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Just Say 'No'

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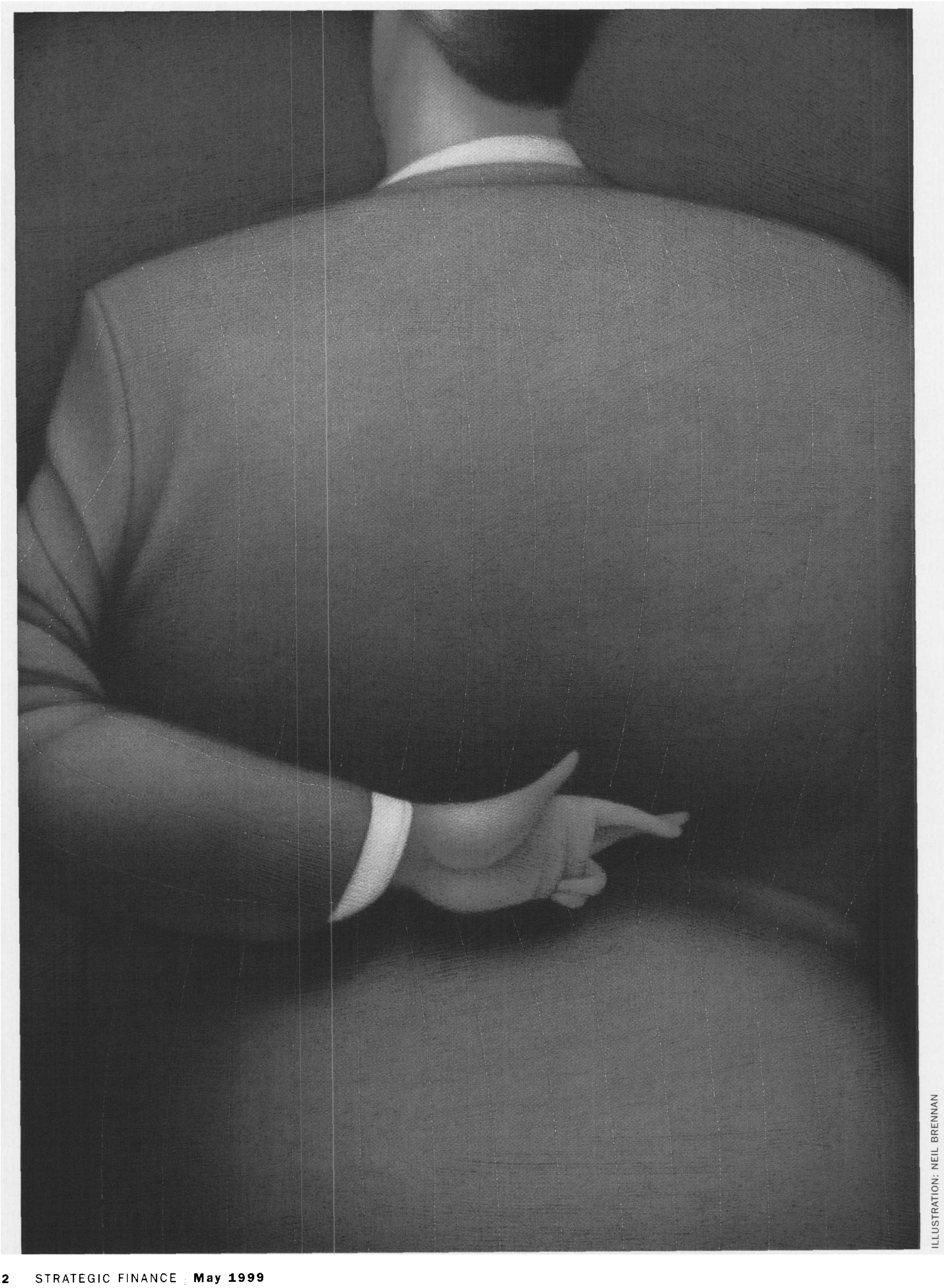

ILLUSTRATION: NEIL BRENNAN

Make this your company motto:

"FINANCIAL FRAUD NOT PERMITTED HERE!"

Just say 'No'

By MARK S. BEASLEY, CPA; JOSEPH V. CARCELLO, CMA, CPA; *and* DANA R. HERMANSON, CPA

If you're a financial manager, controller, or CFO, part of your job is to make sure no one on your staff or anywhere else in the company commits financial fraud. That goes for misstatement of earnings, letting someone else's numbers go through when they're wrong, falsifying sales figures, or anything else someone might dream up. And if you're involved? We don't think you'd like the consequences. You could be fired, fined, and/or go to jail.

"But I wouldn't commit fraud," you protest. "And neither would anyone else on the staff." Perhaps not, but there seems to be a serious problem occurring, especially in smaller companies. And ironically, until recently, little evidence existed that described characteristics of companies and managers allegedly engaged in financial reporting fraud. To provide evidence, we examined instances of such alleged fraud reported by the Securities & Exchange Commission from 1987 through 1997. Our findings were published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies*, © COSO, 1999. If you heed our warnings, you can help your company stay on a course of honesty and stability.

Most companies committing financial statement fraud ranged well below $100 million in assets and revenues in the year preceding the fraud. And many were experiencing financial strain or distress in periods leading up to the first instance of fraud. (See Table 1 for some highlights.) Many companies were in a net loss position, and the median company had net income of only $175,000 in the year before the fraud. Net income trends were mixed. Some companies were experiencing downward trends in net income over the two years preceding the fraud, while others were experiencing upward trends in net income. Relatively few companies' stock traded on the New York or American Stock Exchanges. In fact, 78% of the sample companies traded their stock in over-the-counter markets.

Table 1. Financial Profile of Sample Companies
Last Financial Statements Prior to Beginning of Fraud Period (in 000s)

	Assets	Revenues	Net Income (Loss)	Stockholders' Equity (Deficit)
Mean	$532,766	$232,727	$8,573	$86,107
Median	$15,681	$13,043	$175	$5,012
Minimum Value	$0	$0	($37,286)	($4,516)
Maximum Value	$17,880,000	$11,090,000	$329,000	$2,772,000

SENIOR MANAGERS WERE INVOLVED

Typically, top executives instigated financial statement fraud, and senior management overrode internal controls. The CEO was involved in 72% of the cases and the CFO in 43%. The controller was named in 21% of the cases. The chief operating officer (COO), other vice presidents, and lower-level personnel also were named as participants, but not as often. (See Table 2 for some examples.)

Table 2. Types and Frequencies of Individuals Named in SEC Files

INDIVIDUAL'S RELATION TO COMPANY	FRAUD CASES
Chief executive officer (CEO)	72%
Chief financial officer (CFO)	43%
Either or both CEO or CFO involved	83%
Controller	21%
Chief operating officer (COO)	7%
Other vice president positions	18%
Board of Director (nonmanagement)	11%
Lower-level personnel	10%
Outsiders (e.g., auditors, customers)	38%

How could this happen? Senior management's ability to exert excessive power was enhanced by weak board of director and audit committee governance. Most companies' boards were dominated by insiders and other directors with strong ties to management. True outside directors represented only 40% of the sample companies' boards. And they didn't appear to have significant corporate governance or financial reporting experience. Twenty-five percent of our sample companies didn't even have an audit committee in place. Even for those with an audit committee, the oversight it provided regarding the financial reporting process was apparently weak given that the typical audit committee met less than two times a year. With such weak corporate governance, senior executives appeared to have free rein over their manipulative activities.

NATURE OF THE FRAUDS

Most of the financial statement fraud cases involved the manipulation of reported financial statement data, with only 12% involving misappropriation of assets. Typically, the fraud involved more than one technique and generally affected revenues and assets. Only 18% involved the understatement of liabilities and expenses. The frauds averaged $25 million per company with a median of $4.1 million. Considering that the average company had total assets of $533 million and the median company had total assets of only $16 million, the cumulative amounts of the fraud were relatively large on a per company basis.

So what kind of frauds were they? More than half involved a company overstating revenues by recording revenues prematurely or fictitiously. Techniques involved:

- Sham sales,
- Recording revenues before all terms were satisfied,
- Recording conditional sales,
- Improper cutoff of transactions at period end,
- Improper use of percentage of completion,
- Unauthorized shipments, and
- Recording consignment sales as completed sales.

WHAT'S COSO?

THE COMMITTEE OF SPONSORING Organizations of the Treadway Commission (COSO) is a private sector initiative jointly sponsored and funded by the following organizations:

American Accounting Association (AAA)
American Institute of Certified Public Accountants (AICPA)
Financial Executives Institute (FEI)
Institute of Management Accountants (IMA)
The Institute of Internal Auditors (IIA)

Collectively, these sponsoring organizations represent more than 500,000 members. COSO's mission is to improve the quality of financial reporting through internal controls, governance, and ethics. Our

In addition to overstating revenues, senior executives overstated assets. Even excluding the effects of misstating accounts receivable because of the revenue recognition frauds, over 50% of the companies inflated asset values, most often by overstating inventory and accounts receivable. Often they understated allowances and overstated asset values. In some cases, the financial statements reported nonexistent assets. Other frequently misstated asset accounts included property, plant, and equipment; loans/notes receivable; cash; investments; patent accounts; and valuations of oil, gas, and mineral reserves.

The typical fraud overlapped two fiscal years by misstating the annual or quarterly financial statements in at least two fiscal periods. Many began with misstatements of interim financial statements that were continued in annual financial statement filings. Only 14% of the frauds involved a period of less than 12 months.

study on financial statement fraud validates the need for continued focus on all three areas. COSO previously sponsored the following publications:

Report of the National Commission on Fraudulent Financial Reporting (commonly referred to as the Treadway Commission Report), 1987, and

Internal Control—Integrated Framework, 1992.

To get a copy of the latest study, *Fraudulent Financial Reporting 1987-1997, An Analysis of U.S. Public Companies*, from which our article was adapted, contact the AICPA at 1-888-777-7077 and ask for item #990036.

THE MOTIVATING FACTOR

Why would company representatives commit fraud? There are a variety of reasons, including to:

- Avoid reporting a pretax loss and to bolster other financial results,
- Increase the stock price to increase the benefits of insider trading and to obtain higher cash proceeds when issuing new securities,
- Cover up assets misappropriated for personal gain, and
- Obtain national stock exchange listing status or maintain minimum exchange listing requirements to avoid being delisted.

YOU WILL PAY

The consequences associated with the alleged fraud seem severe. (See Table 3 for some examples.) Thirty-six percent of the companies filed for Chapter 11 bankruptcy, were considered "defunct," or were taken over by a regulator after the fraud was disclosed. An additional 15% changed owners or sold large chunks of assets after the fraud revelation. Twenty-one percent were delisted by the national stock exchange where their stock traded. Many companies experienced stock price declines attributed to the fraud disclosure. For those with available information, the average stock declined in value by 58% after the fraud was announced publicly.

Executives involved also suffered personal consequences. In 37% of our sample companies, CEOs resigned or were fired. In 23%, the CFO or controller resigned or was fired. These percentages may be understated because we identified those events by reading business press articles, which probably didn't consistently report matters related to companies of the size represented by our fraud sample. Executives were also barred by the SEC from serving as officers or directors of another public registrant and in some cases were imprisoned. (See Table 4 for some examples.)

Table 3. Status of Companies After Fraud Disclosed

SAMPLE COMPANIES AFFECTED	By Number	Percentage
Bankrupt, defunct	73	36%
Changed ownership		
Sold large portion of assets	6	3%
Merged with another company	15	7%
Experienced change in controlling shareholders	10	5%
Total	31	15%
Delisted from national stock exchange	42	21%

WHAT DOES THIS MEAN FOR YOU?

What do all these findings tell you, the professionals who oversee the financial reporting process? For starters, you'd better push for as many internal controls as are reasonable, beginning with a baseline level of internal control. If this minimum level of control *isn't* in place, management has a greater ability to override whatever controls might be around. While some may argue that smaller companies can't afford to install key control activities, you as controllers and other financial reporting managers should push aggressively for baseline internal

Table 4. Other Consequences to Executives

Sample Companies Affected	By Number	Percentage
Resignations or terminations of		
CEO or president	76	37%
CFO or controller	47	23%
COO or another senior executive	32	16%
Senior executive(s) barred from service as officer or director of another SEC registrant for period of time	54	26%
Company executives criminally prosecuted for fraud	31	15%

controls when senior executives appear to be more *unwilling* rather than *unable* to implement an effective internal control system. Basics, such as key checks and balances when too many functions are combined into one individual (like the CEO and CFO/controller), should be fundamental components of the control system.

You also need to emphasize the control environment. We can't overstate the importance of the "tone at the top." That so many CEOs and CFOs were involved in fraudulent activities highlights the importance of assessing key performance pressures senior executives face. If you're a controller or other manager responsible for designing and monitoring internal performance benchmarking measures, you should evaluate how much pressure those measures place on senior executives and other employees to meet or exceed company performance targets for compensation and other rewards, such as promotions. Also, senior executives who regularly correspond with parties outside the organization (analysts and institutional investors) should be aware of how those external pressures may be burdening senior management to meet external expectations. This is particularly relevant when companies and their industries are experiencing financial strain or distress.

Is there more? You also should make sure your audit committee is effective. Rather than window dress the audit committee to satisfy expectations of external parties—like the stock exchanges—you should aggressively seek its advice, viewing it as an asset rather than a liability. Enlist the committee's help when you review financial reporting related matters, and provide relevant and reliable data for it to review. The audit committee's effectiveness is restricted by the quality and extent of information it receives. It needs access to reliable financial and nonfinancial information, industry, and other benchmarking data and other comparative information that's prepared on a consistent basis. The management accounting team can take the lead in helping provide such information to the audit committee.

RAISE RED FLAGS

As controllers and others involved in the financial reporting process, you often may experience undue pressure from top management to aggressively report corporate results. In some cases, those above the accounting staff (like CEOs and COOs) may be involved in financial statement fraud in part because they don't understand the severity of the consequences of violating financial reporting requirements. Their involvement highlights the importance of educating CEOs and COOs in basic financial reporting requirements and involving individuals with financial reporting expertise—such as controllers, general counsels, internal and external auditors—in the financial reporting process. In many cases, they can help educate senior executives who lack financial reporting knowledge and experience, and their presence may help restrain senior executives who continue to be overly aggressive in financial reporting matters.

Companies also need to give employees a way out when they're experiencing excessive pressure to participate in questionable activities. You should identify ways that open up lines of communication when someone who reports to you feels pressure to engage in processes that seem overly aggressive. If you're feeling such pressure, consider talking with the board, audit committee, and external auditor. A clear message from our analysis of fraud consequences is that serious ramifications follow participation in a fraud for everyone involved. A message of "fraud isn't worth it" should be emphasized to everyone involved in financial reporting.

IMPROVE INTERIM REPORTING AND OTHER PROCEDURES

Because financial statement fraud so often begins with interim reporting, companies need to evaluate the effectiveness of processes and controls surrounding the preparation of interim financial statements. The presence of some financial statement frauds involving strictly interim periods suggests that processes and controls related to interim reporting may be unduly less rigorous than those surrounding annual financial reporting. Consider the costs/benefits of engaging outside accountants to perform reviews of quarterly financial statements before you file with the SEC.

You also need to evaluate the adequacy of existing company processes and controls designed to ensure compliance with revenue recognition policies, particularly those involving close scrutiny of transactions recorded right at the close of a fiscal period. Procedures that affect transaction cutoff and transaction terms should include basic documentation that makes sure transactions are recorded properly. The need for adequate documentation and tracking is especially critical for entities that might be regularly involved in modifying transaction terms for customers. If you don't monitor side agreements, greater opportunities for financial misstatement might crop up.

The frequency of asset misstatements highlights the importance of establishing proper procedures surrounding asset valuations. You should regularly evaluate accounts subject to extensive judgmental valuation (mineral reserves and receivable allowances, to name a few) to make sure the estimates are reasonable. And you should monitor external conditions that might affect the soundness of assumptions used in estimating asset values. In some cases, management should consider bringing in reputable outside experts who are knowledgeable about issues affecting asset valuations.

> You've got your hands full when it comes to being *responsible* for financial reporting and internal control procedures, especially if some of your own executives might be *playing around* with the numbers.

JUST SAY "NO"

As you can see, you've got your hands full when it comes to being responsible for financial reporting and internal control procedures, especially if some of your own executives might be playing around with the numbers. But hang in there, and resist the pressure to act improperly. You need to keep your company on an honest, even course. That's your job! ■

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ABOUT OUR STUDY

WE ANALYZED INSTANCES OF FRAUDULENT FINANCIAL REPORTING FIRST alleged by the SEC in an Accounting and Auditing Enforcement Release (AAER) issued during the period 1987–1997. 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 because they represent the primary antifraud provisions related to financial statement reporting. In analyzing more than 800 AAERs, we identified approximately 300 instances of fraudulent financial reporting. Then we randomly selected about 200 companies to serve as our final sample that we examined in detail. We captured extensive information about company and management characteristics by reading all AAERs related to each fraud instance, selected financial statements filed before and during the fraud period, proxy statements issued during the alleged fraud period, and business press articles about the sample companies after the fraud was disclosed.