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ADVISER

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COSO Issues its Report on Fraudulent Financial Reporting

Many of us are familiar with the major frauds of recent history, including Enron, WorldCom and Parmalat. However, during the time that these frauds were committed, there were also hundreds of other cases that were not as well publicized.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) conducted a study, *Fraudulent Financial Reporting: 1998-2007*, which provided a thorough analysis of fraudulent financial reporting investigated by the U.S. Securities and Exchange Commission (SEC). The study was a follow up to COSO's 1999 document, *Fraudulent Financial Reporting: 1987-1997*. Here are some of the key findings of COSO's most recent study on fraudulent financial reporting by publicly traded companies.

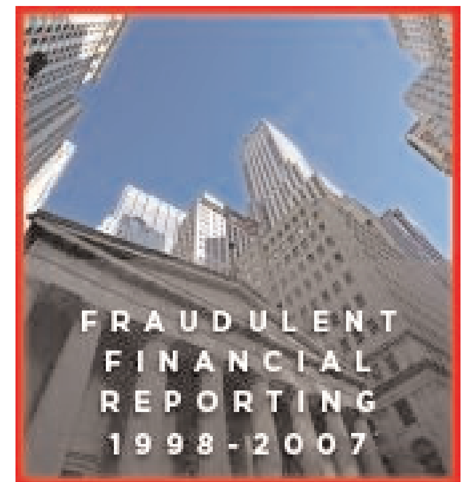
Fraud on the Rise

COSO found that fraudulent financial reporting happens with companies of any size and industry and its magnitude has increased in the past decade. The most recent study analyzed a total of 347 cases of public company fraudulent financial reporting with a mean misstatement of $400 million per case, which compares to 294 cases and $25 million per case, respectively, in the prior study. Along with an increase in the number of cases and the mean misstatement per case, the current study also found that companies engaging in financial statement fraud had median assets and revenues of just under $100 million, compared to under $16 million in the prior study.

The range of company size varied from startups with no revenue or assets to companies with just under $400 billion in assets and over $100 billion in revenue. COSO also found that 20% of fraud occurred at companies in the computer hardware and software industry and another 20% occurred in manufacturing.

Who They Are, How They Do It, and Why

One of the interesting insights provided by the report was that the fraud was being committed at the highest levels. The CEO and/or the CFO were involved in the fraud in close to 90% of the cases during the study period. In over 60% of cases, the technique used to commit the fraud involved improper revenue recognition. This method of fraud was followed by overstatement of existing assets or capitalization of expenses. These types of misstatements are occurring in areas considered high risk audit areas by public company auditors.



As a result of these findings, auditors should be sure to obtain adequate audit evidence when testing these areas. At the same time, the COSO study noted that some of the responsibility to prevent such fraudulent reporting,

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before it ever occurs, rests with non-financial executives. In order to reduce the number of material misstatements found in public company filings, the COSO study recommends better education and training on revenue recognition concepts and SEC reporting obligations.

Through its investigations as to why companies fraudulently reported financial information, the typical reasons documented by the SEC included the need to meet earnings expectations, to hide poor financial performance, to raise the stock price or to achieve higher management compensation based on financial results. These factors should be carefully considered by public company board members as they assess whether similar motivations may exist at their organizations.

Another finding of importance to public company boards was the fact that the average fraud period lasted over 31 months. This indicates that management will continue to perpetrate a fraud in successive periods of financial statement reporting if the fraud is not uncovered. Since most frauds were not isolated to one particular reporting period, the magnitude of the fraud can grow as the financial statement misstatement continues.

The SOX Effect

Given the fact that the Sarbanes-Oxley Act of 2002 (SOX) was implemented during the study, COSO investigated whether SOX had any effect on reducing the number of fraud cases and their magnitude. However, of the 347 fraud cases included in the study, only 61 cases occurred subsequent to 2002 and only a small number of those cases involved companies that were subject to the internal control reporting provisions of SOX.

Perhaps a future study of such frauds will shed more light on the success SOX has had in reducing fraudulent financial reporting.

Fraud's Lasting Effects

As is often the case in fraudulent financial reporting, the authors of the study determined that an announcement of the alleged fraud brought about a decline in the company's stock price and led to future hardship for the company. The study found that within the two days surrounding the announcement, the average stock price decline was approximately 17%. Eventually, many of these companies later experienced bankruptcy, delisting from a stock exchange, or significant asset sales.

While the study uncovered some areas of concern for the readers of public company financial statements, the majority of public company filings do not include fraudulent financial information. However, the findings from COSO's study demonstrate that fraudulent financial reporting continues to occur for many reasons and has a damaging effect on publicly traded companies in various industries. Investors, board members, auditors, regulators and other interested parties should learn from the insights provided by this study to better prevent and detect fraudulent financial reporting.

For more information on uncovering and preventing fraud, contact Senior Audit Manager Paul Becht at (631) 719-3224, PBecht@hrrllp.com.

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