BerkeleyHaas
Haas School of Business
University of California Berkeley

Overview of Accounting Research on Fraud

Richard Sloan
Emile R. Niemela Professor of Accounting & International Business

Defining Accounting Fraud

- Securities Fraud
  - SEC Rule 10b-5 is a general prohibition against fraud in connection with the purchase or sale of a security
- Accounting Fraud
  - Section 13(a) requires filing of annual and quarterly financial statements
  - Section 13(b) requires the financial reports to “accurately and fairly present the transactions” of the issuer
  - Reliance on GAAP to evaluate 13(b)

Percentage of Total Filings

Allegation	2011	2012	2013	2014	2015
Financial Misrepresentations	94	95	97	94	99
False Forward Looking Statements	56	62	54	47	49
GAAP Violations	37	23	24	36	35

Source: Cornerstone Research

Securities Class Action Filings: 2015 Year in Review

Case Summary

Volkswagen AG : American Depositary Receipts Securities Litigation

Case Status: ONGOING

On or around 09/25/2015 (Ongoing date of last review)

Filing Date: September 25, 2015

According to the law firm press release, Volkswagen is one of the world's leading automobile manufacturers and the largest carmaker in Europe.

The complaint alleges that prior to and during the Class Period, defendants engaged in a scheme to defraud and made numerous materially false and misleading statements and omissions to investors regarding the Company's operations and its business and financial condition and outlook. Specifically, defendants misled investors by failing to disclose that the Company had utilized a "defeat device" in certain of its diesel cars that allowed such cars to temporarily reduce emissions during testing, while achieving higher performance and fuel economy, as well as discharging dramatically higher emissions, when testing was not being conducted. The use of this device allowed Volkswagen to market its diesel vehicles to environmentally conscious consumers, increasing its sale of diesel cars in the United States and abroad and, as a result, its profitability. As a result of defendants' scheme and false and misleading statements and omissions, Volkswagen's ordinary and preferred ADRs traded at artificially inflated prices during the Class Period, reaching highs of $54.82 and $56.55 per ADR, respectively, on December 30, 2013.

Motivations for Accounting Fraud

	Stock-Based Comp.	Earnings-Based Comp.	External Financing Pressure	Debt Contracts	Insider Selling
Dechow et al. (1996)		✗	✓	✓	✗
Beneish (1999)	✓		✗	✗	✓
Burns and Kedia (2006)	✓		✓	✓	
Erickson et al. (2006)	✗		✗	✗	
Efendi et al. (2007)	✓		✓	✓	
Peng and Roell (2008)	✓				✓
Johnson et al. (2009)	✓				
Call et al. (2016)	✓				

Characteristics of Accounting Fraud

- Weak governance structures
- Robust past sales growth and/or profitability that is starting to slow
- Overconfident executives exhibiting optimistic bias and escalating commitment
- Top executives with more prior legal infractions
- CEO dominates CFO

Governance Structures and Fraud

	High % Inside Directors	Chairman =CEO	Weaker Audit Committee	Non-Big N Auditor	Weak Internal Audit
Beasley (1996)	✓		✗		
Dechow et al. (1996)	✓	✓	✓	✗	
Beasley et al. (2000)	✓		✓		✓
Farber (2005)	✓	✓	✓	✓	
Coram et al. (2008)					✓

Operating Characteristics of Fraud Firms

- High sales growth
  - Beneish (1997)
- Decelerating growth in EPS
  - Johnson et al. (2009)
- Declining ROI
  - Dechow et al (2011)
- History of meeting/beating analysts forecasts
  - Chu et al. (2016)

Role of Executive Overconfidence

- ‘Slippery Slope’ paper by Schrand and Zechman (2011)
  - Detailed analysis of 49 AAERs involving financial misstatements
  - Most initial misstatements reflect optimistic bias, but are not clearly intentional
  - Executives feel compelled to make optimistic subsequent misstatements to cover initial bias
  - Overconfident executives are more likely to display optimistic bias and start down the slippery slope to intentional misstatements
    - Less variable compensation
  - Remaining fraud cases involve high fixed and variable compensation, consistent with CEO narcissism

Link to "Off-the-Job" Behavior

- Davidson, Dey and Smith (2015) on "off-the-job" behavior and financial reporting risk
  - CEOs and CFOs with a prior record of legal infractions are more likely to perpetrate fraud
  - No direct link between executive frugality and propensity to commit fraud
  - Unfrugal CEOs oversee a relatively loose control environment and other cultural changes associated with increased fraud risk

CFO Involvement

- Feng, Ge, Luo and Shevlin (2011) on CFO involvement in accounting manipulations
  - No evidence of higher CFO equity incentives
  - But their CEOs have higher equity incentives and more power
  - CFOs succumb to CEO pressure rather than seeking immediate financial benefit

Concluding Remarks

- Accounting fraud is a relatively common and well documented type of securities fraud
- Existing research suggests that high equity incentives combined with weak governance and deteriorating firm performance create the environment for fraud
- CEO traits including overconfidence, narcissism and prior legal infractions also appear to play a significant role