

The Risk List

Why Corporate Fraud Is On The Rise

James A. Kaplan, 06.10.10, 06:00 PM EDT

Lax boards, equity-linked pay lead to rise in financial wrongdoing.



James A. Kaplan

Newspaper headlines aside, only a fraction of corporate executives who manipulate or misrepresent their companies' performances get exposed by regulators for such misdeeds. My company, Audit Integrity, is in the business of uncovering such wrongdoing because it represents a substantial risk to stakeholders.

A subset of such manipulation and misrepresentation is [securities fraud](#), which itself is so egregious that the Securities and Exchange Commission does prosecute some offenders civilly. An indication of just how common such behavior is appears in a study analyzing fraudulent financial reporting in the decade through 2007 that was recently released by the [Committee of Sponsoring Organizations \(COSO\)](#) of the Treadway Commission.

In Pictures: Retailers At Risk

It is important to note that, while auditors actively support fraud-detection research, they do not guarantee in their audited statements that they will uncover it. That's because auditors believe they too can be misled by clever fraudsters. I understand the auditors' reluctance; material manipulation and misrepresentation are difficult actions to uncover. Turning to the COSO report, the interesting conclusions include these:

- The number of fraud cases increased between 1998 and 2007 in comparison with the level in the prior 10-years studies.
- The dollar value of fraudulent financial reporting soared in the last decade, despite the implementation of the [Sarbanes-Oxley Act](#) of 2002.
- Companies involved in fraud were much larger than those observed in a 1988-1997 study.
- Fraud occurred most frequently in the computer hardware and software industries.
- The [SEC](#) cited a company's chief executive officer and/or chief financial officer for some level of involvement in 89% of fraud cases studied.
- The most common fraud techniques involved improper revenue recognition, followed by overstatement of assets and bogus expense recognition.
- Among firms involved in fraud, 26% changed auditors between the filing of their final clean financial statement and their final fraudulent financial statement. Sixty percent of the firms involved in fraud that changed auditors did so during the period the wrongful reporting was taking place; the remaining 40% changed auditors in the fiscal period just before the fraud began.

--Press reports of an alleged fraud resulted in an average 17% abnormal stock price decline in the two days surrounding the announcement. News of an SEC or Department of Justice investigation resulted in an average 7% abnormal stock price decline.

--Long-term negative consequences of fraud included bankruptcy, de-listing from a stock exchange or material asset sales.

--The most commonly cited motives for fraud included the desire to: meet earnings expectations; conceal the company's deteriorating financial condition; bolster performance for pending equity or debt financing; or to increase management compensation.

--The average period during which fraud occurred was 31 months.

--There appears to be no difference between the number or character of frauds since the passage of Sarbanes-Oxley. (Note: the sample periods after 2002 are shorter than those prior to 2002.)

--Fraudulent firms disclosed significantly more related-party transactions than non-fraudulent firms.

--All 347 firms prosecuted by the SEC for financial fraud during the decade studied received unqualified opinions from their auditors for their final set of misstated financial filings.

--Financial statement fraud sometimes implicated the external auditor.

--The consequences associated with financial statement fraud were severe for the individuals allegedly involved. However, the severity of the penalties may not be a sufficient deterrent, the COSO believes.

--There were few differences in the boards overseeing companies involved in fraud and those that weren't.

Audit Integrity's independent findings largely mirror the COSO's conclusions. From our perspective, four important issues stand out:

1. Fraud continues to increase, despite Sarbanes-Oxley.
2. The motivations continue unabated.
3. The methods of committing financial fraud have not materially changed.
4. Traditional measures of corporate governance have no impact on predicting fraud.

While the COSO study does not categorically state that fraud has increased (or, at least, has not diminished) since the implementation of the [Sarbanes-Oxley Act](#), it does confirm that there is no evidence Sarbanes-Oxley has had any impact on the commission of fraud.

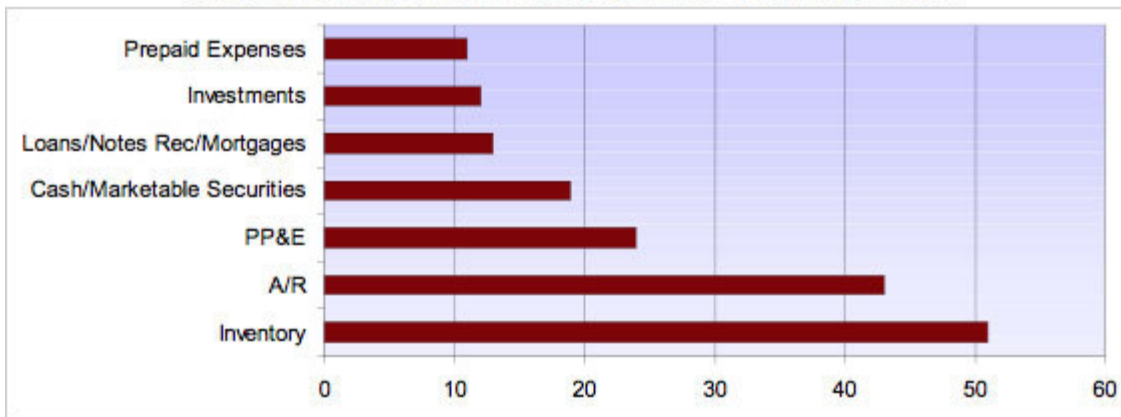
We are highly doubtful that additional analysis would show any decline in the fraud rate. As mentioned in the COSO report, 89% of the fraud cases implicate the CEO and/or CFO. Sarbanes-Oxley's primary focus is on establishing more rigorous internal controls (Reg. 404); those controls are targeted at multiple levels of management but only indirectly at the C-suite. The board of directors is responsible for protecting stakeholders; it is our opinion that until corporate directors are held to a higher standard, fraud will continue regardless of the rigor of internal controls.

In fact, the motivation for committing fraud by manipulating financial information has been increasing since SarbOx was enacted. CEOs' and CFOs' biggest incentive to "cross the line" is to maximize their own compensation. And that incentive has gotten ever bigger as the percentage of pay linked to stock prices has increased.

As the economy has faced mounting stress, many companies have been feeling pressure merely to survive. This pressure may lead to fraudulent behavior to mask decaying operations, the COSO points out.

The COSO and our analysis concur that the methods of committing fraud remain unchanged: The majority of the fraud metrics included in Audit Integrity's Accounting and Governance Risk (AGR) model have remained relatively stable over the past decade.

Number of Fraud Cases With Asset Accounts Misstated



Common Financial Statement Fraud Techniques

347 Fraud Companies 1998-2007

Methods Used to Misstate Financial Statements

Improper revenue recognition	61%
Recording fictitious revenues – 48%	
Recording revenues prematurely – 35%	
No description/“overstated” – 2%	
Overstatement of assets (excluding accounts receivable overstatements due to revenue fraud):	51%
Overstating existing assets or capitalizing expenses – 46%	
Recording fictitious assets or assets not owned – 11%	
Understatement of expenses/liabilities	31%
Misappropriation of assets	14%
Inappropriate disclosure (with no financial statement line item effects)	1%
Other miscellaneous techniques (acquisitions, joint ventures, netting of amounts, etc.)	20%
Disguised through use of related party transactions	18%
Insider trading also cited	24%

The subcategories such as premature revenues or fictitious revenues and assets do not sum to the category totals due to multiple types of fraud employed at a single company. Also, because the financial statement frauds at the sample companies often involved more than one fraud technique, the sum of the percentages reported exceeds 100 percent.

To avoid double-counting, the information about the overstatement of assets does not include overstatements of accounts receivable due to the revenue recognition frauds.

Revenue recognition, asset/liability valuation and expense recognition are the keystones of the AGR model.

It is interesting to note that insider trading was involved in 24% of the cases; insider trading is a key high-risk metric in assessing potential fraud.

In contrast, board composition resulted in no significant difference in the prevalence of fraud, the COSO found. Audit Integrity's research likewise indicates that board composition plays a very small part in predicting fraud.

We do, however, believe certain governance metrics that are independent of accounting metrics do have an impact. These include frequent amendments to financial filings; boards chaired by the CEO; prevalence of incentive pay vs. annual pay for the CEO and CFO; a high ratio of CEO to CFO total pay; large volumes of stock sales by top executives, relative to market capitalization; frequent legal and regulatory issues; and frequent officer changes.

Among the important conclusions that could be used to curb future fraudulent activity are the following:

--Fraud will persist until boards of directors are held more accountable for their actions.

--If the economy remains under pressure, fraud will continue to increase.

--The 347 cases of fraud prosecuted by the SEC between 1998 and 2007 represent a small number and a nadir during which a blind eye was often turned to fraudulent activity. Under Chairman Mary Shapiro, the SEC appears to have "found its legs." We believe the number of enforcement actions will increase substantially in the coming years.

--The 347 companies prosecuted in the decade through 2007 represent a small fraction of the number of financial fraud cases that occurred. Very few frauds result in SEC enforcement action; many more are adjudicated by class actions. Most are recorded only in stakeholder disappointment, large price drops, bond defaults and insolvency.

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<http://www.forbes.com/2010/06/10/corporate-fraud-executive-compensation-personal-finance-risk-list-2-10-kaplan.html>