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Much criticized though it has been, this financial rule provides provides early warning of corporate fraud, study finds

Since its passage in 2002 in response to financial scandals that shook the corporate world, the Sarbanes-Oxley Act, or SOX, has been a constant target of criticism. And probably no provision of SOX has provoked more complaints than Section 404(b), which requires companies to have external auditors assess the adequacy of the internal controls the firms establish over their financial reporting.

Indeed, the criticism shows no sign of letting up. Testifying before a Congressional panel in July of this year, the president of the New York Stock Exchange claimed that 404(b) deserved much of the blame for the dwindling number of public corporations in the U.S., lamenting that the provision has saddled companies with "significant cost" but "doesn't show clearly that we've reduced fraud and [hasn't] greatly inspired confidence."

Now some new research may inspire greater confidence.

A study in the current issue of ***Auditing: A Journal of Practice & Theory***, published by the **American Accounting Association**, concludes that 404(b) provides what the paper calls "an early warning system" for company fraud. It finds "a statistically and economically significant association between material weaknesses [in internal controls] and the future revelation of fraud...driven entirely by instances where the internal control issue reflects a general opportunity to commit fraud."

According to the new research, the incidence of fraud disclosures at companies previously found to have material weaknesses is about 80% or 90% greater than it is among the general run of firms. Further, of the 127 fraud cases identified by the study, 36 of them, or almost 30%, were preceded by auditor reports of material weakness in internal controls.

"Although material-weakness reports mostly reflect accounting errors and portend revelations of fraud only infrequently, the fact that they precede almost 30% of the instances where fraud does, in fact, come to light should lead investors, regulators, and legislators to take notice," comments Matthew Ege of Texas A&M University, who carried out the study with Dain C. Donelson and John M. McInnis of the University of Texas at Austin.

Or, in the words of the study, "SOX Section 404(b) provides a potential benefit of an early warning system for future fraud revelation. Given the criticism of SOX and discussion in favor of its repeal or curtailment, this benefit is an important consideration alongside the costs of internal control reporting."

Whether material weakness in internal controls is connected to fraud has been a hotly debated issue in accounting. At the time SOX was implemented, SEC commissioners expressed strong confidence that requiring internal-control assessments would deter the kind of massive fraud that had recently been exposed at Enron and other companies. Yet, scholars and accounting professionals alike have expressed skepticism, contending that top company managements could override the best-laid internal controls. In fact, some argued that devious corporate leaders would *favor* strong controls, since it would reduce the chance of discovery of their own malfeasance and its fruits would fall to them personally rather than to fraudsters in the ranks.

Thus, as the new paper explains, “the idea that strong internal controls reduce the fraud risk has long been controversial.” And, while it has been well established that material weaknesses lead to financial restatements and low accounting quality, "these studies generally do not distinguish between errors and fraud...We provide the first evidence that weak internal controls are associated with a higher risk of unrevealed accounting fraud."

To do so, the professors collected some 14,000 auditor internal-control opinions issued for large and mid-sized corporations and analyzed the relationship between reports of material weaknesses and revelations of company fraud within the following three years. Fraud was identified through review of 1) settled securities class-action lawsuits for violations of generally accepted accounting principles and 2) federal enforcement actions by the SEC or Department of Justice.

In all, auditors issued some 1,500 reports of material weakness, of which 127 (about 8.5%) were followed within three years by legal actions that revealed fraud. This infrequency notwithstanding, if the time frame is turned around, 36 of the 127 fraud revelations (about 30%) turn out to have been preceded by reports of material weakness. CEOs were named in 111 of the 127 fraud cases and CFOs in 108.

In three fourths of the 36 cases preceded by material-weakness reports, the fraudulent activity that later came to light was taking place undetected at the time of the audit. How did the weakness enable fraud? The professors test three plausible mechanisms – 1) opportunity created by a specific account or process; 2) opportunity stemming from a company-wide operational lapse (such as general accounting incompetency); and 3) cultural failings, such as habitual tolerance of misconduct. The evidence, they conclude, supports the second route, a finding, they believe, that should make investors or regulators especially wary of shrugging off operational weaknesses that are company-wide.

The paper takes note of earlier research which found that only a minority of firms made timely reports of material weaknesses in their financial statements and which took regulators to task for failure to penalize companies for not doing so. Comments Prof. Ege: “Our study may very well suggest a reason, at least in some instances, for firms’ reluctance to report material weaknesses. In any event, it certainly should provide some further incentive for regulators to penalize such omissions.”

As for whether their findings argue for saving Section 404(b), the authors demur. As Prof. Ege explains, “Much of the criticism of the provision has to do with the cost it imposes on companies, an issue that our research doesn’t engage. What this study certainly should do is persuade regulators and legislators to think extra hard before repealing or curtailing this rule.”

The study, entitled "Internal Control Weakness and Financial Reporting Fraud," is in the August/October issue of ***Auditing: A Journal of Practice & Theory***, published quarterly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *The Accounting Review, Accounting Horizons, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Journal of Information Systems, Journal of Financial Reporting, The Journal of the American Taxation Association,* and *Journal of Forensic Accounting Research.*

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