthur Andersen was the auditor in WorldCom also, but it was the vice president and head of internal audit that discovered the fraud. After what was going on in Enron she no longer trusted the auditing done by the auditing firm. WorldCom fired their CFO, and told the public that they had inflated their profits. The profits had been overstated with over \$9 billion (Eilifsen et al. 2006).

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Table 1



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