PAC ANNUAL CONFERENCE

PROFESSIONAL ACCOUNTING FUTURES

How well do we Understand who the Winners and Losers are from Adverse Accounting Events

(Frauds, Weakness of Internal Control, KAM Reporting, Going Concern)

Karim Jamal

Professor, University of Alberta

Professional Accounting Centre
UNIVERSITY OF TORONTO
MISSISSAUGA

WHAT DO WE LEARN FROM CORPORATE FAILURES?

Karim Jamal
University of Alberta
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At The Start of the Modern Audit.

- William Welch Deloitte and Especially Edwin Waterhouse Sell Private Audits in an Unregulated Market.
  - They make Companies Auditable (no Sam Bankman-Fried).
  - Give Suggestions for Internal Control and Efficiency.
  - Issue Written Accounting Standards and Audit Methodologies.
  - Issue Audit Reports (Deloitte – “Audited”; Waterhouse differentiated by writing longer audit reports = KAM reports now).
  - Work for Shareholders (and report Top Management Fraud)

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Now

- More Diffuse Share Ownership.
- Rise of Managerial Power.
- De-Professionalization (Commercialization) of Audit.
- More Litigation.
- More Regulation/Regulators.

- Should We Be Changing our Intuition About How Audit and Fraud Work?

Lets Look at 3 Recent Issues.

- 1) Does Fraud Attract (or Repel) Students from Choosing Accounting as a Major?.....(Attracts).
- 2) What Happens to an Auditor Who is Strict and Issues a Deficient Internal Control Report to Clients? .....(Career Limiting Move).
- 3) What are Costs of Getting Caught for Fraud? And How Many Fraudsters Don't Get Caught? .....(Lot).

Students [Carnes,Christensen and Madsen], JAR Dec 2023.

- Idea of Imprinting – First impressions have huge lifetime effects.
- Idea of Local Effects – Reputation and Contagion are very local.
- Survey conducted every year in the US (HERI) – 953 Universities in all 50 States (over 2 million observations from 1985-2009).
- Look at effect of local frauds on College Major chosen by Freshman students … then later follow up on career choices

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Findings

- Local Fraud exposure (while in high school) leads to (4%) more students choosing Accounting as a Major.
- Academic aptitude is higher for these students (SAT Scores).
- Express more pro social views (want to help others, be a leader).Express less commercial views (want a job, want to make a lot of money).
- More likely to become a CPA, and work in public accounting

Strict Auditors[Cowle, Rowe et al] TAR, May 2022, working paper

- Test Idea about Managerial Power in Audit Firm / Partner Selection.
- Firm level Question – What happens if an office issues higher than average level of Material Weakness in Internal Control Opinions (ICO's)?
- Lower rate of growth of office (lose Adverse ICO clients, lose non Adverse-ICO existing clients, less new clients).
- Lower growth in audit fees.(More visible client).
- Give less adverse ICO's – Growth comes back.

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How About the Partner who Issues Adverse ICO?

- Get reassigned from Adverse ICO Company.
- Lose 404(b) (larger) clients – existing, new.
- Lower # of 404(b) Clients, and Audit fee growth (even 3 yrs later) – lower overall fee growth. For larger client ICO – more loss to Partner Portfolio.
- No loss if Partner Inherited Adverse ICO company.

- What if Adverse ICO was Not Given? – Would Need Restatement / Fraud to Trigger Negative Outcomes.

Does Fraud Pay?

- Can Look at Frauds That Get Caught.
- What is a Fraud?
- Like Adverse ICO, it Depends on What Someone Says is a Fraud (Financial Misrepresentation More Broadly).

- 1) SEC – goes after small companies, financially weak companies, revenue recognition issues – Many studies done with this data = a biased subset of fraud? Many SOX reforms are questionable because they are based on only this data (AAER's).

More Sources of Fraud

- Class Action Lawsuits / Media like the Opposite Cases – Big Companies (Deep Pockets).
- Some Studies use Restatements (Depends on Auditor / Regulator Judgment)
- Other Lawsuits / Short Sellers etc.
- Lots of Debates About Adequacy of Legal Penalties (Fines – Should Shareholders Pay again?, Jail), Though Karpoff et al propose the Largest Source of Loss are Reputational (Lost Sales, Cost of Capital, Go Bankrupt etc).

Cost of Fraud Detected

- Huge Loss in Stock Market Value of Company.
- 28% of SEC Companies File for Bankruptcy. (More Fines?).
- 90% of Named Executives Fired.Some Fined, Jail.
- Auditor Change, Fine, Jail.
- No / Low Cost to Directors (Yet Governance Reform often Cited as Remedy).

What is Probability of Getting Caught?

- Some Statistical Models are Developed to Predict Fraud.
- Natural experiment by Dyck, Morse and Zingales (RAST, 2023) to use Collapse of AA to Estimate Undetected Fraud.
- Use Multiple Definitions of “Fraud”
- Test Shows AA Clients are not Different than Clients of other Accounting Firms Prior to 2000 (Accruals, Restatements, AAERS, Lawsuits)

Post Enron (2001-2003)

- More Scrutiny of AA clients (and to some extent everyone else also)
- Show that Former AA Clients get more Qualified Opinions, More Restatements, More AAER's, More Lawsuits – More of Everything.
- Estimate that Only About 1/3 of Bad Reporting is Caught During Normal Times.
- Main Beneficiaries of Aggressive Reporting are CEO's With Large Option Grants (and Founder CEO's).

After 2004

- Less Pressure / Scrutiny on Former AA clients
- Former AA Client Propensity for Being called “Fraud” Same as Everyone Else.

Conclusion

- Shareholders of Companies Called “Fraud” and their Executives (and Auditors) Suffer Huge Penalties.
- Yet Frauds occur so
- Either There is a Non Rational Component Driving Fraud (Overconfidence, Excitement, Narcissism), or
- Probabilty of Getting Caught is Too Low. Need More Enforcement and Better Auditing.
- Need to Focus Ethics and Penalties on Executives.
- Directors Unlikely To be The Solution.