



The Committee of Sponsoring Organizations of the Treadway Commission

Overview of COSO Research Study

Fraudulent Financial Reporting: 1998-2007, An Analysis of U.S. Public Companies

by

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Agenda

- About COSO and its Mission
- Purpose of Research Study
- Research Approach
- Findings and Insights
- Next Steps



About COSO

- Formed in 1985
 - To sponsor the National Commission on Fraudulent Financial Reporting (i.e., Treadway Commission)
- A voluntary private sector organization
- Sponsors:
 - American Accounting Association (AAA)
 - American Institute of Certified Public Accountants (AICPA)
 - Financial Executives International (FEI)
 - Institute of Management Accountants (IMA)
 - The Institute of Internal Auditors (IIA)





COSO's Mission

“to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations.”



1987: Treadway Commission Report

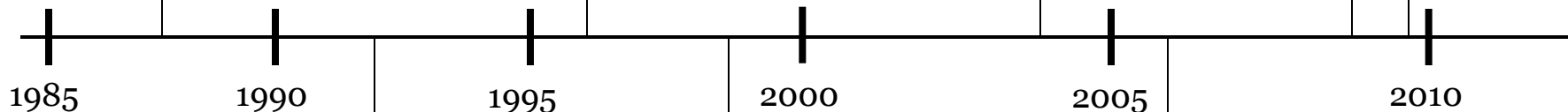
1996: Internal Control Issues in Derivatives

2004: Enterprise Risk Management Framework



2009: Guidance on Monitoring Internal Control Systems

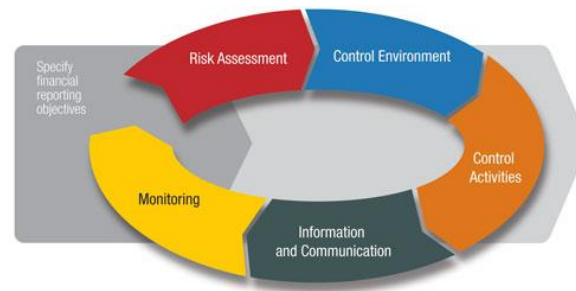
2009: ERM Thought Papers



1999: Fraud Study I - Fraudulent Financial Reporting: 1987-1997

2006: Guidance for Smaller Businesses on Internal Control over Financial Reporting

1992: Internal Control Framework





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Purpose of Current Study

- Update understanding of fraudulent financial reporting since 1997
 - Builds upon COSO's 1999 *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*
- Same team of researchers as 1999 study – plus Terry Neal and 19 graduate students
- Examine findings for insights relevant to financial reporting for U.S. public companies
 - Benchmark with similar no-fraud firms



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Research Approach

- Identified fraud cases from SEC's AAERs
 - AAERs issued January 1, 1998 – December 31, 2007
 - 1,759 AAERs analyzed
 - Rule 10-b(5) or Section 17(a) violations
 - 347 companies allegedly involved in fraud, versus 294 in 1987-1997
- Analyzed AAERs for information
 - Nature of fraud – size, technique, length, etc.
 - Individuals involved – titles, motivations, etc.
- Gathered information from F/S, proxies, and press

Research Approach

- Matched fraud companies with similar no-fraud companies (year, exchange, industry, size)
 - Compared governance characteristics
 - Board, audit committee, compensation committee
 - Auditor characteristics
 - Compared subsequent consequences
 - Subsequent impact to companies
 - CEO and CFO turnover, indictments, convictions



Key Findings

- Nature of Fraud Companies
 - Median assets and revenues just under \$100 M
 - Median close to breakeven prior to fraud
 - Stock trading – 50% on NASDAQ
 - Variety of industries

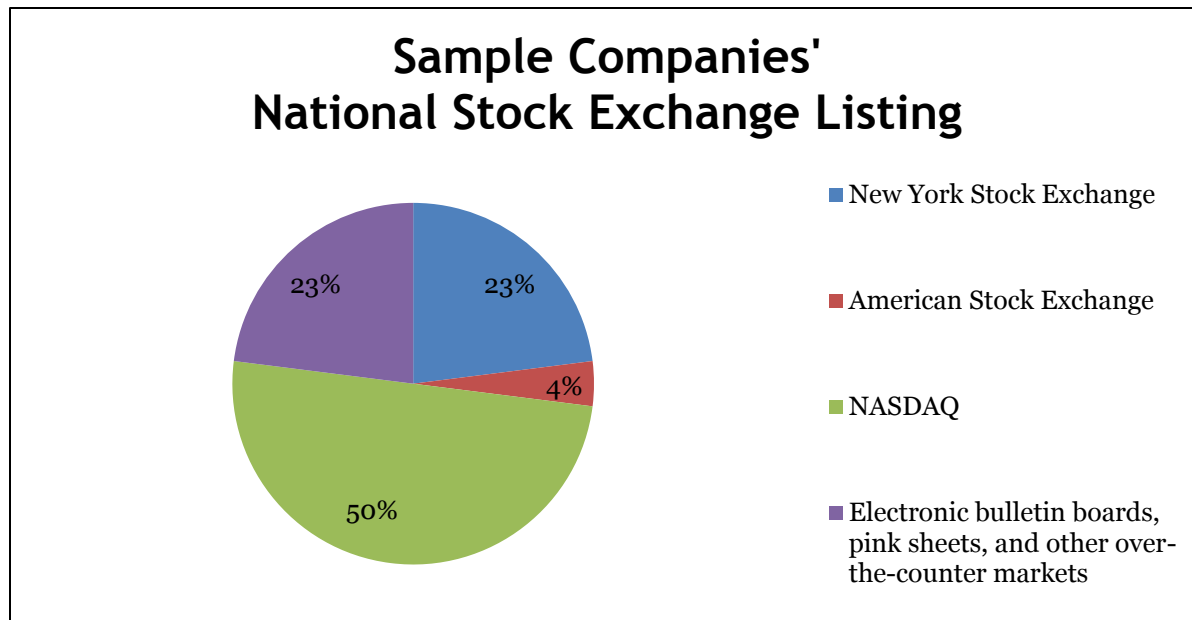


**Table 1: Financial Profile of Sample Companies (in \$000's)
Last Financial Statements Prior to Beginning of Fraud Period**

	Mean	Median
Total Assets	\$5,771,693	\$93,112
Revenues	\$2,557,298	\$72,360
Stockholders' Equity	\$1,000,508	\$39,457
Net Income	\$140,097	\$875
Cash Flow From Operations	\$246,332	\$317



**Table 2: Sample Companies' National Stock Exchange Listing
(n = 313 with Available Information)**



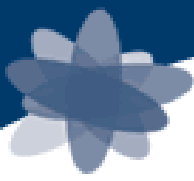
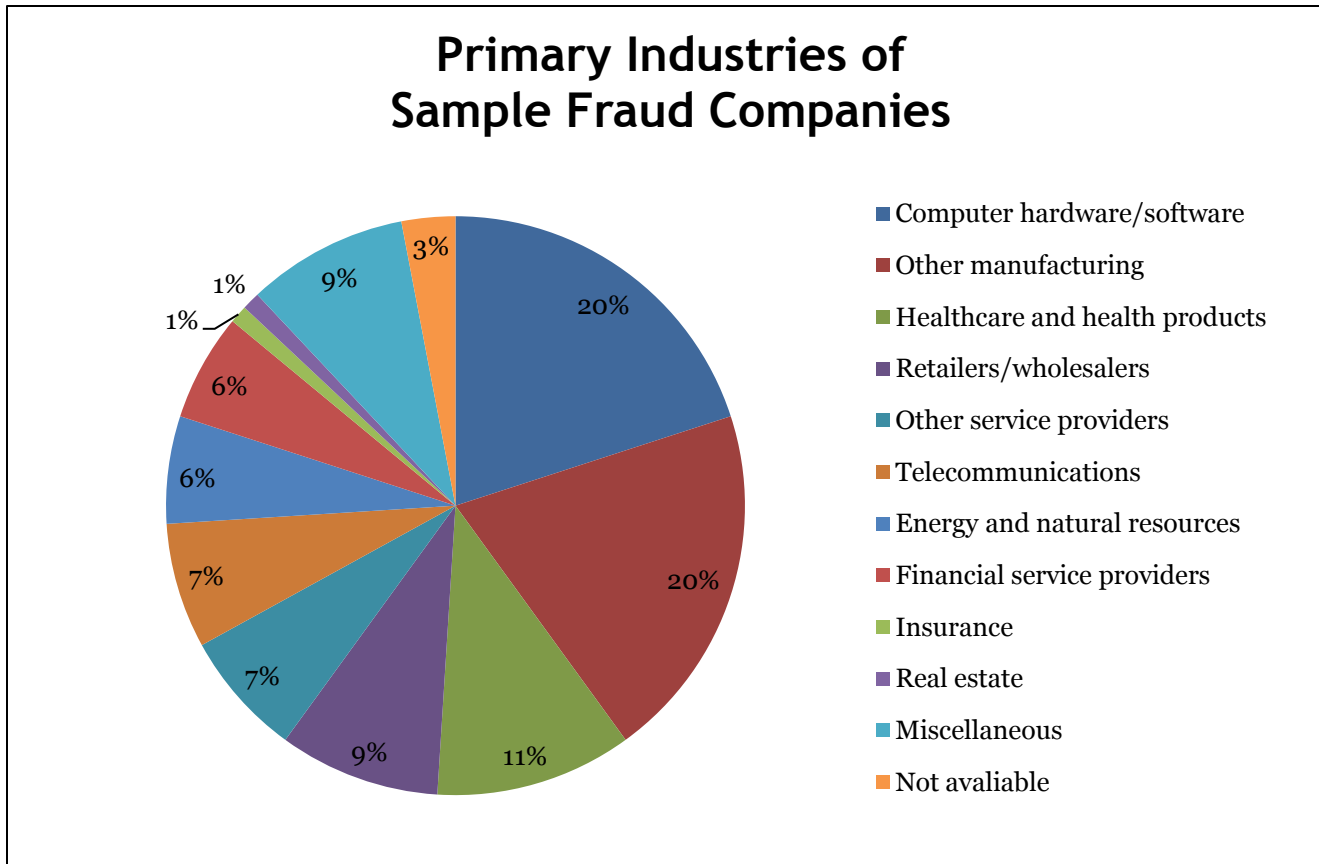


Table 3: Primary Industries of Sample Fraud Companies





Key Findings

- Alleged Perpetrators
 - 89% of cases – CEO and/or CFO named
 - Motivations include meeting expectations, concealing deteriorating financial condition, preparing for debt/equity offering

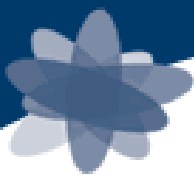
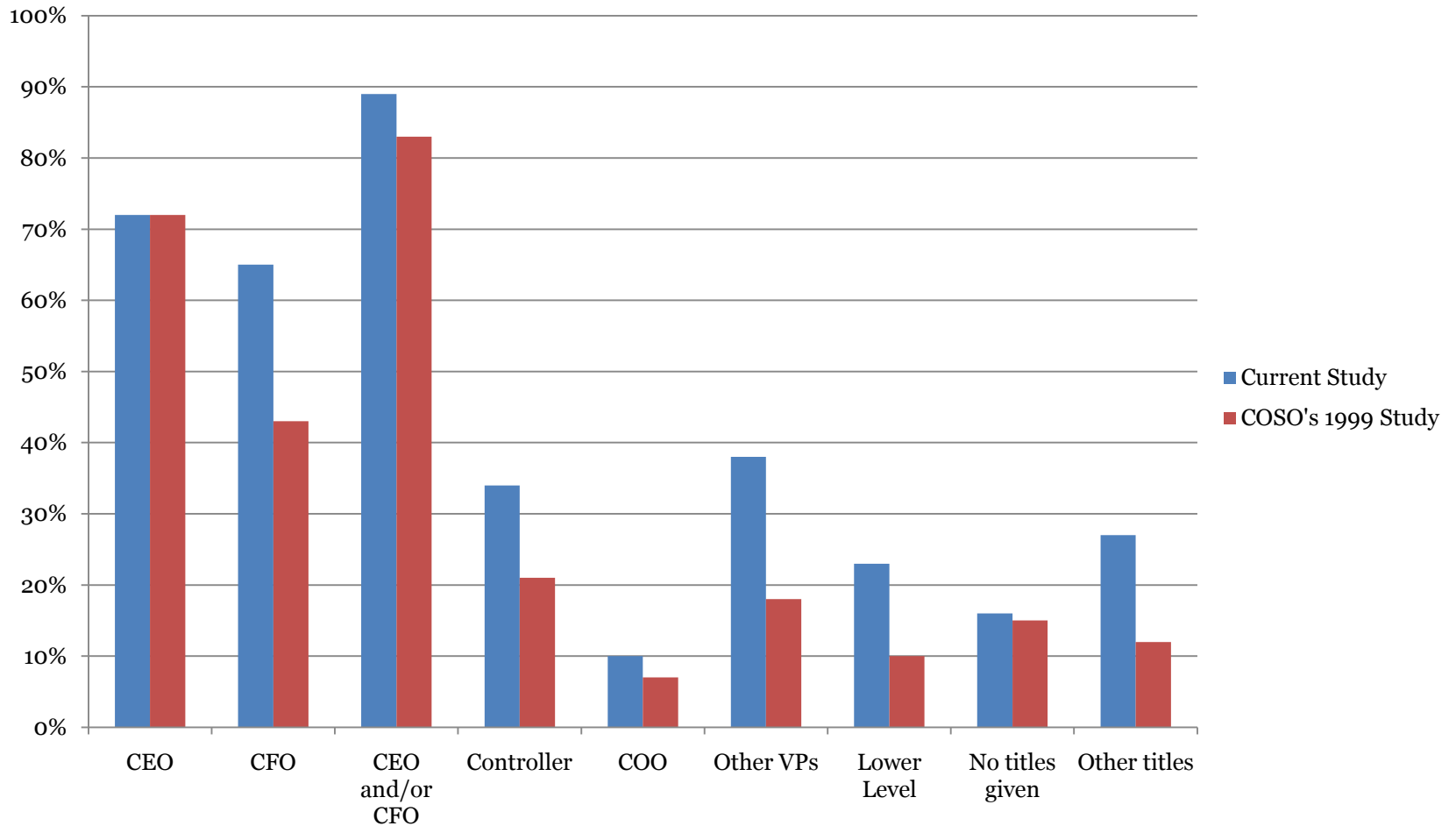


Table 5: Types and Frequencies of Individuals Named in AAERs





Key Findings

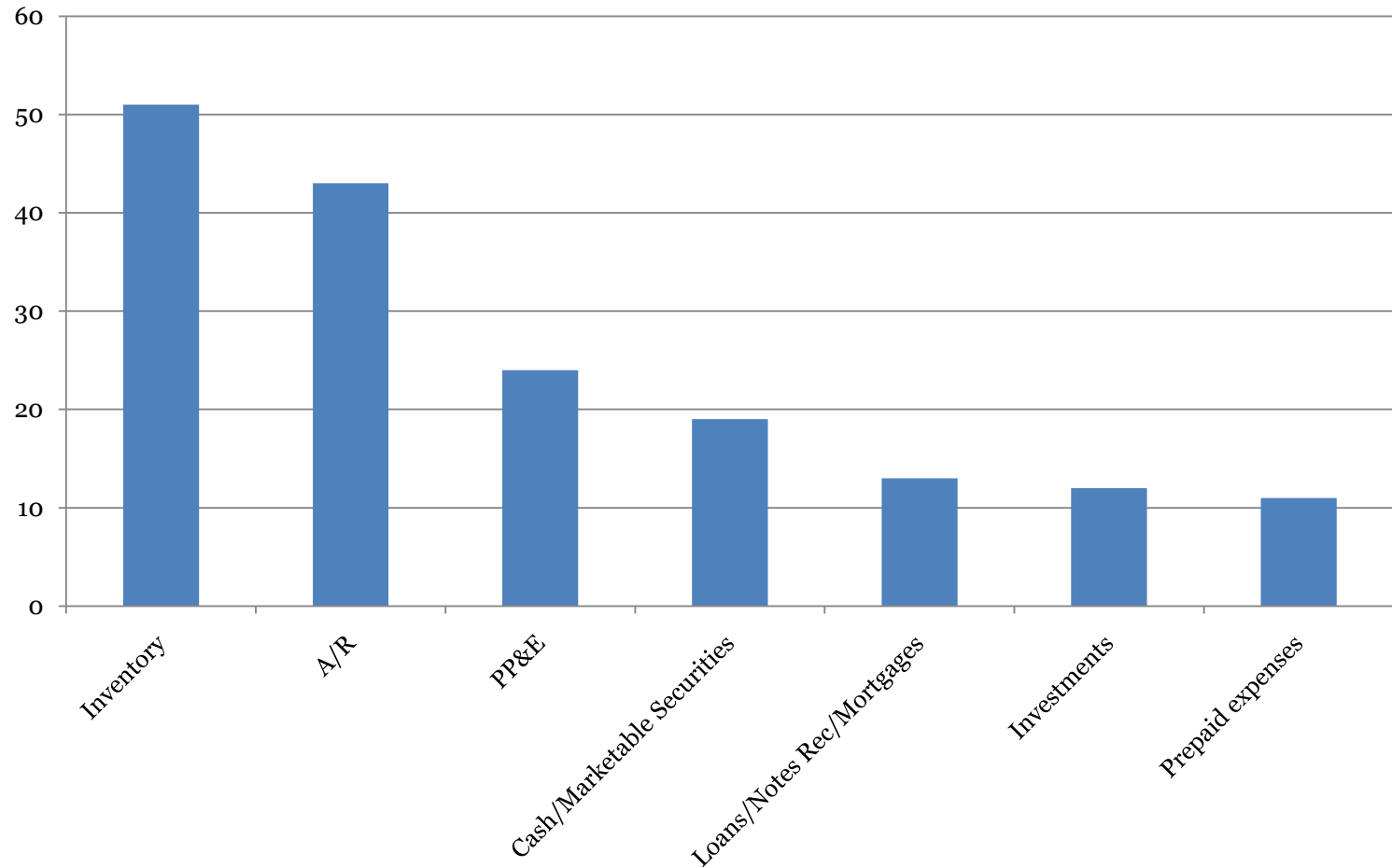
- Nature of Fraud
 - Median fraud \$12 M, mean fraud \$400 M
 - Average length about 2.5 years, median 2.0 years
 - 61% involve revenue recognition
 - Variety of techniques – fictitious, premature
 - 51% overstated assets
 - Overvaluing existing assets (often inventory and A/R)
 - Capitalizing expenses
 - Misappropriation of assets – 14%
 - Most precede SOX due to AAER time lag

Table 9: Common Financial Statement Fraud Techniques

Methods Used to Misstate Financial Statements	Percentage of the 347 Fraud Companies Using Fraud Method
Improper revenue recognition	61%
Overstatement of assets	51%
Understatement of expenses/liabilities	31%
Misappropriation of assets	14%
Inappropriate disclosure	1%
Other miscellaneous techniques	20%
Disguised through the use of related party transactions	18%
Insider trading also cited	24%



Table 10: Number of Fraud Cases With Asset Accounts Misstated





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Key Findings

- Role of Board of Directors
 - Overall, few major differences between fraud and no-fraud firms
 - Similar in size, percentage of outsiders, levels of ownership, CEO as Chair as no-fraud firms
 - Almost all fraud companies had audit committees with similar size and similar number of meetings as no-fraud firms
 - Most have compensation committees
 - Some differences opposite of expectations – financial expertise
 - Some statistical differences, but appear to have few meaningful differences



Board of Directors

	Fraud Sample	No-Fraud Sample
Number of Board members	7.7	8.0
<i>Type of Board member:</i>		
Grey director	10%	12%
Outside director	60%	63%
Board members with accounting or finance expertise	11%	9%
Companies with at least 1 accounting or finance expert on Board	57%	51%
<i>Type of Board chair:</i>		
Inside director	75%	70%
Number of Board meetings per year	7.7	6.6



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Audit Committee

	Fraud Sample	No-Fraud Sample
Existence of an audit committee	95%	98%
# of individuals on audit committee	3.1	3.2
<i>Type of audit committee member:</i>		
Outside director	84%	87%
# of audit committee meetings per year	3.5	3.7
Percentage of audit committees with at least 1 accounting or finance expert	34%	28%



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Compensation Committee

	Fraud Sample	No-Fraud Sample
Existence of compensation committee	88%	94%
# of individuals on compensation committee	3.1	3.2
<i>Type of compensation committee member:</i>		
Outside director	85%	88%
# of compensation committee meetings per year	3.3	3.2



Table 20: Related Party Transactions

	Percentage of Companies with Related Party Transactions Disclosed in the Proxy
Fraud Sample	79%
No-Fraud Sample	71%

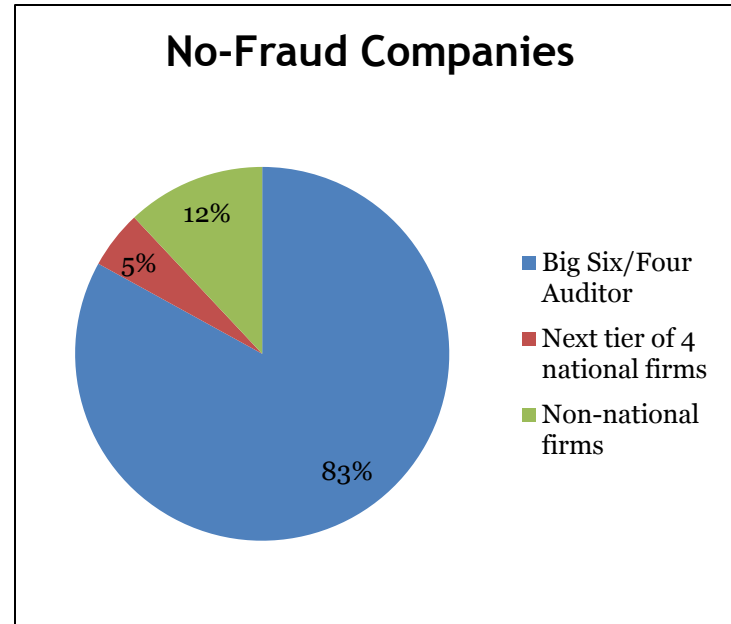
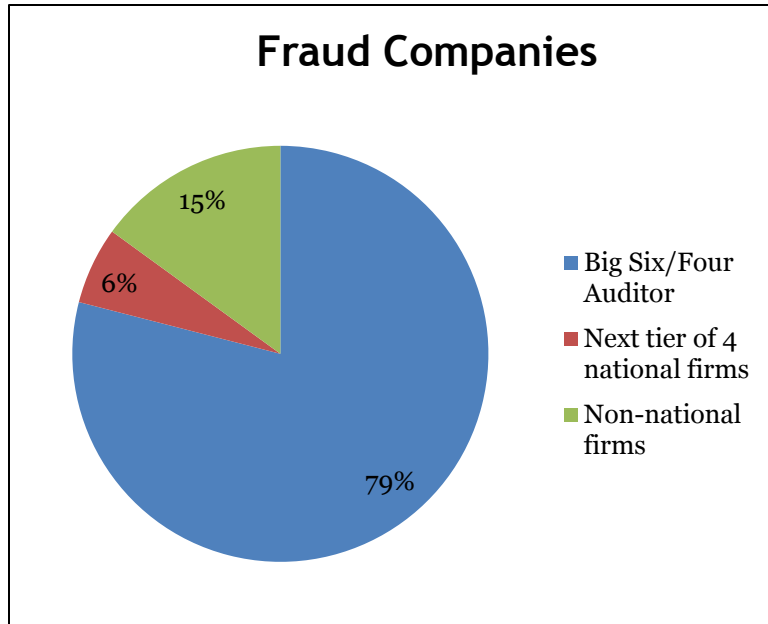


Key Findings

- Auditor Characteristics
 - Mostly Big N auditors
 - Higher percentage of fraud firm audit reports were unqualified opinion with explanatory paragraph
 - 56% for fraud firms vs. 36% for no-fraud firms
 - Limited analysis of SOX 404 reports
 - Rate of auditor changes surrounding fraud period twice the rate of change for no-fraud firms
 - Auditor named in 23% of fraud cases
 - 32 of 83 cases – auditor charged with violating anti-fraud statutes or aiding/abetting violators
 - Smaller auditors named more often



Table 21: Size of Audit Firms Issuing Reports





**Table 23: Analysis of Section 404 Internal Control Opinions
(n = 22 company years)**

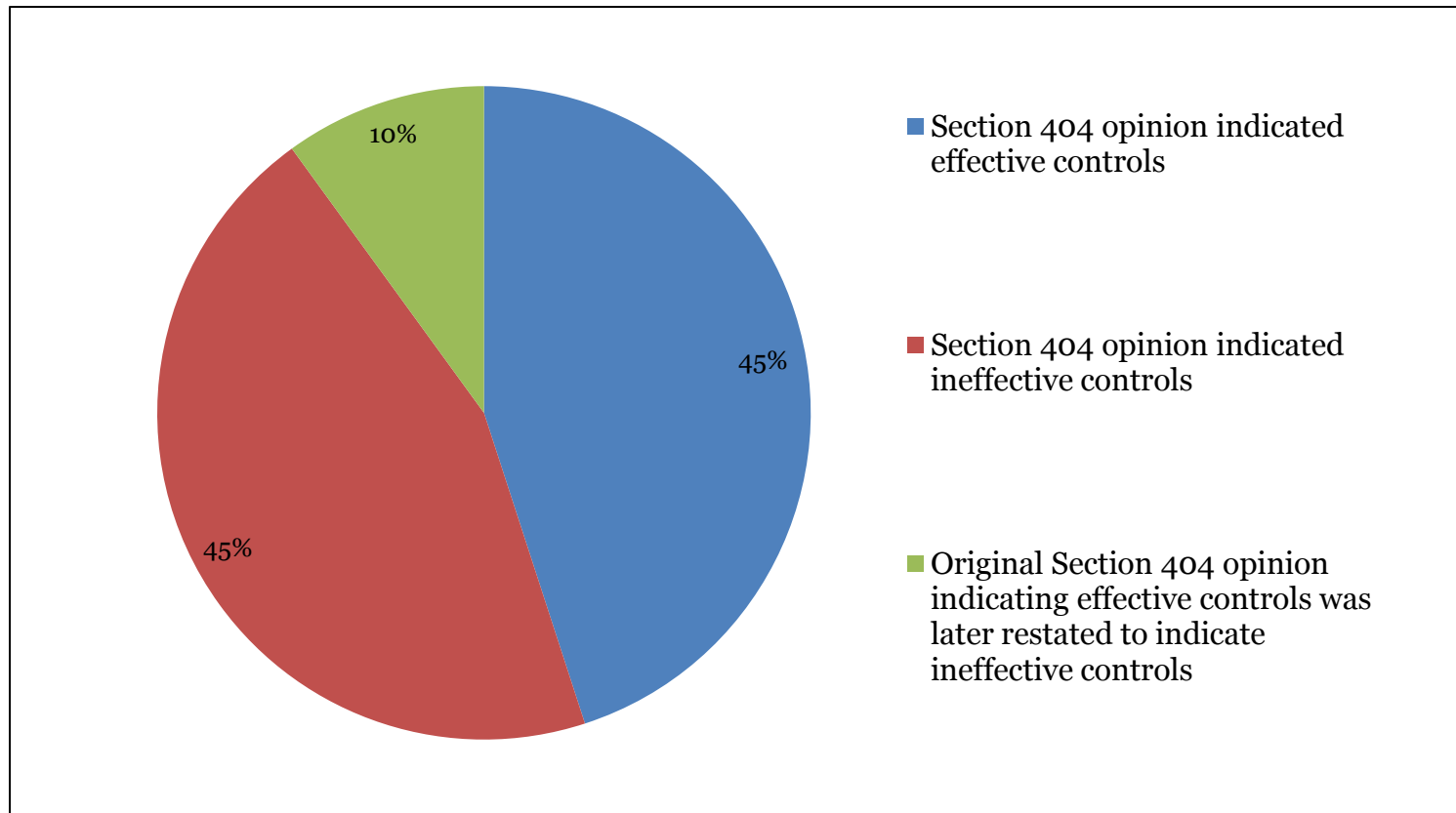
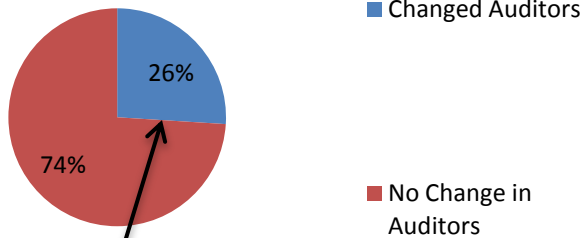




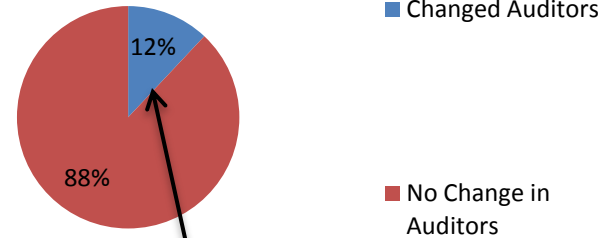
Table 25: Auditor Changes

Fraud Companies



26% Changed Auditors

No-Fraud Companies



12% Changed Auditors



Key Findings

- Consequences

- Variety of SEC sanctions – bars, fines, disgorgements
- 16.7% average negative abnormal stock return on initial fraud announcement
 - 7.3% average negative abnormal stock return on announcement of government investigation
- Fraud firms suffer higher rates of adverse financial outcomes than no-fraud firms – bankruptcy, delisting, material asset sales
- CEO and CFO turnover for fraud firms much higher than no-fraud firms
- Approximately 20% of fraud firm CEOs and CFOs were indicted, and over 60% of those indicted were convicted



Table 26: SEC Consequences Based on AAER Information (n = 347)

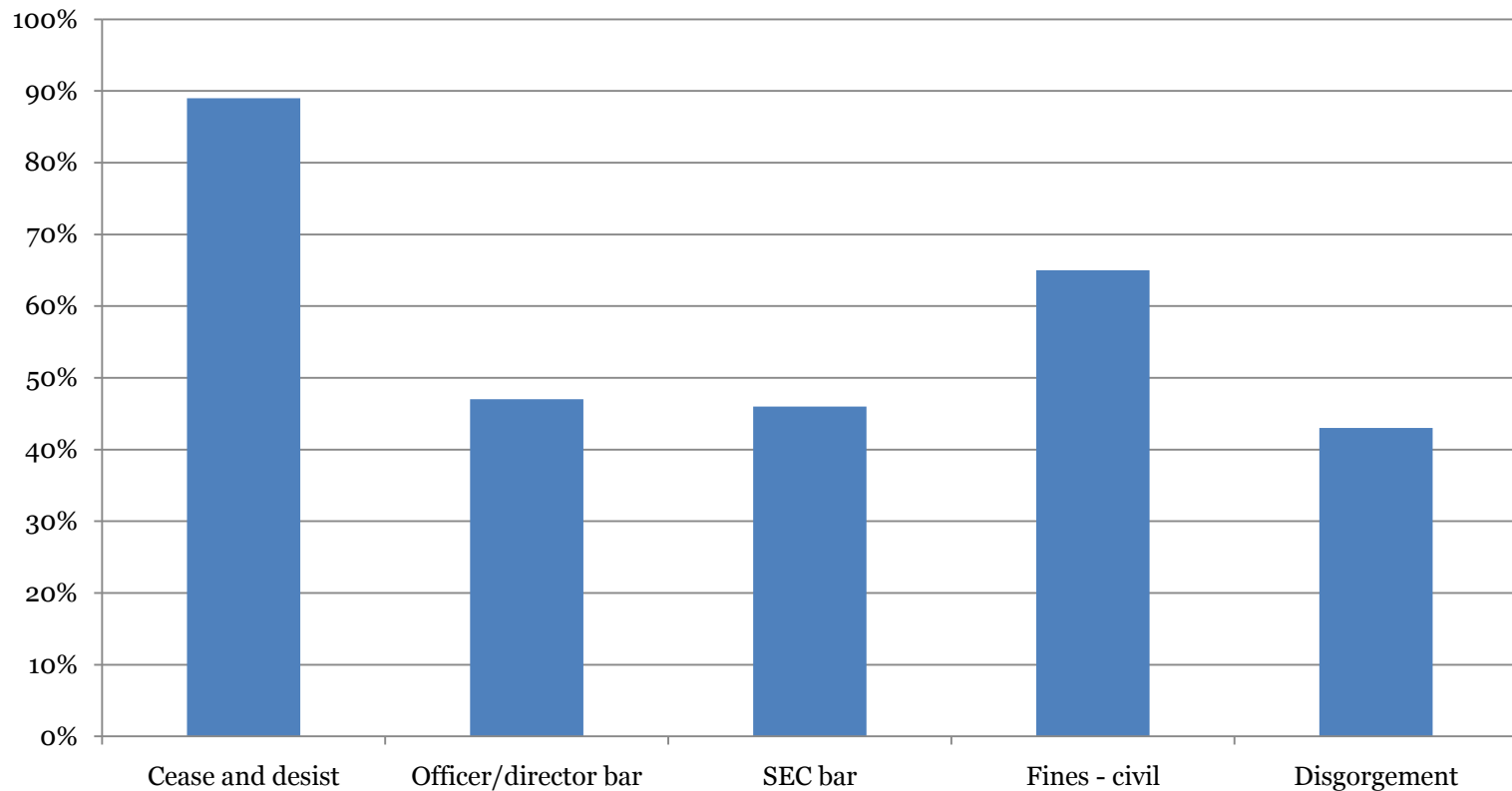




Table 28: Other Consequences to Company (n = 311)

Subsequent Consequences	Percentage of Fraud Companies Affected	Percentage of No-Fraud Companies Affected
Bankrupt, liquidated, etc.	28%	13%
Involuntary stock exchange delisting	47%	20%
Material asset sales	62%	31%



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Insights

- Continued efforts to prevent, detect, and deter fraud are warranted
- More research needed to understand control environment
 - e.g., Screening and oversight of senior executives, ethical rationalizations, leadership
- Closer examination of revenue recognition techniques and industry issues
- More research needed on organizational behaviors
 - Board of director processes
 - Psyche of fraud perpetrators



Insights

- Auditor issues
 - More research is needed to determine if there is any linkage between the occurrences of fraud and
 - Timing and nature of auditor changes
 - Issues triggering explanatory paragraph in audit report
 - More research to
 - Assist auditors in evaluations of the control environment, including the board of directors and senior management
 - Understand lessons learned from auditor involvement in 23% of cases where auditor is named
- More time to observe impact of SOX 404 reporting



Next Steps

- PDF free download from COSO website – www.coso.org
 - Hardcopies for sale through AICPA
- Future COSO efforts
 - Develop guidance dealing with the control environment
 - Sponsor behavioral and other research
- Other questions and comments