Sociological study reflects high financial malfeasance rates in largest US corporations

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The need to "fix" or restate financial statements is an admission by corporate management that these reports (prior to their being corrected) to the government and the investing public misrepresented the corporations' financial positions, Texas A&M University sociology professor Harland Prechel reports in a research paper published in the June 2010 issue of the *American Sociological Review* (ASR).

Prechel and Theresa Morris of Trinity College in Hartford, Connecticut, examined the revised statements from hundreds of the largest U.S. companies between 1995 and 2004, then co-authored the paper, titled "The Effects of Organizational and Political Embeddedness on Financial Malfeasance in the Largest U.S. Corporations: Dependence, Incentives, and Opportunities."

The researchers' analysis examines restatements that occurred after Congress passed the 2001 Sarbanes-Oxley Act, which held chief financial officers (CFOs) and chief executive officers (CEOs) personally responsible for corporate violations of security and exchange laws. Soon after this legislation was passed, the number of financial restatements rapidly increased. After eliminating the legitimate reasons for financial restatements such as accounting rule changes, their analysis shows that over 21 percent of the corporations in their study group restated their finances at least once, and some as many as seven times, during the study period.

Their research centers on financial statements, corporate structure, and politics. And the findings have important implications for public policy, Prechel says. "The corporate and state structures enacted in the late 20th century were the outcome of a long-term, well-financed and systematic political strategy that provided managers with unprecedented power, autonomy, and opportunity to engage in financial malfeasance," the paper's summary states.

There are three main findings from their quantitative analysis. First, capital dependence on investors creates incentives to engage in financial malfeasance. Second, managerial strategies to increase shareholder value create incentives to engage in financial malfeasance. Third, the multilayer-subsidiary form and the political structure permitting corporate political action committees' (PAC) contributions create opportunities to engage in financial malfeasance.

A key point of the analysis, Prechel says, is that the multilayer-subsidiary business model, where parent companies own multiple legally independent subsidiary corporations, creates opportunities for managers to engage in financial malfeasance by overstating the value of the assets in these corporate entities. Prechel says that one case of improper reporting involved Enron, which overstated the value in one of its subsidiaries by $256 million.

He says he and Morris focus on the concept of "malfeasance"—an act that violates a law or a rule (or violates their intent) established by a government agency or a nongovernmental organization responsible for corporate financial oversight—rather than "crime," because behaviors that are legal may still mislead investors, especially small investors, due to information asymmetry (i.e., when one party (e.g., the company) has access to information that the other (e.g., investor) lacks).

Individual investors are vulnerable when they invest in corporations directly or via mutual funds, Prechel says. "There are opportunities for management to

engage in financial malfeasance that investors aren't even aware of," he explains. "Management is aware of the true financial picture, while individual investors are not."

Companies that do not use the multilayer subsidiaries form file revisions less frequently, Prechel says.

"The more subsidiaries a parent company has, the higher the likelihood it will restate its finances," he says. "But, in the cases that were included in the analysis, there is no good reason for management to not understand their corporation's financial status."

He says Congress could fix the problem by reinstating the tax on capital transfers that it removed in 1986.

Provided by American Sociological Association

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