

Two out of three corporate frauds go undetected, research finds

February 18 2023



Credit: Pixabay/CC0 Public Domain

To professor Alexander Dyck, corporate fraud is like an iceberg: a small number is visible, but much more lurks below the surface.

How much more, he wondered? And, at what cost to investors?

Prof. Dyck and his team found that under typical surveillance, about three percent of U.S. companies are found doing something funny with their books in any given year. They determined that number by looking at financial misrepresentations exposed by auditors, enforcement releases by the U.S. Securities and Exchange Commission (SEC), financial restatements, and full legal prosecutions by the SEC against [insider trading](#), all between 1997 and 2005.

However, the freefall and unexpected collapse of auditing firm Arthur Andersen, starting in 2001, due to its involvement in the Enron accounting scandal, gave Prof. Dyck, from the University of Toronto's Rotman School of Management, and other researchers the chance to see how much [fraud](#) was detected during a period of heightened scrutiny. It represented "a huge opportunity," that rarely comes along, said Prof. Dyck, putting 20 percent of all U.S. publicly traded companies—the slice that had been working with Andersen and were forced to find new auditors—under a higher-powered microscope due to their previous association with the disgraced accounting firm.

Those companies did not show a greater propensity to fraud compared to other companies in the 1998 to 2000 period. But that changed once the spotlight was turned on beginning Nov. 30, 2001—the date when Andersen client Enron began filing for bankruptcy—until the end of 2003, the period the researchers looked at. The new auditors, as well as regulators, investors and [news media](#) were all looking much more closely at the ex-Andersen companies.

"What we found was that there was three times as much detected fraud in the companies that were subjected to this [special treatment](#), as a former Andersen firm, compared to those that weren't," said Prof. Dyck, who holds the Manulife Financial Chair in Financial Services and is the Director of the Capital Markets Institute at the Rotman School.

The researchers used the finding to infer that the real number of companies involved in fraud is at least 10 percent. That squares with previous research that has pegged the true incidence of [corporate fraud](#) between 10 and 18 percent. While the researchers were looking at U.S. companies, Prof. Dyck speculated that the ratio of undetected-to-detected fraud is not significantly different in Canada.

Given those numbers, the researchers estimated that fraud destroys about 1.6 percent of a [company's](#) equity value, mostly due to diminished reputation among those in the know, representing about \$830 billion in current U.S. dollars.

The figures also help to quantify the value of regulatory intervention, such as through the Sarbanes-Oxley Act, or SOX, introduced in 2002 in response to Enron and other financial scandals. Its not hard to come up with the compliance costs of SOX. What their study shows is that the legislation would satisfy a [cost benefit analysis](#), even if it only reduced corporate fraud by 10 percent of its current level.

The results should capture the attention of anyone with responsibility for corporate oversight and research, Prof. Dyck says, "I spend a lot of time running a program for directors of public corporations and I tout this evidence when I say, 'Do I think you guys should be spending time worrying about these things? Yes. The problem is bigger than you might think.'"

The research was co-authored with Adair Morse of the University of California at Berkeley and Luigi Zingales of the University of Chicago. It appears in the [Review of Accounting Studies](#).

More information: Alexander Dyck et al, How pervasive is corporate fraud?, *Review of Accounting Studies* (2023). [DOI: 10.1007/s11142-022-09738-5](#)

Prof. Dyck will present his research during an event hosted by the Capital Markets Institute on February 23, which will also include a discussion with representatives from academia, the plaintiff's bar, regulators, and accountants. Further details are [online](#).

Provided by University of Toronto

Citation: Two out of three corporate frauds go undetected, research finds (2023, February 18) retrieved 24 May 2024 from <https://phys.org/news/2023-02-corporate-frauds-undetected.html>

<p>This document is subject to copyright. Apart from any fair dealing for the purpose of private study or research, no part may be reproduced without the written permission. The content is provided for information purposes only.</p>
--