

**A COMPARATIVE STUDY OF CORPORATE ACCOUNTING MALFEASANCE AND
RESTATEMENTS FOR 100 COMPANIES WITH FINANCIAL AND MARKET IMPACT AND
ANALYSIS OF MONITORING CHARACTERISTICS**

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A Comparative Study of Corporate Accounting Malfeasance and Restatements for 100 Companies with financial and market impact and analysis of monitoring characteristics

ABSTRACT

This study examines corporate accounting malfeasance from an exploratory and empirical perspective for 100 companies to determine if there is an association between the Jenkins recommendations SOX requirements. The exploratory perspective discusses the types of corporate malfeasance and gives the dollar impact for the financials and the market dollar impact (\$140 and \$857 billion respectively) of 100 companies with publicly announced malfeasance. In addition to the dollar impact, the results of the exploratory study supports previous studies which found that revenue was the most common area of corporate malfeasance and actual theft was the least. The exploratory study was followed with an empirical examination of corporate malfeasance using internal (corporate governance) and external (auditor and financial analysis) monitoring characteristics by matching the malfeasance companies with non-malfeasance companies. The results of the empirical study did not find any significant differences in the monitoring characteristics of malfeasance as compared to non-malfeasance companies even though these characteristics were chosen based on an examination of recommendations/requirements for business reporting for SOX and several accounting committees over the years.

The research contributes to the body of contemporary accounting literature by providing a review of current business reporting drivers, a dollar measurement of the accounting and related market impact for malfeasance companies and a systematic investigation indicating that the difference tested, in corporate governance characteristics between malfeasance and non-malfeasance companies may not be as significant as deemed in previous studies due to the changing board of director and committee requirements by the SEC and other bodies.

I. INTRODUCTION

Announced corporate malfeasance has increased significantly since the mid-1990s resulting in a significant increase in the number of previously issued financial statements having to be restated. This has also resulted in increased dissatisfaction with the current financial reporting process by regulators and investors. Arthur Levitt's speech, The "Numbers Game" in 1998 highlighted the Securities and Exchange Commission's (SEC) discontentment with the volume of corporate malfeasance, emphasized the need for reform in the financial reporting arena and called on the accounting profession to help in the reformation process. Levitt was the Chairman of the SEC in 1998. The Enron and WorldCom accounting scandals in late 2001 and 2002, refueled the reform issue compelling regulatory and political intervention to change the financial/business reporting process with an implied objective that the reforms would reduce or eliminate corporate malfeasance.

Congress' passage of the Sarbanes-Oxley Act of 2002 (SOX) was a direct response to the accounting scandals and an attempt to reform the financial/business reporting process. But there have been several other efforts during the 20th century to reform or improve the financial reporting process due to misleading or fraudulent financial reporting: the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants during the early 1930s (Storey 1964) in response to the stock market crash of 1929; the National Commission on Fraudulent Financial Reporting formed in 1985, chaired by James C. Treadway (the Treadway Commission), (Minter 2002); etc. In 1991 the American Institute of Certified Public Accountants (AICPA) formed the Special Committee on Financial Reporting as part of the AICPA's broad initiative to improve the value of business information and the public's confidence in it. This committee was deemed the Jenkins' Committee since it was chaired by Edmund Jenkins, then a partner in Arthur Andersen.

The Jenkins' Committee report, *Improving Business Reporting-A Customer Focus; Meeting the*

Information Needs of Investors and Creditors (AICPA 1994), was published in 1994. The 200 page report, and the underlying 1600 page database is considered the most comprehensive study on user needs for business reporting information and continues to be utilized today. While none of the Jenkins' Committee recommendations have been fully implemented, these recommendations have been extremely influential in providing user information relative to financial standard setting and reporting since publication of the report as evidenced by the inclusion of several of the recommendations in the Enhanced Business Reporting Consortium's (EBRC) proposed business reporting framework (ERBC 2005) and the SOX legislation (SOX 2002). For a better perspective on the history of accounting please see Previs (1997) and Zeff (2003). The Jenkins Committee and EBRC recommendations and SOX requirements all include, in addition to other items, more transparency in business reporting, more board of director independence and less related party transactions between board members, corporate officers and the corporation (Arnold, 2006). This research seeks to examine corporate malfeasance and the historical value of these recommendation/requirements' impact on corporate malfeasance.

1.1 Corporate Malfeasance & Business Reporting

Since SOX and EBRC requirements/proposal resulted from the recent accounting scandals (corporate malfeasance) and mirror several of the Jenkins Committee recommendations, this research project includes an initial exploratory study of 100 selected accounting malfeasance companies to determine if the accounting malfeasance announced by several companies could be identified to a Jenkins' Committee recommendation and a follow-up empirical study of some of the internal and external monitoring characteristics of these companies and a matched non-malfeasance company. Overall, these studies seek to examine corporate malfeasance and some of the business reporting elements as recommended Jenkins' or required by SOX and the level of the corporate accounting malfeasance experienced in today's society. It is acknowledged that this is difficult, if not impossible to determine, therefore this study identifies and quantifies accounting malfeasance activity (\$140 billion) and the resulting marketing impact (\$857 billion) and associates the activity with the Jenkins' recommendations/SOX requirement where possible.

For purposes of these studies, we are defining corporate accounting malfeasance as the use of false or misleading accounting information or omission of these entries in the financial reporting process (announcements, filings, etc.) that later requires a restatement. This approach to restatements includes accounting errors, accounting misstatements and/or any other accounting irregularity similar to the approach utilized by the United States General Accounting Office (GAO) in their restatement study (GAO 2002). The primary difference between this and other studies is the association of the dollar impact of the accounting irregularity with the market impact and the cataloging of the malfeasance items according to Jenkins' recommendations.

Results of the study indicated that there were 180 accounting malfeasance observations for the 100 companies with an accounting impact (table 5) of over \$140 billion (overlapping) and a market impact (table 7) of over \$857 billion using the 6 months window for 96 of the 100 firms. Appendix D and tables 5, 6 and 7 summarizes the dollar impact of the observation association with Jenkins' recommendations and the accounting and market outcomes.

From the selected sample, each malfeasance companies (from the initial study) was matched with a comparable non-malfeasance company based on their standard industry classification (SIC) code and size (total assets). One of the malfeasance companies was dropped due to its closely held corporation status and the lack of publicly available data. The 4 digit SIC code was used where possible, the 3 digit, and so on until all included companies were matched. For the final phase, financial and corporate governance data for the sampled and matched companies were extracted and tested to determine if there was a statistical difference in the characteristics between malfeasance and non-malfeasance companies as the changes in business reporting recommendations and SOX requirements implied. Financial and auditor data, for these companies, was retrieved from COMPUSTAT and the corporate governance data were

extracted from the proxy statement or 10-K for each company.

The characteristics tested for internal monitoring consisted of the size of each company's board of director; the number of independent directors on the board; whether or not the audit committee was independent; the terms (staggered or same) for the board of directors; and the existence of more than one related party transactions (directors or officers). The characteristics tested for external monitoring were the brand of auditor (Big 4 or other) and auditor change in the last five years. The company's financial position was examined by carefully scrutinizing the firms leverage – total liabilities to total assets. It was hypothesized that accounting malfeasance would be positively associated with board size, classified (staggered) board terms, related party transactions and auditor change; and, accounting malfeasance would be negatively associated with board independence, independent audit committees, auditor brand and leverage.

While other studies (Farber 2005, Frankel et al 2005, etc.) examined the association between fraud and various components of corporate governance addressing board independence, audit committee make-up and the auditor type (Big 4 or other). Frankel (2005) found that in the year prior to the announced fraud, consistent with prior research, that the fraud firms had poor governance relative to his control sample. Frankel et al (2005) also found that board independence shapes the quality of earnings. Findings during this research revealed no correlation between board independence, auditor type and corporate malfeasance. The test of the control variables (not shown) showed no statistical difference between malfeasance and non-malfeasance firms (R-square of .065, adjusted R-square of .02). Although the results differ, this may be due to the years included in our studies. Farber (2005) examined companies from 1982-2000 and Frankel et al (2005) examined companies from 1988-2002, while our study examined companies from 1996-2002. The recommendation of the Blue Ribbon Committee (1999) influenced the make-up of the board of directors and board committees. The results did not reflect any statistical difference except for auditor change during this study. Several of the auditor changes were from Arthur Andersen LLP to another audit firm in 2002. Consequently, this will be examined through a future study.

While the passage of SOX (2002) and the formation of the EBRC (2005) are the most recent broad attempts at mitigating corporate malfeasance and empowering the users of public company reported information, the question is - will this help curb the volume or magnitude of corporate malfeasance? While the question appears rhetorical, what will be used to measure the success or failure of either SOX or SCEBR? Section 2.0 of this research provides an overview of corporate malfeasance and restatements and related studies on these topics; section 3.0 of this article discusses corporate malfeasance and the Jenkins Committee and SOX recommendations/requirements; section 4.0 presents the exploratory study of 100 malfeasance companies and the resulting financial and market impact; section 5.0 presents the empirical study and its results when comparing the malfeasance and non-malfeasance companies. Section 6.0 presents the summary, conclusions and areas of future research.

2.0 Corporate Malfeasance Overview & Literature Review

Identification of corporate malfeasance in this study was obtained through analysis of accounting irregularities or other announced inappropriate financial activity for a company, i.e. bribes. Fraud and accounting errors are included in this operationalization of corporate malfeasance. While it is difficult to interpret whether accounting errors and or misstatements are intentional or unintentional, they exist under managements jurisdiction and as such are management's responsibility. Therefore, these and other accounting irregularities are included as corporate malfeasance for purposes of this discussion. Other studies have addressed this in a similar manner. Dechow and Skinner (2000) made a distinction between fraud and earnings' management. They defined earnings' management as within-GAAP choices that are used to obscure or mask true economic performance (management intent). Whereas, they defined fraud as a clear intent to *deceive* using accounting practices that violate GAAP. Palmrose et al (2002) agreed

with their definition of fraud. But, they also maintained that "it is difficult for researchers, regulators and courts to distinguish empirically between unintentional errors, aggressive accounting (resulting in non-GAAP reporting) and fraud." While Dechow and Skinner (2000) define all non-GAAP reporting as fraud, they discussed in their article the difficulty expressed by Palmrose et al. (2002) of distinguishing intent. Hence, corporate malfeasance in this study contains all accounting irregularities including fraud. This studies approach to examining corporate accounting malfeasance includes accounting errors, accounting misstatements and/or any other accounting irregularity similar to the approach utilized by the GAO (2002) in their study. Here the focus is placed on corporate malfeasance and not fraud to address business reporting concerns.

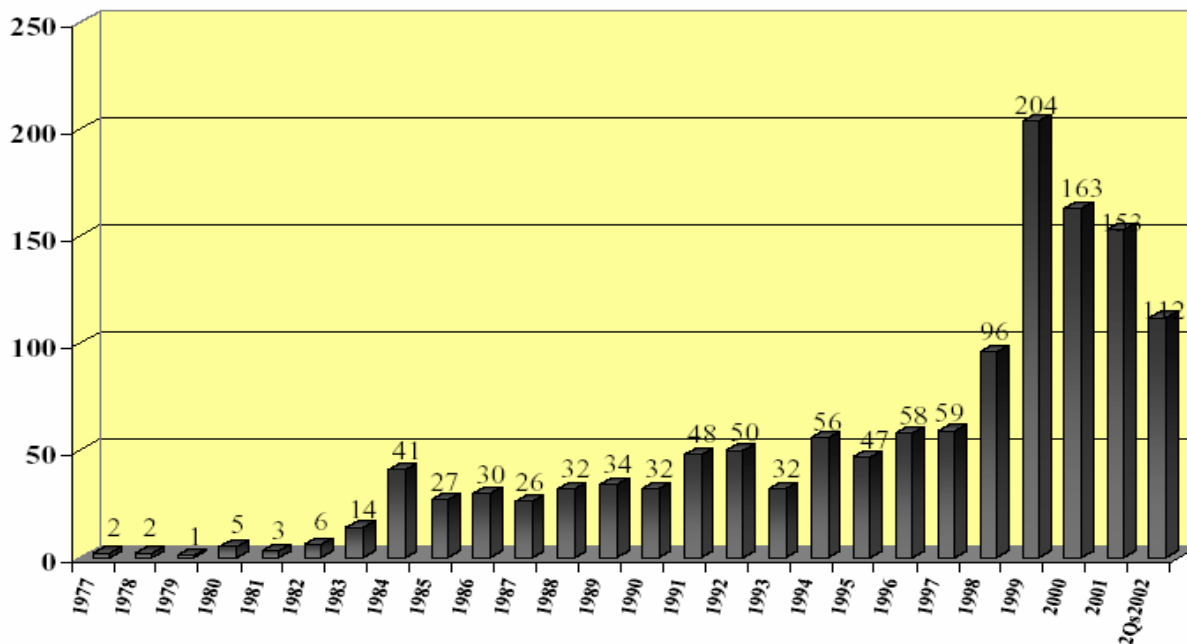
Other interesting work on this topic includes Lynch and Gomaa's (2002) discussion on technology and fraud using Ajzen's theory of planned behavior (1985) and Kohlberg's theory of moral reasoning (1981). The behavior for this type of fraud may or may not involve financial reporting, but it is the type of analysis used to determine if separation of duties, job rotation, and/or time off from job etc. will be useful as a control to prevent or detect fraud in this area. However, this paper addresses whether or not business reporting, as suggested by Jenkins, would have reduced the opportunity or exposed the malfeasance. Gillett and Uddin's (2005) study of CFO intent found CFOs of large companies were more likely to commit fraud than CFOs of smaller companies.

2.1 Increases in Corporate Malfeasance

The number of restatement companies and the magnitude of restatement dollars have been increasing significantly since the mid 1990s, whether examining the number of restatements filed or the number of restatements announced. However, the number of SEC public registrants has been decreasing. Wu's (2002) examination indicated that announced restatements increased from 56 in 1994 to 153 in 2001 – a 273% increase. The GAO study (2002) also reflected a similar growth in announced restatements with 92 announced restatements in 1997 and the volume increasing to 225 in 2001. Huron Consulting (2003) provided data that indicated restatements filed in 2002 (330) increased 285% over the number filed in 1997 (116). Results of these studies and the 1998 Levitt speech denote that the increase in corporate malfeasance reached significance even before the Enron and WorldCom scandals in late 2001. The graph below highlights this effect as it shows the number of restatements filed, between 1977 and 1997, were small relative to the number of public companies registered with the SEC.

Exhibit 3

Restatements by Year 1977-2Q2002



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 Note: Year 2001 and 2002 numbers are preliminary.

The GAO (2002) noted that the average number of companies listed on NYSE, NASDAQ, and AMEX decreased annually from 9,275 in 1997 to 7,446 in 2002. Huron (2003) also noted this decrease in the number of public registrants. Their results indicate that the number of public registrants decreased by 14% from 1997 to 2001 while the number of restatements rose by 53%. The CPA Journal further reiterated that the total number of registered companies decreased from over 10,500 in 1999 to around 9000 in 2002 (includes all US public trading companies). Some of the decrease is attributed to delisting and bankruptcy due to corporate malfeasance. Yet, there is also some decrease in the number of public registrants due to the increase in the number of public companies going private (Grant Thornton, 2003).

In past studies (Kinney and McDaniel 1989, Feroz et al 1991, Gerety and Lehn 1997), results indicated that restatement companies (1976-1984) were smaller, less profitable and slower growing than their industry or control counterparts etc. The COSO study (1999) also described restatement companies as having the same characteristics. However, recent studies (Huron 2003, Wu 2002, Palmrose et al. 2002, etc.) found that trend had changed. As the Huron report (2003) indicated, there had been a shift from small company (less than \$100M) to large companies requiring more restatements. Their study revealed that 58% of the companies filing restatements in 2002, have revenue over \$100M and 22% have revenue over \$1B.

While there have been several studies examining restatements and accounting irregularities the volume of restatements can differ significantly for the same time period. I.e. the 1997 restatement volume for GAO (2002) is 92, for Huron (2003) the volume is 116 and for Wu (2002) the volume is 59. The difference is based primarily on the type of restatement (announced or filed) and/or the type

of accounting irregularities contained in the restatements selected. For example, Huron (2003) restatement volume contains filed restatements by company in the year the restatement was filed. Both quarterly and annual restatements, with accounting errors (problems applying accounting rules, human and system errors, and fraudulent behavior), were counted. Huron (2003) source was the SEC Electronic Data Gathering and Retrieval System (EDGAR). GAO (2002) and Wu (2002) examined announced restatements in the year the restatement was initially announced. GAO (2002) included both annual and quarterly restatements while Wu (2002) only included annual restatements. Their announced restatement volume was based on accounting misrepresentation, irregularities, fraud and/or other errors. Sources for the announcements were from business news media and/or other public sources such as the SEC.

Although most restatements are announced before they are filed, as noted by Wu (2002) the time difference between when a restatement is announced and when it is actually filed can result in a lag of one to eighteen months or longer. However, the volume difference between announced and filed restatements is not just a timing difference as not all announced restatements result in filed restatements. Some companies become delisted or go bankrupt and no filing is required or can be made.

As restatements have increased, the SEC Auditing and Accounting Enforcement Releases (AAER) have also risen. Although the increase in the number of AAERs is not proportional to restatements, it is related since an announced or filed restatement can be the result of an AAER or can trigger an SEC investigation that may result in an AAER. But all restatements for accounting irregularities do not have a corresponding AAER. AAERs are issued by the SEC only after an investigation. SEC investigations are conducted to see if registered companies or persons associated with registered companies have complied with SEC regulations for accounting principles, auditing standards and/or fiduciary responsibilities. Violations of these regulations or other forms of corporate malfeasance result in AAERs. While a company or an individual may receive multiple AAERs as the SEC uncovers different violations, a company may announce or file only one restatement that contains correction of several irregularities (Callen et al 2002).

From 1982 to 1995 the SEC had issued 675 AAERs to companies and individuals (Bonner et al 1998). As of July 30, 2001, they had issued over 1480 AAERs (SEC 2003). The corresponding number of announced restatements issued during those time periods was 475 and 1208 respectively. However, this includes multiple AAERs for the same restatements and those for individuals associated with other SEC violations. For example, Dechow et al. (1996) noted that 165 of 436 AAERs from 1982-1992 were issued for actions against auditors for violations of auditing standards. In examining AAERs, we found as did Bonner et al. (1998) and COSO (1999) that AAERs corresponding to the restatement provided a more detailed description of the corporate malfeasance than can be detected from other sources. Note: From July 30, 2001 to January 30, 2006, the number of AAERs issued increased by almost 1000 to over 2300 (SEC, 2006).

As malfeasance increased, so has the impact on market value of the related companies. Buckster (1999) pointed out that \$31B in market value was lost from January 1997 to January 1998 due to corporate malfeasance. Preliminary study indicated almost a trillion dollar impact for 100 companies. This research and other studies (Wu 2002, and Palmrose et al 2002) found that while the market reacts when there is some measure of materiality, the market reacts more when there is no dollar impact stated in the initial announcement of malfeasance.

3.0 Corporate Malfeasance and Jenkins' Recommendations/SOX Requirements

Since SOX and EBRC requirements/proposal resulted from the recent accounting scandals (corporate malfeasance) and mirror several of the Jenkins Committee recommendations, we will focus on the Jenkins Committee recommendations as they relate to corporate malfeasance. While the intent of the

Jenkins' recommendations was not to address fraud directly, the underlying concept of accounting is relevant, reliable, and timely business reporting. If the information is not reliable, it is not useful. The analysis of the preliminary study and the Jenkins' recommendations indicated that there are some areas of corporate malfeasance events that were specifically addressed in the Jenkins' Committee recommendations. This would include recommendations related to the comprehensive business reporting model; specifically, those recommendations related to off-balance sheet and other innovative financial arrangement (Rec. 2 & 3 under improving the financial statements; director and management information element #7); business segment reporting and unconsolidated entities.

The two major categories of Jenkins' recommendations, 1) Improving the type of information in business reporting (comprehensive model) and 2) Improving the financial statements and related disclosure, focused on making the company more transparent through disclosures. For example, the recommendation for changing the financial reporting model to the comprehensive business reporting model included providing more detailed information and disclosure. Further analysis of the detailed requirement of the comprehensive business reporting model indicated that significant disclosure is also required in this recommendation. This study examined the detail of the accounting malfeasance for the selected companies and correlated it with Jenkins' recommendation where possible. Although not able to directly link each malfeasance event with a Jenkins recommendation (26 of 180 events/activity or 14% were directly linked), there was an indirect link with each item. This resulted in the total accounting dollars related to malfeasance events and activities being allocated between the two major recommendation categories with 87% to the first category, "Improving the Type of Information in Business Reporting (comprehensive model) and 13% to the second category, Improving the Financial Statements and Related Disclosure. However, there is overlapping of the dollars and the recommendations since both of these recommendations focus on making the company more transparent through disclosures.

A more specific and direct connection of the accounting malfeasance event(s) of the 100 companies selected to the Jenkins' recommendations indicated that: 15 had malfeasance involving off-balance sheet financing and innovative financial instruments; 10 had malfeasance involving executive management and director information; and, 1 company's malfeasance activity included a one-time gain on the sale of real-estate as continuing operating income. Other malfeasance activity did not readily lend itself to association with a specific recommendation from the Jenkins' Committee. Therefore, attention was focused on the corporate malfeasance events that related to recommendations included in the Jenkins' Comprehensive Business Reporting Model and other information such as, corporate governance, auditor information, and the overall financial condition of the company later comparing malfeasance and non-malfeasance companies.

4.0 Exploratory Malfeasance Study of 100 Companies

In order to assess whether or not the recommendations would have an impact on corporate malfeasance, this study focused on 100 companies to 1) validate previous conclusions, 2) determine what additional conclusions could be made, and 3) evaluate the relationship of the Jenkins' recommendations to the accounting irregularity. A small sample of 100 companies was selected to address Dechow and Skinner's (2000) concern that academics' samples are usually too large and too general to show an impact on investors.

In addition the announcement date of the corporate malfeasance activity for each company was used to obtain stock price information to determine the market impact of the stock price change for each company where possible. The primary difference, between this and other studies, is the association of the dollar impact of the accounting irregularity with the market impact and the cataloging of the malfeasance items according to Jenkins' recommendations. The objective was to see it were possible to associate a dollar value of corporate malfeasance with specific Jenkins' recommendations for business reporting. Since a direct connection to the malfeasance activity and the recommendations were not made, the Jenkins

recommendations were summarized in two major categories as noted in the study results. The rest of this section discusses preliminary study methodology and results which includes the assertions/conclusions derived for the accounting impact, marketing impact, Jenkins' recommendations and other areas. The results of this study are covered in section 4.4.

4.1 Sample Selection

The 100 malfeasance companies were selected based on publicized malfeasance over the late 2001 to early 2003 time period, and prior related companies discussed in the announcement articles for the selected companies. Forty-nine of the companies were selected from Rutgers University's "Cooking The Books" seminar. In addition, the 16 companies with detailed history were selected from the GAO report (2002), and the balance of the companies was then selected from the SEC AAERs (2002-2003). These companies were selected from these sources without regard to size, auditor, malfeasance activity or other criteria other than an announced accounting malfeasance event as discussed above to ensure the group would be diverse. Sources, of the accounting irregularity and for the details of the accounting irregularity, were taken from various business news articles and regulatory filings. These media were examined to obtain as much detail as possible regarding the malfeasance, the dollar impact of the malfeasance, the financial statement account(s) impacted and the earliest announced date of the irregularity. In some cases, multiple accounting irregularities were described for a company.

Detailed standard industry classification and summary classification for these companies are included in table 1 and table 2. Descriptive financial information and malfeasance information is included in tables 3 and 4 for these companies. As included in table 4, there were 180 observations of malfeasance activity for the 100 companies selected. Fifty one of the malfeasance companies were listed as fortune 500 companies at the time of the malfeasance activity according to COMPUSTAT. Fifty-three of the 100 companies include in this study were also included in the GAO study (GAO 2002). In addition, 61 of the companies had been issued at least one Accounting and Auditing Enforcement Release by the SEC (SEC 2005) with 43 of the malfeasance companies being included in both the GAO study and the SEC AAER database. There were 20 companies included in this study that were not in the GAO study nor at the time of this dissertation, had been issued an AAER.

4.2 Methodology:

The details of the accounting irregularity was further reviewed and categorized according to a detailed accounting taxonomy (Appendix A). This taxonomy was based on the taxonomies from other studies (Bonner et al 1998, Wu 2002 and Huron 2003), but modified for this study. The accounting taxonomy classified the malfeasance activity of the 100 companies into 5 major categories as they related to the company's financial statements and/or type of fraud: 1) Revenue; 2) Expense; 3) Income Inflation (including asset and liabilities impacts); 4) Theft-misappropriations (endogenous); and, 5) Exogenous (bribes, insider trading, etc.). Each of the major categories further segregated the malfeasance activity according to type. These categories were used to group the accounting and marketing dollar impacts (results of this analysis are summarized in table 5). Two coders were used to categorize the details of the accounting malfeasance and in cases where there were differences, a third coder was used to determine the applicable taxonomy category.

Classification of the malfeasance activity of the 100 companies resulted in a total of 180 accounting items for the 100 companies. The reported malfeasance was further categorized in this study according to the Jenkins' recommendations referring to the reporting model and the recommendation referring to disclosures (Jenkins' chapter 5 & 6 – AICPA 1994). The earliest located public announcement date of the malfeasance was used to assess market reaction by getting the stock price for each company 3 months before the event and 3 months after the event. In most cases, the earliest announcement date was taken from the business article. For two companies, the announcement date was taken from the GAO report and for one company from the SEC AAER.

Most market studies use a 1 to 3 day window for market reaction (Wu 2002, Palmrose et al 2002, etc.). GAO analyzed a market impact using a 1 day window and a 30 day window before and after the announcement date (GAO 2002). As noted by Wu (2002) the market starts to exhibit the decline ahead of the announcements'. Possible explanations provided are that early warnings, missing analysis forecast, or SEC formal or informal investigation, could precede restatement announcement. To ensure the decline for the market reaction was captured in this study, the announcement date was used as day zero and retrieved the common stock price for the announcement date, 3 months prior to the announcement date and 3 months subsequent to the announcement date for each company. (If the calculated date was on Saturday, the previous Friday's stock price was used and if it was on Sunday, the following Monday's stock price was used.) The S&P 500 price for each day was also obtained and each company's stock price was indexed using the S&P 500 price. The company stock price was taken from yahoo finance (<http://finance.yahoo.com>) and the S&P Daily Stock Price Record for each stock exchange for the appropriate time period. The volume for common stock outstanding, for each company, was taken from the SEC form 10K or Daily Stock Price Record for the stock price announcement window chosen.

4.3 Malfeasance Study Results – Assertions/Conclusions

The summarized results of this study indicate that the accounting impact was \$140 billion (overlapping), but the market impact using a 6 month window for 96 of the 100 firms was over \$857 billion (table 5). This study found, similar to other studies, that the majority of the restatements due to accounting irregularities (over 95%) reduced earnings for the restating company. Callen et al. (2002) examined filed restatements to see if there was any good news in restatements and found that about 15% of the filed restatements, due to accounting errors, increased the company's earnings. Results also found that restatements, particularly those related to the "Big Bath" concept, will result in an increase in earnings if restated for the current period in some cases. For example, correction of misstatements that previously created "reserve" earnings for a future period ("cookie jar" reserves) will increase earnings in the current period. Results also indicated that several of the malfeasance companies had undisclosed liabilities, special purpose entities or other off-balance sheet arrangements that should have been included on the face of the balance sheet as a liability. It was noted that 15% of the companies had violations in this area with the bulk of the problem relating to special purpose entities (SPEs) cited the most often.

Results of this study of the 100 companies with corporate malfeasance are discussed below in the next three sections (results summary Appendix D and tables 5, 6 and 7): Accounting Assertions/Conclusions; Market Assertions/Conclusions; and, Malfeasance Study and Jenkins Recommendations. Results were similar to other studies and also revealed some differences during examination of the Jenkins recommendations categorization. The similarities included that revenue recognition was the most common form of corporate malfeasance; loss of market value is significantly greater than the magnitude of the accounting dollar loss; actual theft or physical loss is the least of corporate malfeasance items; and the growth in the dollar magnitude of the loss/restatement from initial announcement to final restatement increased significantly. Listed below are conclusions from this research and related prior studies, and/or ongoing work on the assertions.

4.3.1 Accounting Assertions/Conclusions

Accounting assertions/conclusions summarize the malfeasance events and activities into the specific financial statement account or footnote requirement category according to GAAP. This categorization was determined based on details from announcement articles on the company. Again, the announced dollars related to the accounting category were included, when available. However, in some cases, only high level information (i.e. net income, assets) was provided in the announcement and therefore accounting specifics (revenue or expense) could not be ascertained. Accordingly, the high level information was included based on the taxonomy category. Table 5 provides the malfeasance activity based on taxonomy classification.

Assertion #1: Most of the malfeasance occurred in the revenue and revenue recognition area (49 of the 100 companies had revenue as an impacted account).

GAO (2002) results indicate that 39% of the restatements included revenue recognition. Palmrose and Bonner's (1998) findings also showed that revenue was the most common variety of fraud. Palmrose and Scholz (2002) also found that revenue misstatements are the most frequent reason for restatement (37%) and their evidence indicated that revenue restatements are associated with significantly higher payments by defendants.

The SEC issued Staff Accounting Bulletin 101 in 1999 to provide further guidance on Revenue Recognition. Both the FASB and the ISB have revenue recognition projects underway (FASB 2002). But as the Jenkins' Committee (1994) and others have reiterated, more information, beyond GAAP revenue, is needed to help project future earnings and cash flows.

Assertion #2: Actual dollar adjustments for malfeasance restatements are often significantly larger than initially announced.

The dollar magnitude, of the final restatement actually filed, is usually larger than the initial or other (sometimes several announcements before restatement) prior announced restatement dollars for accounting irregularity. (i.e. WorldCom accounting dollar concerns grew from the initially announced \$2.9B to a possible net income overstatement of over \$11B in improper bookings). Once a restatement is required, companies often use this opportunity to more closely examine their accounting records and processes. Swieringa (1984) and Levitt (1998) considered this phenomenon as "accounting magic" and "big bath" respectively. The dollar amount of a restatement grows larger as more items are revealed that will require restatement. Again, it is difficult to determine what is accounting malfeasance and/or what was an unintentional mistake. Most of the accounting entries included in a "Big Bath" can be done in accordance with GAAP since GAAP requires that estimated costs (current and future) associated with restructuring be charged against income in the year in which the decision to restructure is made (Swieringa (1984). This was also seen in several studies even during profitable years as companies smoothed earnings. Other examples of increasing the final restatement include:

- a. Although the initially announced restatement may have been due to revenue overstatement, the final restatement may include increases in expenses for the restatement period thereby further reducing income.
- b. Large expenses are sometimes set aside into 'restructuring' reserves reducing income. Later these reserves are deemed excessive and returned to the income statement thereby increasing income for the then current period.
- c. Asset write-downs or write off (asset cumulative impairment) are also common during this time.

Assertion #3: Theft is the least likely malfeasance item for restatements in most large public companies.

Out of the estimated \$131.5B accounting dollars related to the malfeasance for the 100 companies studied, only \$0.4B (less than .5%) was attributable to direct theft. The evidence indicates that it's not about stealing; it's about manipulating the books or creating opportunity for manipulation of the market price. The preponderance of this type of white-collar fraud occurs in the manipulation of accounting dollars to obtain market reaction/value. Additional fraud occurs through the misappropriation of assets (e.g. purchase art for CEO) or incurrence of liabilities (e.g. guarantee loan) on behalf of officers or directors of the company.

The CFE Report (2002) noted that over 80% of occupational fraud involved asset misappropriation, 13% were corruption schemes, and 5% were fraudulent statements. The results of this study showed

that the smaller the company, the greater the median loss. This concurs with this study's results that actual theft is usually not material relative to the size of most public companies and therefore not usually cited as the reason for restatement.

4.3.2 Market Assertions/Conclusions

The market assertions/conclusions are based on the results of subtracting the 3 months window before the announcement date from the 3 months window after the announcement date for each company and determining the price difference. The 3 months (before and after) window was also used to index the stock price using the S&P 500 for each company as described above. Results (Table 6) indicate that there was an overall market impact of \$858B (\$598B indexed to S&P 500). It was also found, as did other studies (Palmrose et al 2003, GAO 2002 and Wu 2002), that there was a more negative market reaction to restatements involving revenue recognition than any other type.

Assertion #4: The loss of market value of a company due to malfeasance allegations is significantly higher than the accounting value of the direct effects on the financial statements. Adjusted market value change is about 20 times larger than net income effect.

While the approximately 20 multiplier mirrors the P/E ratio, the results are more direct and broadly reflective than the PE ratio. Although the accounting dollar amounts may not have been provided in the initial announcement of restatement/malfeasance, the news itself, that the dollars would have to be restated and/or an investigation (internally or SEC), was enough to cause a reaction in the market. The market reaction is more pronounced if the announcement mentions an effect on revenue or net income.

Studies (Wu 2002; Palmrose et al 2002; and Dechow et al 1996) found that the most significant decline of value is during the initial announcement windows. Dechow et al. (1996) found that the average stock price dropped approximately 9% at the initial announcement of alleged earnings manipulation. Although Palmrose et al. (2002) used a 2 day window to test market reaction and sample of announced restatement companies from 1994-1999, and Wu (2002) used a 3 day window for companies that announced restatements from 1977-2Q2002, similar results were observed. Both studies found that the market reacts to some measure of materiality, and there is a penalty or punishment for the company when no dollar amounts are given with the announcement.

Market reaction noted by Palmrose et al (2002), commented that "substantial portion" of the restatements examined (1995-1999) were due to in process research and development (IPR&D), but there was only mild market reaction to these restatements. While IPR&D was a major restatement item for companies 1999 and prior Palmrose 2003), Huron (2003) found that only 3 of 833 restatements filed from 2000 through 2002 reflected IPR&D as an explanation for restatements. (Additional guidance on IPR&D was provided in 2000 by the AICPA in the form of a practice aid.)

Assertion #5: The market reacts more to changes in values that are presented/disclosed in the financial statements than to missing items/events that should have been included or disclosed. While there has been much discussion about disclosure, the malfeasant sample seems to indicate much larger effects in account over/under statement than the known absence of disclosure (information that should have been included in the financial statements).

Dollars related to actual accounting errors, erroneous accounting activity, or questionable use of GAAP which impacted the accuracy and/or reliability of the financial statements were more common in the 100 malfeasance companies selected for this study. Items requiring disclosure had fewer dollars which could be indicative of the lack of information available to determine a more accurate impact. However additional disclosure on inaccurate accounting information for malfeasance companies would also be inaccurate and therefore not useful for decision making.

5.0 Empirical Study: Corporate Malfeasance & Monitoring Characteristics

From the historical analysis of Jenkins and the exploratory study above, identification was made although indirectly, of the Jenkins' recommendations that addressed the types of accounting malfeasance in this study's selected sample. The identified Jenkins' recommendations include: events related to off-balance sheet and other innovative financial arrangement; director and management information; business segment reporting and unconsolidated entities. These items were also included in either SOX or EBRC. Since the Jenkins' recommendations were not implemented, this study continued by testing characteristics of the malfeasance companies that related to a Jenkins' recommendation, SOX requirement, or EBRC proposed framework: more disclosure, more board independence, and less related party transactions between board members, officers and the corporation. Secondly, corporate governance, auditor characteristics and a financial condition proxy were examined comparing each malfeasance company selected for our initial study to a matched non-malfeasance company and tested using a logistic regression. This follow-up study examined corporate governance as an internal monitoring tool; and, the financial analysis and auditor characteristics as an external monitor tool.

5.1 Corporate Governance – Internal Monitoring Tool

With the accounting scandals of the late 20th and early 21st centuries, public interrogations continue - where was the board? Where were the auditors? In some cases of malfeasance, the answer resonates: they (the board and the auditors) were there, but they were part of the problem (SEC AAER 1996-2003). From the initial study, 10% of the malfeasance companies had accounting irregularities that included related party transactions and compensation issues involving management and directors. Since management and director malfeasance were found to be a problem in the initial study, an examination was conducted of whether or not there is a significant difference between malfeasance companies and non-malfeasance companies in the make-up of the board of directors, their relationship with management, major shareholders, etc. and the type of information included about directors. Beasley (1996) and Abbott et al. (2000) had conflicting results regarding characteristics of the board of directors and their relationship to financial misstatements. Characteristics examined included independence, director tenure, shareholdings, etc. Beasley found these characteristics were related to financial misstatements and Abbott et al. (2000) found that they were not. Gordon and Henry (2004) found a negative relationship between industry-adjusted returns and related party transactions, which supports the perceived conflict of interest between the management board/ and the shareholders.

The Jenkins' Committee determined, from user comments, that users were concerned about the relationship between management, shareholders and directors. Users wanted identity and background checks of members of executive management and the board of directors to be provided in the business reporting package inclusive of any criminal convictions. This would also include publicizing the compensation, and compensating policies for these individuals as well as who decided on the compensation (with interlock and insider participation being the concern). Other information users wanted disclosed included any transactions or relationship issues among major shareholders, directors, management, suppliers, customers, competitors and the company. Since the Jenkins' report was published, there have been some actions taken to strengthen the board of directors from the shareholder's perspective, such as the requirements from the Blue Ribbon Committee.

Interestingly, Jonas and Blanchet (2000) were concerned about the Jenkins' Committee and recommendations from other committees. Their concern was that recommendations were either user needs motivated (the focus of the Jenkins' recommendations, the FASB Conceptual Model and the Earnings persistence Model) or shareholder/investor protection motivated (the focus of the Kirk recommendations, SEC, Blue Ribbon recommendation #8 and SAS 61.) They maintained that quality financial reporting should encompass both user needs and investor protection. According to Jonas and Blanchet (2000), user needs tend to focus on valuation related issues, while investor protection tends to focus more on corporate governance and stewardship issues. The following 5 hypotheses were utilized

during this follow-up study: H1: Company malfeasance is positively associated with board size (the number of directors on the board). H2: Company malfeasance is negatively associated with the number of independent directors on the board. H3: Company malfeasance is negatively associated with the number of independent directors on the audit committee. H4: Company malfeasance is positively associated with staggered terms of the directors on the board. And, H5: Company malfeasance is positively associated with the number of officer/director related party transactions.

5.2 Auditor Brand and Change/Tenure

One of the Jenkins' model element requests that "information about management and shareholders," include the disclosure of the nature of any disagreements between management and directors, independent auditors, bankers, and lead council that are no longer affiliated with the company. This would reveal information to users that would have a contrasting or conflicting position of that provided or presented by the company. Disagreements could also point out additional items that the company did not disclose, that the disagreeing party thought should have been disclosed. Regardless of the resolution of the disagreement, information regarding the disagreement would make the company more transparent to users. Auditor disagreements should be documented in the auditor's work papers and resolved to the auditor's satisfaction before the audit report is issued. If not, the disagreement may impact the type of audit report issued by the auditors, depending on the nature and extent of the disagreement. In some cases, auditor disagreements will cause management to change auditors. In these cases, where disagreements result in management firing the auditor or the auditor resigning, the reason for the auditor change has to be provided to the SEC.

Changing auditors is not something that is done lightly since it must be reported. While there are many good reasons for changing auditors (upgrading to a bigger audit firm, changing to an industry specialty firm, etc.) changing due to disagreement over accounting practices or reporting requirements is not that common since most disagreements are resolved between auditor and management or directors. Changing auditors is an expensive process for the company and for the audit firm. There are significant start-up costs on both sides when new auditors are engaged. While it has been discussed that usually the initial fee for audit engagements may be low to get the audit client, ("low balling") that is not the focus of this paper. Here the focus is on whether or not an auditor change occurred for a malfeasance company during the 5 years prior to the announced malfeasance. Then, the reason for the change will be determined, if the information is accessible.

The Jenkins' Committee discussed user concern about auditor independence, but only to reiterate the importance of auditor independence. The Committee's recommendations and primary focus in this area addressed the topic of flexible auditor association. Flexible auditor association specifies that the auditors should be associated with the business reporting records of the company at all levels as agreed to by the user and the company. The Committee did not address other services or specific issues relating to the auditor's association with the company as does SOX. However, Kinney et al. (2003) found that there did not appear to be evidence to support that audits were less independent due to performance of other services. Kinney et al. (2003) they did find some positive association between "other services and restatements. As in previous studies, the quality of the audit was also an issue. Therefore, Big 4 or non-big 4 auditor differences were tested. For this study two hypotheses on auditor brand and auditor change are set forth: H6: Company malfeasance is negatively associated with the brand of the auditor (Big 5 or non-big 5) and H7: Company malfeasance is positively associated with auditor change in the five years prior to the announced malfeasance.

5.3 Malfeasance and Debt

Malfeasance companies were not expected to be highly leverage due to utilization of the appearance of a "healthy" financial position to continue to obtain cash from investors through the market. The market benefit, in several instances for malfeasance companies, is for the benefit of a few individuals

(management, directors and other insiders) and not for the benefit of the company. Therefore, there is usually no reason other than fraud to take creditor money and not use it for the purpose intended. Several studies have been done to indicate that debt covenant restrictions may be one reason for earnings management. These restrictions are not being considered in this study on corporate accounting malfeasance. While earnings management usually implies using the accounting rules (GAAP) to your advantage to manage earnings, corporate malfeasance for this study's purpose is the intentional or unintentional use of an accounting irregularity in published or announced financial results for a company. It is contended that malfeasance companies, are not any more leveraged than other companies, but may not have as much cash or cash equivalent assets as non-malfeasance companies. For that reason, hypotheses # 8 is: Company malfeasance is negatively associated with firm leverage.

5.4 Data Selection for Empirical Study

The actual announcement date, for the selected malfeasance sample, was used as the focal point not only for the initial study, but also for the follow-up study data retrieval for the testing of malfeasance characteristics. The company's annual financial data in the year prior to the announcement was utilized for analysis in this study. For example, if the malfeasance announcement was made in 2002, then data for the year 2001 was used. Financial statement data for each malfeasance company (the sample) was taken from COMPUSTAT data using the Wharton Research Database System (WRDS) based for the year prior to the announcement date. However for 3 of the sample companies, no data was available in the year prior to the announcement, so data for the previous prior year prior was used, i.e., announcement year minus two. This approach (announcement year minus one) was also applied to the selection of the non-malfeasance firms for hypotheses testing.

5.5 Matching Methodology

Since one of the companies was a closely held corporation, it was excluded from the sample. For the remaining 99 malfeasance companies, an attempt was made to match each with a non-malfeasance company based on the malfeasance company's 4-digit SIC and size (total assets). COMPUSTAT Research Insight was used to gather this historical data. Initially, the 4-digit SIC was used for the sample companies to retrieve the total assets for all companies with the specified SIC. In most cases the number of companies retrieved for a specified SIC was too large to easily isolate a match, therefore, a range based on the sample company's size (total assets) was used to narrow the company volume for that 4-digit SIC. If no comparable size company was found in the 4-digit group, then the SIC code was narrowed to 3 digits, then 2 digits, then 1 digit or finally for 3 companies; they were matched simply on size as the remaining non-malfeasance companies in their SIC (even one digit) were too small.

After a comparable match was determined, the matched companies were each checked for malfeasance using the same sources used for the sampled companies, news media, professional/business journals and publications, google.com and yahoo.com as well as the GAO study and SEC AAERs. After the initial match, 15 of the 98 non-malfeasance companies were eliminated (due to malfeasance) and the matching process repeated to select another non-malfeasance company. After the date of the initial matching process, several other companies (5) deemed to be non-malfeasance companies committed some type of accounting malfeasance and were replaced by repeating the matching process. Therefore, the matching non-malfeasance sample had a cut-off of no known malfeasance as of May 2005.

5.6 Proxy Statements for Sample and Matching Companies

Proxy statements were examined to ensure they included director information. When the proxy statements were not available, the 10K director information was used. For foreign companies listed in the U.S., the 20-F required by the SEC was used. In cases where the data from a wholly owned subsidiary was used, the proxy for the parent company was employed to capture the director information.

No SEC filings or information could be located for three matched companies' board of directors. These

were foreign companies who apparently did not file any reports with the SEC. There were no indications that a 20-F, 10K, or even a Williams Report had been filed in the last 10 years. COMPUSTAT did however have financial data for these companies. To keep the matching as similar as possible, these companies were replaced in both the financial analysis and corporate governance section with 3 other companies using the matching process described above. In addition, 2 other matching companies were replaced during the proxy search due to malfeasance activity by their parent company and in one instance, the company had recently changed its name, seemingly due to an accounting malfeasance issue under its previous name.

5.7 Malfeasance Characteristics Hypotheses

The characteristics tested for internal monitoring were the size of each company's board of director; the number of independent directors on the board; whether or not the audit committee was independent; the terms (staggered or same) for the board of directors; and the existence of more than one related party transaction (directors or officers). The characteristics tested for external monitoring were the brand of auditor (Big 4 or other) and auditor change in the last five years. An examination was conducted of the company's financial position by examining the firms leverage – total liabilities to total assets. It was hypothesized that malfeasance would be positively associated with board size, classified (staggered) board terms, related party transactions and auditor change and negatively associated with board independence, independent audit committees, auditor brand and leverage.

5.8 Malfeasance Characteristics Study Results

The dependent variable in this study is a dichotomous variable: either the company has malfeasance or it does not. Therefore, logistic regression was used for the testing. But, the resulting regression only had an adjusted R-square of .02. The only significant variable in the correlation matrix was company size as expected since this was one of the parameters for matching.

Farber (2005) also examined the association between fraud and various components of corporate governance addressing board independence, audit committee make-up and the auditor type (Big 4 or other). He found that in the year prior to the announced fraud, consistent with prior research, that the fraud firms had poor governance relative to his control sample. Dunn (2004) also had similar results. Frankel et al. (2005) also found that board independence did shape the quality of earnings. No correlation was found in this study between board independence, auditor type and corporate malfeasance. The test of the control variables (not shown) shows no statistical difference between malfeasance and non-malfeasance firms (R-square of .065, adjusted R-square of .02). Although results differ for this research, it may be due to the years included in these studies. Farber (2005) examined companies from 1982-2000, Dunn (2004) examined companies from 1992-1996, and Frankel et al (2005) examined companies from 1988-2002, whereas this study examined companies from 1996-2002. The recommendation of the Blue Ribbon Committee (1999) influenced the make-up of the board of directors and board committees. Results of this research did not show any statistical difference except for auditor change. Since several of the auditor changes were from Arthur Andersen LLP to another audit firm in 2002, this pinpoints further examination in a future study.

6.0 SUMMARY, CONCLUSIONS AND FUTURE RESEARCH

6.1 Summary –Corporate Malfeasance

Summarization of this study of the 100 companies, with accounting malfeasance, was divided into three sections (Appendix D - results summary): accounting assertions/conclusions; market assertions/conclusions; and, malfeasance study and Jenkins' recommendations. Accounting and market results indicated that the accounting impact was \$140 billion (table 5), and the market impact (using the 6 month window for 96 of the 100 companies) was over \$857 billion (table 6). Table 7 provides the market to accounting relationships using the malfeasance taxonomy classifications. Results, for this study, were similar to other studies and also revealed some differences during examination of the Jenkins

recommendations categorization. The similarities included that revenue recognition was the most common form of corporate malfeasance; loss of market value is significantly greater than the magnitude of the accounting dollar loss; actual theft or physical loss is the least of corporate malfeasance items; and, the growth in the dollar magnitude of the restatement from initial announcement to final restatement (“Big Bath” or “Cookie Jar”). The initial exploratory study also validated findings from other studies. Listed below are the conclusions from this initial study and/or ongoing work on the assertion:

1. Most of the malfeasance occurred in the revenue and revenue recognition area (49 of the 100 companies had revenue as an impacted account).
2. Actual dollar adjustments for malfeasance restatements are often significantly larger than initially announced.
3. Theft is the least likely malfeasance item for restatements in most large public companies.
4. The loss of market value of a company due to malfeasance allegations is significantly higher than the value of the direct effects on the financial statements.
5. The market reacts more to changes in values that are presented/disclosed in the financial statements than to missing items/events that should have been included or disclosed.

The follow-up study, after analysis of the categorized accounting malfeasance companies, matched the malfeasance companies with a non-malfeasance company to examine the difference, if any, in corporate governance issues (i.e., board size, board independence, audit committee independence, staggered term board, and related party transactions), auditor, auditor change and company leverage. Results did not show any statistical difference except for auditor change. Since several of the auditor changes were from Arthur Andersen LLP to another audit firm in 2002, therefore, further examination of the 2002 auditor changes is warranted for future study.

6.2 Study Limitation

The primary limitation of this study was that the initial 100 accounting malfeasance companies were not selected in a random manner from one population. However, there was also no bias in their selection. Although this limitation and other occurred, they did not hinder the contribution of this research to the contemporary accounting literature.

Conclusions and Future Research

There is definitely more disclosures in business reporting than there were during the early 1990s due to the SEC and FASB requirements issued since that time. However, those requirements did not prevent the accounting scandal (Enron, WorldCom, etc.) culminating in 2002. Will the SOX requirements or a new business reporting model reduce corporate malfeasance in the future as currently, corporate malfeasance continues to flourish (DHB 2007, AIG 2006, etc)? Although malfeasance is a behavioral issue, enhanced business reporting and penalties for non-adherence to reporting requirements are attempts to reduce and change that behavior. Will it work? As the SEC now has more staff and, therefore, will be conducting more investigations and reviews of public companies’ financial filing, future opportunities will enable study of the SEC’s results and assess what’s working and what’s not working.

This study contributed to the current accounting literature by providing a dollar measurement of the accounting and market impact for malfeasance companies, supported findings in previous studies in some areas, provided more detail on the areas of malfeasance and utilized a 6-month window as opposed to a 6 day window generally used in market assessment studies. In addition, the study provided brief historical information regarding business reporting drivers.

6.4 Future Research

A follow-up study of the status of the 100 selected malfeasance companies and their matches for a period of time to assess survivors, merger, bankruptcies, etc. would be an opportunity for future research. Future accounting issues on corporate malfeasance could include an assessment of whether malfeasance firms indicate more book value than market value of non-malfeasance companies. Future work, pertaining to

corporate governance, could include whether firms with malfeasance are more likely to have a higher percentage of interlock directors than non-malfeasance firms. It could also compare the number of other directorships held by directors of malfeasance firms as compared to a control group of firms with no announced malfeasance.

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APPENDIX A - MALFEASANCE TAXONOMY

1) Revenue

1-1: Fictitious Revenue – Revenue created through fictitious sales transactions or revenue created through cooperation/collusion with another company to increase both company's financial profile.

- a. *Round-tripping*; sale of contract from company A to company B and then from company B back to company A (at least one round-trip, but can be more) to increase revenues for each company.
- b. *Back-to-back*; sale of assets from company A to company B at a gain and then from company B back to company A at a gain to increase income for each company. Round tripping is a form of back-to-back but usually with no gain.
- c. *Fraudulent sales*; Revenue created from fictitious sales transactions with or without sales' orders and/or shipping documents (customer names can be legitimate or fictitious).

1-2: Revenue Timing – A valid sales transaction recognized as complete in a different accounting period than when the actual transaction was completed. This overstates revenue in one period and understates it in another.

- a. *Premature revenue recognition*; recognizing revenue on a valid sales transaction before the sales transaction is completed.
- b. *Backdating sales or software invoices/contracts*; a form of premature revenue recognition in which the date for a completed sales or software contract transaction is changed to an earlier accounting period than when the actual transaction was completed.

1-3: Revenue Misclassification & Other Improprieties – Recognition or misclassification of sales transactions that are not valid sales transaction due to terms being incomplete and/or other contingent information.

- a. *Improper classification/recognition of revenue*; recognition of revenue from sales that are not completed sales transactions – i.e. goods on consignment, overselling goods to distributorships, and/or other buy-back/return agreements.
- b. *Improperly revenue disclosures*; Recognition of sales transaction (one-time revenue gain) without disclosing in footnotes that this was a one-time gain/transaction.
- c. *Reduction of inflated reserves*; revenues created by reversing previously created expense reserves (cookie jar reserves – put away reserves in good times to be used in bad times to increase income).
- d. *Revenue reduction*; Skimming revenue for regulatory rate increases.

2) Expense

2-1: Expense/Cost Classification – Misclassification, non-recognition or unauthorized expenses of the period.

- a. *Compensation Abuses*; Unauthorized pay and bonuses, excess/unauthorized use of company assets and backdating of stock options.
- b. *Fraudulent capitalization of current expenses*; capitalizing expenses as assets to be written-off over a period of time that should be included as costs of the current period.
- c. *Expense or Cost Misclassifications/Manipulation*; recording expense(s) in a later period than incurred or changing the amount of an expense in the current period.
- d. *Non-recognition of losses*; Disregarding or erasing expenses of the period.
- e. *Fictitious or inflated expenses to boost regulatory rates*.

2-2: Big Bang Theory – The process of recordings more costs and expense during an accounting period than normal when 1) a restatement resulting in lower income is required to be filed or 2) a significant loss has occurred for the reported period.

- a. *Restructuring Costs (Fraudulent or Misclassified)*; using a loss/restatement situation to create a reserve (asset) for future restructuring/reorganization of the business by expensing the dollars in the current period (required by GAAP). As the restructuring occurs in the future, the charges will

be written off against the reserve account. However if it is determined that the reserve is not needed or that the reserve is overstated, then the unneeded dollars are added to income in the period for which it was determined the reserves were not needed.

- b. *Erroneous or Inaccurate reserves recorded*; recording expenses in periods of high income to build “cookie-jar” reserves and/or to reduce income.
- c. *Write-downs*; using a loss/restatement situation to write-down or write-off assets that were later be used or sold. This will reduce the asset cost when sold in a later period thereby increasing income.

3) Income Inflation-Assets-Liabilities

3A: Inflated Income – Income inaccurate but the specific revenue or expense impact or detail was not available. Only income impact is provided.

- a. *Earnings inflation to meet analyst expectation*; inappropriate use of reserves, false financial statements, etc.)
- b. *Improper accounting to inflate income*; bundling leases, insufficient disclosures, etc.
- c. *Fraudulent accounting schemes*; Use of shell companies, erroneous reserves, etc.
- d. *Accounting errors*; overstatement of perishable inventory, premature revenue recognition, etc.
- e. *Improper internal controls*; internal controls did not detect errors.

3B1: Assets overstated – Any situation where the specific revenue or expense detail was not available, but the resulting asset(s) detail or impact was provided:

- a. *Mark-to-market abuse*; recognize gross revenues as profits resulting in receivables overstated.
- b. *Assets not properly written down*; inventory overstated, goodwill overstated, etc.
- c. *Overstating reserves through restructuring*; Creating excess reserves based on big-bang theory (see expenses above) or cookie-jar reserves (see revenue above).

3B2: Disclosures & Understated Liabilities – Any situation where the specific revenue or expense detail was not available, but the resulting liability detail or impact was provided.

- a. *Non-Disclosure or inadequate disclosure of liabilities*; debt and guaranteed loans not disclosed, liability not included in financial statement in the appropriate manner, etc.
- b. *Improper off-balance-sheet financing of assets*; inappropriate synthetic leases, etc.
- c. *Fraudulent use of SPEs and inadequate disclosure of SPE accounting issues*; inappropriate reclassification of debt related to SPE, SPEs listed that did not meet SPE criteria, unauthorized SPEs; transfer of bad debt and other items to SPE inappropriately.
- d. *Non-recognition of liability*; liability not disclosed that should have been disclosed or presented in financial statements.

4) Theft - Misappropriation

4A: *Inappropriate purchases/payments to/for employees/officers*; Misuse of company assets by employees and officers.

4B: *Compensation and/or stock abuse by officers*; granting of options or other stock payments to officers that is not included in the contract or that does not meet company requirements for such action.

4C: *Inadequate or no repayment of loan by officers/directors*; loans repayment dismissed resulting in a decrease in assets or earnings of the company.

5) Exogenous

5-1 *Insider trading*; trading by an employee of his company’s stock based on knowledge of an impending downturn or upturn in the company’s financial position thereby increasing the employee’s financial position. Also sharing this information with others (family or friends) and they then act upon the employee’s privileged information.

5-2 *Bribery/Influence Peddling*; illegal payment by a company to a public official or private individual to

gain favorable treatment for that company or the company's goods or services.

5-3 *Conflicts of interest*; Taking a fiduciary position in a situation or making a fiduciary decision on an issue where you are not independent (personal or business relationship, stock owner, etc.).

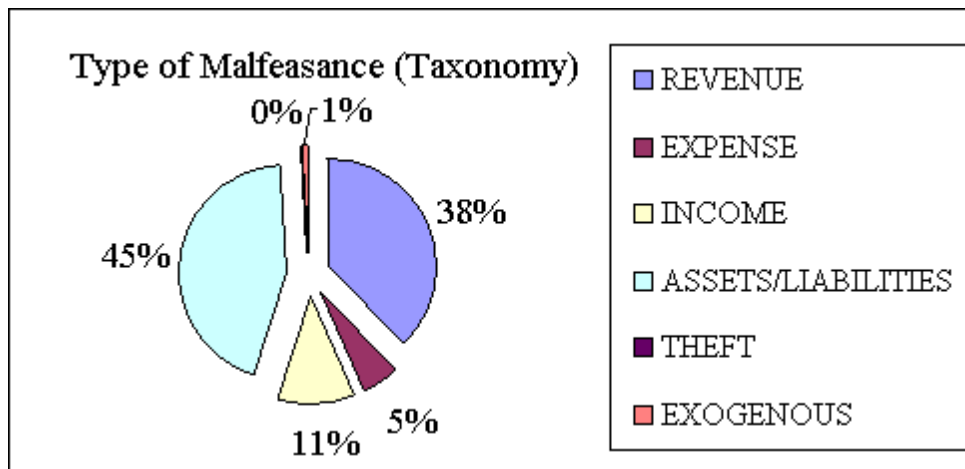
5-4 *Abetment/Accessory to malfeasance of others*; assisting others in misrepresenting financial information.

5-5 *Loan guarantees for executive*; Excessive or inappropriate loan guarantees for employees or board members.

5-6 *Related party transactions*; Transactions occurring with approval being made or sanctioned by persons with a personal or business relationship with the person, organization or company requiring the approval.

APPENDIX D SUMMARY RESULTS OF INITIAL MALFEASANCE STUDY

| <u>TAXONOMY ACCOUNTING EFFECT</u> | | | |
|--|--------------------|--------|---------|
| 1- | REVENUE | 53174 | 37.88% |
| 2- | EXPENSE | 7468 | 5.32% |
| 3-A | INCOME | 16109 | 11.48% |
| 3-B | ASSETS/LIABILITIES | 62571 | 44.58% |
| 4- | THEFT | 42 | 0.03% |
| 5- | EXOGENOUS | 1008 | 0.72% |
| | | 140372 | 100.00% |



| <u>ACCOUNTING: JENKINS' RECOMMENDATIONS IMPACT</u> | | |
|---|--------|--------|
| Improving Information - Comprehensive Model | 122073 | 86.96% |
| Improving Information - Related Disclosures | 18299 | 13.04% |
| | 140372 | |

| <u>MARKET IMPACT</u> | <u>Gross</u> | <u>Indexed</u> |
|-----------------------------|---------------------|-----------------------|
| Gross Market Impact | 857415.00 | 655418.00 |
| Market Mean | 8931.41 | 6827.27 |
| Market/Accounting | <u>Gross</u> | <u>Indexed</u> |
| Mkt/Rev | 16.1 | 12.3 |
| Mkt/Exp | 114.8 | 87.8 |
| Mkt/Inc | 53.2 | 40.7 |
| Mkt/A&L | 13.7 | 10.5 |
| Mkt/Theft | 20414.6 | 15605.2 |
| Mkt/Exogenous | 850.6 | 650.2 |

Table 1-Panel A: Detailed Standard Industry Classification

| SIC | Industry Title | Number* firms | Percent |
|-----|--|------------------|---------|
| 01 | Agriculture Production - Crops | 1 | 1.01% |
| 13 | Oil and Gas Extraction | 2 | 2.02% |
| 20 | Food and Kindred Products | 1 | 1.01% |
| 23 | Apparel and Other Textile Products | 1 | 1.01% |
| 26 | Paper and Allied Products | 2 | 2.02% |
| 27 | Printing and Publishing | 1 | 1.01% |
| 28 | Chemical and Allied Products | 6 | 6.06% |
| 32 | Stone, Clay, Glass and Concrete Products | 1 | 1.01% |
| 34 | Fabricated Metal Products | 1 | 1.01% |
| 35 | Computer Equipment | 5 | 5.05% |
| 36 | Electrical Equipment | 6 | 6.06% |
| 37 | Transportation Equipment | 3 | 3.03% |
| 38 | Measurement Analyzing, Control, etc. | 2 | 2.02% |
| 48 | Communications | 6 | 6.06% |
| 49 | Electric, Gas & Sanitary Products | 8 | 8.08% |
| 50 | Durable Goods | 1 | 1.01% |
| 51 | Non-Durable Goods | 4 | 4.04% |
| 53 | General Merchandise Stores | 3 | 3.03% |
| 54 | Food Stores | 3 | 3.03% |
| 57 | Home Furniture, Furnishings Stores | 1 | 1.01% |
| 58 | Eating and Drinking Places | 2 | 2.02% |
| 59 | Miscellaneous Retail | 3 | 3.03% |
| 60 | Depository Institutions | 2 | 2.02% |
| 61 | Non-Depository Institutions | 3 | 3.03% |
| 62 | Security & Commodity Brokers, etc. | 1 | 1.01% |
| 63 | Insurance Carriers | 2 | 2.02% |
| 64 | Insurance Agents, Brokers & Service | 1 | 1.01% |
| 67 | Holding & Other Investment Offices | 2 | 2.02% |
| 73 | Business Services | 19 | 19.19% |
| 78 | Motion Pictures | 2 | 2.02% |
| 79 | Amusement and Recreation Services | 2 | 2.02% |
| 80 | Health Services | 1 | 1.01% |
| 82 | Educational Services | 1 | 1.01% |
| | Total | 99 | 100.00% |

*One company was a closely held corporation and no SIC was available.

Table 2: Summary Standard Industry Classification Code

| SIC | Industry Title | Number firms | Percent |
|-------|-----------------------------------|--------------|---------|
| 01-09 | Agriculture | 1 | 1.01% |
| 10-14 | Mining | 2 | 2.02% |
| 20-39 | Manufacturing | 29 | 29.29% |
| 40-49 | Transportation & Public Utilities | 14 | 14.14% |
| 50-51 | Wholesale Trade | 5 | 5.05% |
| 52-59 | Retail Trade | 12 | 12.12% |
| 60-67 | Finance, Insurance, Real Estate | 11 | 11.11% |
| 70-89 | Services | 25 | 25.25% |
| | Total | 99 | 100.00% |

Table 3: Financial Summary Description of Malfeasance Companies (\$ in millions)

| | N | Minimum | Maximum | Mean | Std. Deviation |
|--------------------|----|---------|---------|----------|----------------|
| TotAsst | 99 | 16 | 902210 | 29988.87 | 100627.533 |
| Sales | 99 | 1 | 111826 | 13470.54 | 22090.580 |
| NetInc | 99 | -13356 | 13519 | 170.19 | 2955.804 |
| Valid N (listwise) | 99 | | | | |

Table 4: Malfeasance by Announcement Year for Firms (\$ in millions)

| | Number Firms | Number Observations | Dollars Amount | Observation Mean | Dollar Mean |
|-------|--------------|---------------------|----------------|------------------|-------------|
| 1997 | 6 | 14 | 1159 | 2.33 | 193.17 |
| 1998 | 8 | 23 | 2954 | 2.88 | 369.25 |
| 1999 | 11 | 17 | 4190 | 1.55 | 380.91 |
| 2000 | 8 | 19 | 4692 | 2.38 | 586.50 |
| 2001 | 18 | 32 | 6388 | 1.78 | 354.89 |
| 2002 | 45 | 70 | 119757 | 1.56 | 2661.27 |
| 2003 | 4 | 5 | 1232 | 1.25 | 308.00 |
| | | | | | |
| Total | 100 | 180 | 140372 | 1.80 | 1403.72 |

Table 5: Malfeasance Taxonomy Classification (\$ in millions)

| | Number Firms | Number Observations | Dollars Amount | Observation Mean | Dollar Mean |
|------------------|--------------|---------------------|----------------|------------------|-------------|
| 1- Revenue | 48 | 67 | 53174 | 116 | 1108.98 |
| 2 - Expense/Cost | 27 | 27 | 7468 | 58 | 132.04 |
| 3-A Income | 33 | 39 | 16109 | 69 | 694.12 |
| 3-B Asset | 12 | 15 | 54438 | 25 | 4290.58 |
| 3-C Liabilities | 12 | 14 | 8133 | 26 | 677.75 |
| 4 - Theft | 4 | 4 | 42 | 8 | 10.50 |
| 5 - Exogenous | 13 | 14 | 1008 | 27 | 77.54 |
| | | | | | |
| Total | 100 | 180 | 140372 | 280 | 1403.72 |

Table 6: Stock Price Change and Market Impact (\$ in millions)

| | ^a N | Minimum | Maximum | Sum | Mean | Std. Deviation |
|-----------------------|----------------|------------|----------|------------|----------|----------------|
| prminus3 | 96 | 1.09 | 169.50 | 3038.91 | 31.66 | 24.64 |
| AnnPrice | 96 | .11 | 102.89 | 2181.55 | 22.72 | 19.93 |
| prplus3 | 96 | .10 | 84.50 | 1622.73 | 16.90 | 15.98 |
| gainloss | 96 | -128.50 | 4.49 | -1416.18 | -14.75 | 17.57 |
| gnlspc | 96 | -.99 | 2.48 | -42.64 | -.44 | .45 |
| sp500chg | 96 | -.29 | 3.03 | -1.79 | -.02 | .34 |
| InX% chg | 96 | -72.66 | 19.83 | -138.46 | -1.44 | 7.69 |
| InXPrChg | 96 | -135.42 | 8.32 | -1241.12 | -12.93 | 18.08 |
| ^b numshrs | 96 | 5.95 | 7324.00 | 58606.06 | 610.48 | 1105.29 |
| ^b Mktgnlos | 96 | -80845.44 | 7354.07 | -601149.01 | -6261.97 | 13635.66 |
| ^b absMktgl | 96 | 2.74 | 80845.44 | 655417.70 | 6827.27 | 13358.67 |
| ^b GrossMkt | 96 | -104224.14 | 3582.52 | -857414.50 | -8931.40 | 17775.90 |

^a Stock prices for 4 of the 100 companies in the original study were not available due to 2 of the companies being closely held corporation and the other two companies stock prices not listed in daily stock records for the time period needed.

prminus3 = Stock price minus 3 months

AnnPrice = Stock price announcement date

prplus3 = Stock price minus 3 months S&P500 market change (index)

gainloss = Price gain or loss \$ from -3 months to +3 months

gnlspc = Price gain or loss percent

sp500chg = S&P500 market \$ change (index)

InX% chg = S&P500 market % change (index)

InXPrChg = Price change indexed using S&P market change

Numshrs = Number of shares (in millions)

Mktgnlos = Market gain or loss - in millions (InXPrChg times Numshrs)

absMktgl = Absolute value of market gain or loss -in millions

Table 7: Accounting/Marketing Dollar Relationships (\$ in millions)

| | <u>Gross</u> | <u>Indexed</u> |
|----------------------------|--------------|----------------|
| Market/Revenue | 16.1 | 12.3 |
| Market/Expense | 114.8 | 87.8 |
| Market/Income | 53.2 | 40.7 |
| Market/Asset & Liabilities | 13.7 | 10.5 |
| Market/Theft | 20414.6 | 15605.2 |
| Market/Exogenous | 850.6 | 650.2 |