Corporate fraud may lead to neighborhood financial crimes

November 16 2020, by Jeff Grabmeier

The former Enron complex in Houston, site of one of the most infamous corporate accounting scandals. Credit: . Alex, CC BY 2.0 , via Wikimedia Commons.

After a major corporate fraud case hits a city, financially motivated neighborhood crimes like robbery and theft increase in the area, a new study suggests.

Researchers from The Ohio State University and Indiana University found that the revelation of corporate accounting misconduct is linked to about a 2.3 percent increase in local financially motivated crimes in the following year.

Corporate fraud had the strongest effect on local crimes in smaller cities with fewer job opportunities and higher income inequality.

The researchers confirmed the finding using several different methods and showed the link applied only to financial crimes and not violent offenses like murder or rape.

"Our results suggest that big corporate fraud scandals can have community implications well beyond the firm itself," said Eric Holzman, co-author of the study and assistant professor of accounting at Ohio State's Fisher College of Business.

"The effect is strongest in smaller cities where the economic impact of the fraud is most severe."

Holzman conducted the study with Brian Miller and Brian Williams at Indiana University. It was published yesterday (Nov. 14, 2020) in the journal *Contemporary Accounting Research*.

The researchers analyzed FBI data on 255 cases of corporate accounting misconduct between 1996 and 2013. They then examined crime rates in the cities where the firms were headquartered.

The 2.3 percent increase in financially motivated crimes was found even after accounting for a variety of other factors, including local unemployment rates at the time of the fraud, poverty rates, and crime rates before the accounting fraud was revealed. The link between the accounting fraud and local crime lasted about three years before it faded.

The findings were strongest when the fraud was associated with a larger drop in the company's stock price and when it received more media attention.

Several of the results suggest crime increased the most in cities where the fraud had the biggest economic impact on the community.

For example, larger impacts occurred when the corporation had to lay off a higher number of employees, when it occurred in smaller cities with fewer job opportunities, and where there were larger income gaps between the rich and poor.

These results didn't surprise Holzman, who spent nine years as a forensic accountant in Washington, D.C., investigating corporate fraud cases.

"I would go to some of these smaller towns and you could see the economic devastation that happened when the big local employer got involved in accounting misconduct and had to close or lay off a lot of employees," he said.

The researchers did several other analyses to confirm their findings. In one, they matched 88 of the cities where fraud occurred to similar cities where there was no corporate malfeasance. They found no similar increases in financially motivated crimes in the cities that had not experienced fraud.

In another analysis, they looked at what would happen if they imagined corporate fraud scandals happening at random times in random cities. Would they still find many cities experiencing increases in financially related crimes the following year?

After running this scenario 10,000 times, they found increases in crime similar to their real findings only 1.7 percent of the time—suggesting their results were unlikely to be random chance.

While the findings are intriguing, Holzman cautioned against drawing too firm a conclusion about why this is happening.

"It doesn't necessarily mean that people who lose their jobs are turning to a life of crime, or that they see this fraud and think it is now OK to steal. It may be something else, like an increase in teen delinquency due to added stress at home linked to the adverse economic conditions brought by the fraud," he said.

"We found a strong association in our study using multiple research designs, but we need different kinds of studies to determine a causal mechanism."

More information: Eric R. Holzman et al. The Local Spillover Effect of Corporate Accounting Misconduct: Evidence from City Crime Rates, *Contemporary Accounting Research* (2020). DOI: 10.1111/1911-3846.12659

Provided by The Ohio State University