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News Flash: Coso Releases Landmark Study on Fraud in Financial Reporting

American Institute of Certified Public Accountants (AICPA)

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FOR IMMEDIATE RELEASE

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COSO RELEASES LANDMARK STUDY
ON FRAUD IN FINANCIAL REPORTING

— New findings from 10 years of SEC enforcement cases —

NEW YORK (March 26, 1999) — In the past decade, most fraud in financial reporting among public companies was committed by small corporations, with well below $100 million in assets. Top senior executives were frequently involved. In addition, boards of directors were dominated by insiders and directors with significant equity ownership and little apparent experience serving on the boards of other companies.

These are among the key findings in *Fraudulent Financial Reporting: 1987 - 1997*, a study released today by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The study analyzes 200 randomly selected cases of alleged financial fraud investigated by the Securities and Exchange Commission, about two thirds of the 300 SEC probes into fraud between 1987 and 1997.

The Committee of Sponsoring Organizations, dedicated to the prevention of fraudulent financial reporting, is an alliance of five professional organizations: the American Institute of Certified Public Accountants (AICPA), the American Accounting Association (AAA), the Financial Executives Institute (FEI), the Institute of Internal Auditors (IIA) and the Institute of Management Accountants (IMA).

"This study makes a significant contribution to the national discussion on financial statement fraud," said John Flaherty, Chairman of COSO and retired General Auditor for PepsiCo Inc. "We now have a current profile of the frauds committed, the companies and individuals involved, and the consequences of the frauds. The report is a 'must read' for everyone involved in corporate governance, including board members, CEOs, financial executives, auditors and regulators."

Typical financial statement fraud techniques, the study found, involved the overstatement of revenues and assets. In more than half the cases, revenues were recorded prematurely or fictitiously. About half of the frauds involved overstating assets by understating allowances for receivables, overstating the value of inventory, property, plant and equipment and other tangible assets, and recording non-existent assets.

Alan Anderson, AICPA Senior Vice President, warned that "all of the parties — management, audit committees, auditors, and in particular board members — charged with safeguarding the public interest need to be fully cognizant of their responsibilities. This study reaffirms our long held view that qualified board members and strong audit committees are essential to the integrity of financial reporting."

Other Critical Findings

- **In 83 percent of the cases, the CEO, the CFO or both were named as being associated with the financial statement fraud.** Other individuals named included controllers, chief operating officers, other senior executives and board members.
- **Most audit committees met only about once a year or the company had no audit committee.** Twenty-five percent of the companies studied had no audit committee while sixty five percent of audit committee members appeared to have no significant experience or qualifications in accounting or finance.
- **Most of the auditors explicitly named in SEC enforcement releases were non-Big Eight/Six auditors.**
- **Audit firms of all sizes were associated with companies committing financial statement fraud.** Fifty-six percent of the companies studied were audited by Big Eight/Six auditors, 44 percent by non-Big Eight/Six.
- **Cumulative amounts of frauds were relatively large in light of the relatively small sizes of the companies involved.** The average misstatement or misappropriation of assets was $25 million, with a median of $4.1 million. Some companies committing fraud were experiencing net losses or were in close to break-even positions in periods before the fraud. Pressures of financial strain or distress may have provided incentives for fraud for some companies.

Based on these results, regulators clearly must redirect their emphasis, according to one of the study's authors. "A regulatory focus on companies with market capitalization over $200 million may inadvertently fail to target those most frequently engaged in fraud," said Joseph Carcello, professor at University of Tennessee. "The audit committee and board practices of smaller companies warrant particular attention."

A summary of the study may be found on the website www.aicpa.org/news/p032699b.htm of the American Institute of Certified Public Accountants, which is a member of COSO. Collectively, the five COSO member organizations represent more than 500,000 members across the United States.

In 1986-87, COSO sponsored a major examination of financial fraud by the Treadway Commission.
