Out Of The Labs

How To Catch A Fraud

Jonathan Fahey, 11.11.09, 06:00 AM EST

New research shows some surprisingly simple ways to sniff out fraudulent companies.

When former **HealthSouth** Chief Executive Richard Scrushy was being tried on fraud charges in 2005, federal prosecutors asked why he wasn't alarmed by the fact that the company's sales were increasing while the number of its facilities was decreasing.

Scrushy's defense argued that, hey, the auditors missed it, too.

Now maybe auditors--and investors--will be able to wise up to this kind of mismatch thanks to new research published in the *Journal of Accounting Research* by a trio of accounting professors from North Carolina State University, Brigham Young University and George Mason University.

Their research shows that when measurements of a company's nonfinancial performance, such as number of employees, amount of warehouse space and number of sales outlets, diverges from a company's financial performance, books could be getting cooked.

Jack Zwingli, chief executive of the research firm Audit Integrity, looks at a whole range of accounting and corporate governance risk measures to come up with ratings on companies that try to predict company troubles. He says part of the difficulty is that fraud isn't perpetrated very often, so it's very hard to predict.

"There's not enough commonality between frauds, so there's no magic formula to predict it," he says. "What we've found is that you have to look at a lot of different things and together they point to an aggressive culture."

BYU's Zimbelman says he hopes that some of the indicators he and his colleagues turned up will be included in models like Zwingli's to make them more useful.

http://www.forbes.com/2009/11/10/financial-accounting-audit-technology-breakthroughs-fraud.html