



Audit Flash Report

No. 2010-06

To:	All Assurance Professionals	Date:	June 11, 2010
Re:	COSO Publishes Results of a Research Study, <i>Fraudulent Financial Reporting: 1998-2007</i>	From:	National Assurance

Last month, The Committee of Sponsoring Organizations of the Treadway Commission (COSO) published the results of a research study it commissioned entitled, *Fraudulent Financial Reporting: 1998-2007, An Analysis of U.S. Public Companies*. The study provides analysis of fraudulent financial reporting occurrences alleged by the SEC in Accounting and Auditing Enforcement Releases (AAERs) issued between January 1998 and December 2007, to provide insights related to preventing, deterring and detecting fraudulent financial reporting.

During this period, 347 alleged cases of fraud were reported, up from 294 cases in the prior ten-year period. While the latest ten-year period encompasses the passage of the Sarbanes-Oxley Act of 2002 (the Act), because of the time lag between the occurrence of fraudulent financial reporting and the issuance of an AAER, most of the instances of fraud noted in the study occurred before passage of the Act, and therefore no conclusions can be made about the impact of SOX 404 on fraudulent financial reporting.

This study builds on the previous COSO-sponsored study on fraudulent financial reporting, released in 1999, and where appropriate, notable differences between the two studies have been highlighted.

To access the full study, go to:

<http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>

The more significant findings included:

Occurrence of Financial Statement Fraud

While fraud affects companies of all sizes, a larger portion of the frauds in the study occurred at smaller companies. Additionally, many fraud companies operated at close to breakeven and/or had negative cash flow. As might be expected, given the high profile frauds at Enron and WorldCom, the dollar magnitude of fraudulent financial reporting increased dramatically over the previous study, from a mean of nearly \$400 million per case in the current study compared to a mean of \$25 million in the 1999 study.

Management's Tone at the Top

The CEO and/or the CFO were involved in 89 percent of the frauds in the current study, up from 83 percent in the prior study. Motivations for the fraud included meeting expectations, concealing deteriorating financial condition, and preparing for a debt or equity offering.

Nature of the Frauds

The most common fraud technique involved improper revenue recognition, followed by overstatement of assets or capitalization of expenses. Revenue frauds accounted for over 60 percent of the cases, versus 50 percent in the previous study. Further, the heaviest concentration of frauds occurred during the 1997 to 2001 time period, when the market was slowing and there was pressure to keep earnings high.

Role of Board of Directors

Relatively few differences in board of director characteristics existed between firms engaging in fraud and similar firms not engaging in fraud. Moreover, in some instances, differences between the board's characteristics were in directions opposite of what might be expected. One example of an unexpected finding is companies with frauds had a slightly higher percentage (11%) of board members with financial expertise than companies that didn't have reported frauds (9%). The authors of the study suggest that additional research on the governance processes and the interaction of various governance mechanisms is necessary to understand the role the board of directors plays in deterring fraud.

Related Party Transactions

Companies with fraud disclosed significantly more related party transactions than non-fraud companies. The higher frequency of related party transactions for companies with a fraud suggests that the presence of such transactions may reflect a higher risk of fraud. Further, the study may also imply that the nature of these transactions has broader implications regarding management's integrity, philosophy, and ethical culture.

Auditor Considerations

Twenty-six percent of companies with a fraud had a change in auditor between the issuance of the last clean financial statements and the issuance of the last set of fraudulent financial statements, whereas, non-fraud companies changed auditors only 12 percent of the time. Sixty percent of the fraud-companies that changed auditors did so during the fraud period, while the remaining 40 percent changed in the fiscal period just before the fraud began.

Additionally, a higher percentage of companies with a fraud had unqualified audit reports with an explanatory paragraph (56 percent), compared to non-fraud companies (36 percent). The study found no meaningful difference in the rate of frauds at companies audited by big four firms and companies audited by non-big four firms.

If you have any questions related to this Audit *Flash* Report, please contact Sue Lister at 305-8375 (internal) or 212-885-8375 (external).