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Implications of Recent Research

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Accounting fraud, or fraudulent financial reporting, has been an ongoing concern for U.S. investors for several decades, with periodic waves of accounting fraud cases leading to substantial investor losses and overall reductions in investor confidence. Research has documented the devastating effects of accounting fraud cases. For example, Jonathan M. Karpoff, D. Scott Lee, and Gerald Martin ("The Cost to Firms of Cooking the Books," *Journal of Financial and Quantitative Analysis*, 2008) found that firms committing fraud are severely punished by the market: "For each dollar that a firm misleadingly inflates its market value, on average, it loses this dollar when its misconduct is revealed, plus an additional $3.08." In addition, a recent Committee of Sponsoring Organizations of the Treadway Commission (COSO)–sponsored study, "Fraudulent Financial Reporting: 1998–2007," found that fraud firms were much more likely than similar no-fraud firms to declare bankruptcy, be involuntarily delisted, or have material asset sales in the wake of the fraud. Thus, the consequences to investors of accounting fraud often are quite severe.

Recent research provides important new insights into the role of CEOs and CFOs in accounting fraud. In this article, the authors discuss these findings and offer a number of implications for directors, audit committee members, and auditors seeking to prevent or detect accounting fraud. The authors conclude by highlighting some useful antifraud resources.

Recent Research Findings

The *Exhibit* presents information on six recent studies that examined issues related to CEOs, CFOs, and accounting fraud. The first two studies documented that accounting fraud is largely driven by the CEO and CFO (top management). The first study, "Fraudulent Financial Reporting: 1998–2007," examined 347 alleged accounting fraud cases investigated by the SEC. The study revealed that financial statement fraud cases often involve the top executives, with the CEO or CFO implicated in 89% of the cases. CEOs were implicated in 72% of the cases, and CFOs in 65%. While lower level personnel often are coerced into carrying out the mechanics of the fraud scheme, the percentages for CEO and CFO involvement are far higher than for any other type of employee in the company (all less than 40%). In a prior COSO-sponsored study, "Fraudulent Financial Reporting: 1987–1997," the CEO or CFO were named in 83% of the cases; therefore, CEO/CFO involvement continues to be found in the vast majority of fraudulent financial reporting cases, and this appears to be increasing. Given the significant expenditures of time and money devoted to reducing fraud in recent years, such results suggest that fraud prevention and detection efforts may be performed in a more effective and efficient manner with a more targeted focus on the CEO/CFO.

The second study, "Report to the Nations: 2010 Global Fraud Study," was based on a global survey administered by the Association of Certified Fraud Examiners (ACFE) and found a similar result. The study analyzed more than 1,800 fraud cases (primarily occupational fraud) that were investigated by certified fraud examiners. Nearly 14% of the frauds involving executives or upper management were fraudulent financial reporting cases, while less than 5% of the total cases involved fraudulent financial reporting. Thus, fraudulent financial reporting cases were concentrated among executive and upper-management perpetrators.

Based on these two studies, it is clear that accounting fraud typically involves CEOs and CFOs, who may coerce lower level employees to participate as well. What is not clear, however, is why some CEOs and CFOs participate in accounting fraud. The third study, by Mei Feng, Weili Ge, Shuqing Luo, and Terry Shevlin, offers new insights into this issue ("Why Do CFOs Become Involved in Material Accounting Manipulations?" *Journal of Accounting and Economics*, 2011). First, the authors found that CEO involvement in accounting manipulation appears to be driven by CEOs' compensation incentives and facilitated by their power. In other words, the CEO is involved for personal gain through equity compensation, and the CEO's power (e.g., serving as board chair, being the company founder, or having higher pay relative to other executives) is useful in perpetrating the fraud.

For CFOs, the results are much different. CFOs of companies accused of manipulating their results do not have equity compensation incentives that are different from CFOs serving "clean" firms. Thus, CFOs do not appear to be participating in accounting schemes for direct personal gain through equity pay. Rather, the authors conclude that "CFOs are involved in material accounting manipulations because they succumb to pressure from CEOs."

While Feng et al. and others have found evidence that CEO equity incentives are associated with accounting manipulations, it is important to note that the evidence on this issue is mixed, with various studies in the past decade providing inconsistent results. One recent example of a study reaching a different conclusion than Feng et al. is the fourth study in the Exhibit, by Chris S. Armstrong, Alan D. Jagolinzer, and David F. Larcker. Those authors used a very advanced matching process (ensuring that their sample matched each fraud company with a similar clean company) and found no evidence of a link between accounting fraud and CEO equity incentives. In fact, there was some evidence that accounting fraud is less likely as CEO equity incentives increase. Thus, recent research lacks consensus regarding the relationship between CEO equity incentives and accounting fraud.

The fifth study in the Exhibit, by Joel H. Amernic and Russell J. Craig, developed a theoretical argument related to CEO narcissism and accounting fraud. The authors stated:

> Our central thesis is that accounting has unique and distinctive features which plausibly encourage ego-boosting behaviour by certain, more extreme, narcissistic CEOs. Narcissists possess an exaggerated sense of self-importance, a pre-occupation with being the centre of attention, a lack of compassion for others, a high degree of sensitivity to criticism, and high levels of envy and arrogance. … It is important for auditors, analysts, regulators and other corporate stakeholders to generally monitor the language of CEOs for narcissistic-like signs—including such signs provided by financial accounting language and measures. This importance is stressed by Amernic and Craig (2007, p. 27) who contend that CEOs possessing extreme narcissistic-like tendencies are 'more prone to "play loose" with the company's reported financial position, to shun remediation strategies and to live in a fantasy world of delusion about the company's financial strength. ("Accounting as a Facilitator of Extreme Narcissism," *Journal of Business Ethics*," 2010, p. 80)

The authors provide a rich discussion of how CEO narcissism can lead down a path to materially manipulating the financial statements to fit the CEO's inflated view of himself and the company's performance.

Finally, Jeffrey R. Cohen, Ganesh Krishnamoorthy, and Arnold Wright interviewed 30 Big Four audit partners and managers on a range of corporate governance issues ("Corporate Governance in the Post-Sarbanes-Oxley Period: Auditors' Experiences," *Contemporary Accounting Research*, 2010). This included two issues that relate to the present discussion: Who really hires the auditor, and have the Sarbanes-Oxley Act of 2002 (SOX) section 302 certifications by CEOs and CFOs affected the integrity of financial reporting? The authors find that auditors believe, even in the post-SOX period where the audit committee legally hires the audit firm, that the CEO and CFO still largely drive the auditor selection process. (In fact, one interviewee asserted that CEOs are even more interested in auditor selection now than pre-SOX.) Clearly, heavy involvement by management in the auditor selection process has the potential to undermine auditor objectivity. With respect to the SOX section 302 certifications by CEOs and CFOs (where management personally certifies the financial statements), most auditors interviewed believe that such certifications have helped to improve the integrity of financial reporting post-SOX. It appears that CEOs and CFOs may feel more personal accountability due to the section 302 certifications.

Based on these six studies, the following major themes emerge:

- Accounting fraud is largely driven by CEOs/CFOs, who may coerce lower level personnel to participate as well.
- CEOs may engage in accounting fraud related to equity incentives (although the evidence is mixed), power, and narcissism.
- CFOs appear to engage in accounting fraud due to pressure exerted by CEOs, rather than due to their own equity incentives.
- In many companies, CEOs and CFOs still appear to drive the auditor selection process, but section 302 certifications by CEOs and CFOs are perceived to have improved the integrity of financial reporting post-SOX.

Implications for CPAs

These themes have a number of implications for those focused on preventing or detecting accounting fraud, especially the board/audit committee and external auditor, who oversees the CEO/CFO and tests the financial statements, respectively.

First, it is important for the board, audit committee, and external auditor to understand the CEO's personality and level of power within the organization. CEOs with

EXHIBIT
Selected Recent Research Related to CEOs, CFOs, and Accounting Fraud

Study	Scope	Selected Findings (Excerpts in Quotes)
Beasley, Carcello, Hermanson, and Neal, "Fraudulent Financial Reporting: 1998–2007," COSO (2010)	347 SEC fraud-related enforcement cases from 1/1/98 to 12/31/07	"In 72 percent of the cases, the AAERs named the CEO, and in 65 percent the AAERs named the CFO as being associated with the fraud. When considered together, in 89 percent of the cases, the AAERs named the CEO and/or CFO as being associated with the financial statement fraud. In COSO's 1999 study, the CEO and/or CFO were named in 83 percent of the cases."
Association of Certified Fraud Examiners, Report to the Nations: 2010 Global Fraud Study	1,843 fraud cases reported by certified fraud examiners in a survey; the respondents were from more than 100 countries	"Financial statement fraud schemes were also much more common among executives and upper management." Financial statement fraud cases accounted for 13.8% of the 224 executive/upper management cases, versus only 4.8% of the total cases in the study.
Feng, Ge, Luo, and Shevlin, "Why Do CFOs Become Involvedin Material Accounting Manipulations?" *Journal of Accounting and Economics* (2011)	SEC enforcement cases involving material accounting manipulations from mid-1982 to mid-2005 and a control sample	"We find that while CFOs bear substantial legal costs when involved in accounting manipulations, these CFOs have similar equity incentives to the CFOs of matched non-manipulation firms. In contrast, CEOs of manipulation firms have higher equity incentives and more power than CEOs of matched firms. Taken together, our findings are consistent with the explanation that CFOs are involved in material accounting manipulations because they succumb to pressure from CEOs, rather than because they seek immediate personal financial benefit from their equity incentives."
Armstrong, Jagolinzer, and Larcker, "Chief Executive Officer Equity Incentives and Accounting Irregularities," *Journal of Accounting Research* (2010)	Firms with restatements, accounting-related lawsuits, or SEC enforcement actions from 2001 to 2005	"This study examines whether Chief Executive Officer … equity-based holdings and compensation provide incentives to manipulate accounting reports. While several prior studies have examined this important question, the empirical evidence is mixed and the existence of a link between CEO equity incentives and accounting irregularities remains an open question . . . In contrast to most prior research, we do not find evidence of a positive association between CEO equity incentives and accounting irregularities after matching CEOs on the observable characteristics of their contracting environments. Instead, we find some evidence that accounting irregularities occur less frequently at firms where CEOs have relatively higher levels of equity incentives."
Amernic and Craig, "Accounting as a Facilitator of Extreme Narcissism," *Journal of Business Ethics* (2010)	Theoretical argument	"We argue that the special features possessed by financial accounting facilitate extreme narcissism in susceptible CEOs. In particular, we propose that extremely narcissistic CEOs are key players in a recurring discourse cycle facilitated by financial accounting language and measures. Such CEOs project themselves as the corporation they lead, construct a narrative about the corporation and themselves using financial accounting measures, and then reflect on how their accounting-constructed performance is perceived by stakeholders. We do not present empirical evidence about whether the use of accounting language and measures leads to unethical behaviour by extreme narcissistic CEOs . . . Rather, we focus on developing alertness to the potential for accounting, when engaged by an extremely narcissistic CEO, to be a precursor or implement of unethical behaviour."
Cohen, Krishnamoorthy, and Wright, "Corporate Governance in the Post-Sarbanes-Oxley Period: Auditors' Experiences," *Contemporary Accounting Research* (2010)	Interviews of 30 Big Four audit partners and managers	"Auditors were asked to share their experiences on who actually has the most influence in the appointment and dismissal of auditors in a public company . . . the mean percentage of actual influence assigned to the management [CEO, CFO] was 53 percent while that assigned to the audit committee was 41 percent … One key element of SOX is the certification of the financial statements by top management (Section 302) … In this study, approximately 68 percent of the respondents indicated that the requirement has had a positive impact on the integrity of the financial reports."

AAERs=Accounting and Auditing Enforcement Releases; COSO=Committee of Sponsoring Organizations of the Treadway Commission tendencies toward narcissism, especially when combined with a great deal of power, may be particularly inclined to misstate the financial results or coerce others to do so. In addition, while research evidence is mixed, it is important to consider the potential for CEO equity incentives to create strong pressure to meet targets, perhaps through manipulation of the results.

Second, the CFO's ability to withstand pressure from the CEO is critical. Research suggests that CEO pressure is key to CFO involvement in accounting manipulations. Therefore, it is important for the board, audit committee, and external auditor to monitor how the CFO responds to pressure—does the CFO always stand her ground, or does the CFO often cave in to the CEO's suggestions on accounting issues?

Third, the CEO's and CFO's role in the auditor selection process should be monitored. If management dominates this process, leaving the audit committee in a ceremonial role, it may be more difficult for the auditor to be as objective as possible. If auditor objectivity is reduced, it may be easier for management to successfully manipulate the results. The audit committee and auditor both need to monitor management's role in the auditor selection process and to take their concerns to the board if management appears to be too involved in this process.

Finally, how do the CEO and CFO approach their section 302 certifications? Is there a meaningful and robust effort to gain complete comfort with the financial results, or is the certification viewed as a "check the box" requirement? Both the audit committee and the auditor can attempt to monitor this process.

Additional Resources

The authors encourage interested readers to consult some additional resources that may be helpful in addressing the accounting fraud problem. First, Jack Dorminey, Arron Scott Fleming, Mary-Jo Kranacher, and Richard A. Riley ("Beyond the Fraud Triangle," *The CPA Journal*, July 2010) discuss several existing models of fraud, including the fraud triangle, fraud scale, and fraud diamond, each of which offers unique advantages. The authors encourage interested readers to consider a variety of models and tools available in the fraud area. For example, in addition to the traditional focus on incentive, opportunity, and rationalization as ingredients of fraud, the fraud diamond adds a fourth component, capability. Capability addresses the unique personal characteristics often needed to exploit a fraud opportunity, such as intelligence, confidence/ego, coercion skills, effective lying, and immunity to stress. (See David T. Wolfe and Dana R. Hermanson, "The Fraud Diamond: Considering the Four Elements of Fraud," *The CPA Journal*, December 2004.)

While many of these traits are desirable in executives, those authors caution CPAs and others to be alert to the risks created by these traits. Boards, audit committees, and auditors are encouraged to consider the capability of top management, including the potential for top management to coerce lower level employees into participating in a fraud. It is important to attempt to assess the level of pressure faced by lower level employees and for lower level employees to have a secure method of communicating their concerns to the board and audit committee (e.g., when inappropriate pressure is being exerted by top management).

Second, the 2008 study, "Managing the Business Risk of Fraud: A Practical Guide," sponsored by the Institute of Internal Auditors, the ACFE, and the AICPA, provides a very rich discussion of antifraud measures. The study develops and discusses five key principles involved in the fight against fraud:

Principle 1: As part of an organization's governance structure, a fraud risk management program should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.

Principle 2: Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.

Principle 3: Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.

Principle 4: Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.

Principle 5: A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and in a timely manner.

Finally, in 2010, the Center for Audit Quality (CAQ) published "Deterring and Detecting Financial Reporting Fraud," aimed squarely at the accounting fraud problem. The report states:

While there is no "silver bullet," the CAQ discussion participants consistently identified three themes:

- A strong, highly ethical tone at the top that permeates the corporate culture (an effective fraud risk management program is a key component of the tone at the top)
- Skepticism, a questioning mindset that strengthens professional objectivity, on the part of all participants in the financial reporting supply chain
- Strong communication among supply chain participants.

Thus, the CAQ report focuses on tone at the top, skepticism, and communication as the foundational elements of efforts to mitigate the accounting fraud problem. The CAQ report includes a number of insights in each of these areas. With respect to tone, the authors believe that the board and audit committee need to take a lead role in establishing and monitoring the tone at the top, for these parties are directly responsible for overseeing top management. If top management does not share or act consistent with the board's and audit committee's desired tone, then top management likely needs to be replaced.

Recent research offers new insights into the role of CEOs and CFOs in accounting fraud. In the final analysis, the accounting fraud problem will never disappear, but numerous resources may be helpful to those seeking to mitigate this problem, especially board members, audit committee members, and auditors. ❑

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