COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION

Fraudulent Financial Reporting: 1987-1997 — An Analysis of U.S. Public Companies

SECTION I

Executive Summary and Introduction

Fraudulent financial reporting can have significant consequences for the organization and for public confidence in capital markets. Periodic high profile cases of fraudulent financial reporting raise concerns about the credibility of the U.S. financial reporting process and call into question the roles of auditors, regulators, and analysts in financial reporting.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) sponsored this research project to provide an extensive updated analysis of financial statement fraud occurrences. While the work of the National Commission on Fraudulent Financial Reporting in the mid-1980s identified numerous causal factors believed to contribute to financial statement fraud, little empirical evidence exists about factors related to instances of fraud since the release of the 1987 report (NCFFR, 1987). Thus, COSO commissioned this research project to provide COSO and others with information that can be used to guide future efforts to combat the problem of financial statement fraud and to provide a better understanding of financial statement fraud cases.

This research has three specific objectives:

1. To identify instances of alleged fraudulent financial reporting by registrants of the U.S. Securities and Exchange Commission (SEC) first described by the SEC in an Accounting and Auditing Enforcement Release (AAER) issued during the period 1987-1997.

2. To examine certain key company and management characteristics for a sample of these companies involved in instances of financial statement fraud.

3. To provide a basis for recommendations to improve the corporate financial reporting environment in the U.S.

We analyzed instances of fraudulent financial reporting alleged by the SEC in AAERs issued during the 11-year period between January 1987 and December 1997. The AAERs, which contain summaries of enforcement actions by the SEC against public companies, represent one of the most comprehensive sources of alleged cases of financial statement fraud in the United States. We focused on AAERs that involved an alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 17(a) of the 1933 Securities Act given that these represent the primary antifraud provisions related to financial statement reporting. Our focus was on cases that clearly involved financial statement fraud. We excluded from our analysis restatements of financial statements due to errors or earnings management activities that did not result in a violation of the federal antifraud statutes.

Our search identified nearly 300 companies involved in alleged instances of fraudulent financial reporting during the 11-year period. From this list of companies, we randomly selected approximately 200 companies to serve as the final sample that we examined in detail. Findings reported in this study are based on information we obtained from our reading of (a) AAERs related to each of the sample fraud companies, (b) selected Form 10-Ks filed before and during the period the alleged financial statement fraud occurred, (c) proxy statements issued during the alleged fraud period, and (d) business press articles about the sample companies after the fraud was disclosed.

Summary of Findings

Several key findings can be generalized from this detailed analysis of our sample of approximately 200 financial statement fraud cases. We have grouped these findings into five categories describing the nature of the companies involved, the nature of the control environment, the nature of the frauds, issues related to the external auditor, and the consequences to the company and the individuals allegedly involved.

Nature of Companies Involved

1. Relative to public registrants, companies committing financial statement fraud were relatively small. The typical size of most of the sample companies ranged well below $100 million in total assets in the year preceding the fraud period. Most companies (78 percent of the sample) were not listed on the New York or American Stock Exchanges.

2. Some companies committing the fraud were experiencing net losses or were in close to breakeven positions in periods before the fraud. Pressures of financial strain or distress may have provided incentives for fraudulent activities for some fraud companies. The lowest quartile of companies indicates that they were in a net loss position, and the median company had net income of only $175,000 in the year preceding the first year of the fraud period. Some companies were experiencing downward trends in net income in periods preceding the first fraud period, while other companies were experiencing upward trends in net income. Thus, the subsequent frauds may have been designed to reverse downward spirals for some companies and to preserve upward trends for others.

Nature of the Control Environment (Top Management and the Board)

1. Top senior executives were frequently involved. In 72 percent of the cases, the AAERs named the chief executive officer (CEO), and in 43 percent the chief financial officer (CFO) was associated with the financial statement fraud. When considered together, in 83 percent of the cases, the AAERs named either or both the CEO or CFO as being associated with the financial statement fraud. Other individuals named in several AAERs include controllers, chief operating officers, other senior vice presidents, and board members.

2. Most audit committees only met about once a year or the company had no audit committee. Audit committees of the fraud companies generally met only once per year. Twenty-five percent of the companies did not have an audit committee. Most audit committee members (65 percent) did not appear to be certified in accounting or have current or prior work experience in key accounting or finance positions.

3. Boards of directors were dominated by insiders and "gray" directors with significant equity ownership and apparently little experience serving as directors of other companies. Approximately 60 percent of the directors were insiders or "gray" directors (i.e., outsiders with special ties to the company or management). Collectively, the directors and officers owned nearly one-third of the companies' stock, with the CEO/president personally owning about 17 percent. Nearly 40 percent of the boards had not one director who served as an outside or gray director on another company's board.

4. Family relationships among directors and/or officers were fairly common, as were individuals who apparently had significant power. In nearly 40 percent of the companies, the proxy provided evidence of family relationships among the directors and/or officers. The founder and current CEO were the same person or the original CEO/president was still in place in nearly half of the companies. In over 20 percent of the companies, there was evidence of officers holding incompatible job functions (e.g., CEO and CFO).

Nature of the Frauds

1. Cumulative amounts of frauds were relatively large in light of the relatively small sizes of the companies involved. The average financial statement misstatement or misappropriation of assets was $25 million and the median was $4.1 million. While the average company had assets totaling $533 million, the median company had total assets of only $16 million.

2. Most frauds were not isolated to a single fiscal period. Most frauds overlapped at least two fiscal periods, frequently involving both quarterly and annual financial statements. The average fraud period extended over 23.7 months, with the median fraud period extending 21 months. Only 14 percent of the sample companies engaged in a fraud involving fewer than 12 months.

3. Typical financial statement fraud techniques involved the overstatement of revenues and assets. Over half the frauds involved overstating revenues by recording revenues prematurely or fictitiously. Many of those revenue frauds only affected transactions recorded right at period end (i.e., quarter end or year end). About half the frauds also involved overstating assets by understating allowances for receivables, overstating the value of inventory, property, plant and equipment and other tangible assets, and recording assets that did not exist.

Issues Related to the External Auditor

1. All sizes of audit firms were associated with companies committing financial statement frauds. Fifty-six percent of the sample fraud companies were audited by a Big Eight/Six auditor during the fraud period, and 44 percent were audited by non-Big Eight/Six auditors.

2. All types of audit reports were issued during the fraud period. A majority of the audit reports (55 percent) issued in the last year of the fraud period contained unqualified opinions. The remaining 45 percent of the audit reports issued in the last year of the fraud departed from the standard unqualified auditor's report because they addressed issues related to the auditor's substantial doubt about going concern, litigation and other uncertainties, changes in accounting principles, and changes in auditors between fiscal years comparatively reported. Three percent of the audit reports were qualified due to a GAAP departure during the fraud period.

3. Financial statement fraud occasionally implicated the external auditor. Auditors were explicitly named in the AAERs for 56 of the 195 fraud cases (29 percent) where AAERs explicitly named individuals. They were named for either alleged involvement in the fraud (30 of 56 cases) or for negligent auditing (26 of 56 cases). Most of the auditors explicitly named in an AAER (46 of 56) were non-Big Eight/Six auditors.

4. Some companies changed auditors during the fraud period. Just over 25 percent of the companies changed auditors during the time frame beginning with the last clean financial statement period and ending with the last fraud financial statement period. A majority of the auditor changes occurred during the fraud period (e.g., two auditors were associated with the fraud period) and a majority involved changes from one non-Big Eight/Six auditor to another non-Big Eight/Six auditor.

Consequences for the Company and Individuals Involved

1. Severe consequences awaited companies committing fraud. Consequences of financial statement fraud to the company often include bankruptcy, significant changes in ownership, and delisting by national exchanges, in addition to financial penalties imposed. A large number of the sample firms (over 50 percent) were bankrupt/defunct or experienced a significant change in ownership following disclosure of the fraud. Twenty-one percent of the companies were delisted by a national stock exchange.

2. Consequences associated with financial statement fraud were severe for individuals allegedly involved. Individual senior executives were subject to class action legal suits and SEC actions that resulted in financial penalties to the executives personally. A significant number of individuals were terminated or forced to resign from their executive positions. However, relatively few individuals explicitly admitted guilt or eventually served prison sentences.

Summary of Implications

The research team analyzed the results to identify implications that might be relevant to senior managers, board of director and audit committee members, and internal and external auditors. The implications reflect the judgment and opinions of the research team, developed from the extensive review of information related to the cases involved. Hopefully the presentation of these implications will lead to the consideration of changes that can promote higher quality financial reporting. The following implications are noted:

Implications Related to the Nature of the Companies Involved

1. The relatively small size of fraud companies suggests that the inability or even unwillingness to implement cost-effective internal controls may be a factor affecting the likelihood of financial statement fraud (e.g., override of controls is easier). Smaller companies may be unable or unwilling to employ senior executives with sufficient financial reporting knowledge and experience. Boards, audit committees, and auditors need to challenge management to ensure that a baseline level of internal control is present.

2. The national stock exchanges and regulators should evaluate the trade-offs of designing policies that might exempt small companies, given the relatively small size of the companies involved in financial statement fraud. A regulatory focus on companies with market capitalization in excess of $200 million may fail to target companies with greater risk for financial statement fraud activities.

3. Given that some of the fraud firms were experiencing financial strain in periods preceding the fraud, effective monitoring of the organization's going-concern status is warranted, particularly as auditors consider new clients. In addition, the importance of effective communications with predecessor auditors is highlighted by the fact that several observations of auditor changes were noted during the fraud period.

Implications Related to the Nature of the Control Environment (Top Management and the Board)

1. The importance of the organization's control environment cannot be overstated, as emphasized in COSO's Internal Control – Integrated Framework (COSO, 1992). Monitoring the pressures faced by senior executives (e.g., pressures from compensation plans, investment community expectations, etc.) is critical. The involvement of senior executives who are knowledgeable of financial reporting requirements, particularly those unique to publicly traded companies, may help to educate other senior executives about financial reporting issues and may help to restrain

senior executives from overly aggressive reporting. In other cases, however, board members and auditors should be alert for deceptive managers who may use that knowledge to disguise a fraud.

2. The concentration of fraud among companies with under $50 million in revenues and with generally weak audit committees highlights the importance of rigorous audit committee practices, even for smaller organizations. In particular, the number of audit committee meetings per year and the financial expertise of the audit committee members may deserve closer attention.

3. It is important to consider whether smaller companies should focus heavily on director independence and expertise, like large companies are currently being encouraged to do. In the smaller company setting, due to the centralization of power in a few individuals, it may be especially important to have a solid monitoring function performed by the board.

4. An independent audit committee's effectiveness can be hindered by the quality and extent of information it receives. To perform effective monitoring, the audit committee needs access to reliable financial and nonfinancial information, industry and other external benchmarking data, and other comparative information that is prepared on a consistent basis. Boards and audit committees should work to obtain from senior management and other information providers relevant and reliable data to assist them in monitoring the financial reporting process.

5. Investors should be aware of the possible complications arising from family relationships and from individuals (founders, CEO/board chairs, etc.) who hold significant power or incompatible job functions. Due to the size and nature of the sample companies, the existence of such relationships and personal factors is to be expected. It is important to recognize that such conditions present both benefits and risks.

Implications Related to the Nature of the Frauds

1. The multi-period aspect of financial statement fraud, often beginning with the misstatement of interim financial statements, suggests the importance of interim reviews of quarterly financial statements and the related controls surrounding interim financial statement preparation, as well as the benefits of continuous auditing strategies.

2. The nature of misstatements affecting revenues and assets recorded close to or as of the fiscal period end highlights the importance of effective consideration and testing of internal control related to transaction cutoff and asset valuation. Based on the assessed risk related to internal control, the auditor should evaluate the need for substantive testing procedures to reduce audit risk to an acceptable level and design tests in light of this consideration. Procedures affecting transaction cutoff, transactions terms, and account valuation estimation for end-of-period accounts and transactions may be particularly relevant.

Implications Regarding the Roles of External Auditors

1. There is a strong need for the auditor to look beyond the financial statements to understand risks unique to the client's industry, management's motivation toward aggressive reporting, and client internal control (particularly the tone at the top), among other matters. As auditors approach the audit, information from a variety of sources should be considered to establish an appropriate level of professional skepticism needed for each engagement.

2. The auditor should recognize the potential likelihood for greater audit risk when auditing companies with weak board and audit committee governance.

Overview of Report

The remainder of this report is organized as follows. Section II provides a description of the approach we took to identify the sample cases of fraudulent financial reporting and contains a summary of the sources we used to gather data related to each sample case. Section III contains a summary of the results from our detailed analysis of approximately 200 cases of fraudulent financial reporting.

The detailed analysis of findings from this examination of fraudulent financial reporting violations produced numerous insights for further consideration. Section IV highlights those insights that have implications applicable to senior managers, board of director and audit committee members, and internal and external auditors. Section V provides a historical perspective on efforts related to financial statement fraud that have occurred since the issuance of the Treadway Commission's 1987 report (NCFFR, 1987). That section highlights numerous efforts by a variety of organizations related to the roles of external auditors, management, boards of directors, and audit committees.

Section VI provides an overview of significant findings from academic research that has been conducted since the late 1980s. This overview provides a summary of key insights coming from academic literature that provide additional perspective on the financial statement fraud problem.

We are confident that this report, Fraudulent Financial Reporting: 1987-1997, will prove helpful to parties concerned with corporate financial reporting. We hope it will stimulate greater awareness of opportunities for improvements in the corporate financial reporting process.