AN EMPIRICAL ANALYSIS OF MARKET REACTION TO CORPORATE ACCOUNTING MALFEASANCE
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ABSTRACT
This study examines corporate accounting malfeasance from an exploratory and empirical perspective for 100 companies to determine if there is an association between the Jenkins recommendations and SOX requirements and to determine if there are any differences between the internal and external monitoring characteristics of malfeasance and non-malfeasance companies. The exploratory perspective discusses the types of corporate malfeasance and gives an accounting and market dollar impact ($140 and $857 billion respectively) of 100 companies with publicly announced malfeasance and supports previous studies findings that revenue was the most common area of corporate malfeasance and theft was the least. The empirical study examined internal (corporate governance) and external (auditor and financial analysis) monitoring characteristics by matching the malfeasance companies with non-malfeasance companies. This empirical study did not find any significant differences in the monitoring characteristics of the companies even though these characteristics were chosen based on an examination of recommendations/requirements for business reporting for SOX and several accounting committees over the years. Previous studies indicated a difference. The research contributes to contemporary accounting literature by providing a dollar measurement of the accounting and related market impact for malfeasance companies and a systematic investigation testing monitoring characteristics between malfeasance and non-malfeasance companies.

JEL: -M4, M40, M41, M48, M49.

KEYWORDS: Accounting Restatements, Accounting Malfeasance, Corporate Malfeasance, SOX, Jenkins Report, Jenkins Recommendations.

INTRODUCTION
Announced corporate malfeasance has increased significantly since the mid-1990s resulting in a significant increase in the number of previously issued financial statements having to be restated. This has also resulted in increased dissatisfaction with the current financial reporting process by regulators and investors. Arthur Levitt’s speech, The “Numbers Game” in 1998 highlighted the Securities and Exchange Commission’s (SEC) discontentment with the volume of corporate malfeasance, emphasized the need for reform in the financial reporting arena and called on the accounting profession to help in the reformation process. The Enron and WorldCom accounting scandals in late 2001 and 2002 refueled the reform issue compelling regulatory and political intervention to change the financial/business reporting process with an implied objective that the reforms would reduce or eliminate corporate malfeasance.

Congress’ passage of the Sarbanes-Oxley Act of 2002 (SOX) was a direct response to the accounting scandals and an attempt to reform the financial/business reporting process. But there have been several other efforts during the 20th century to reform or improve the financial reporting process due to misleading or fraudulent financial reporting: the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants during the early 1930s (Storey 1964) in response to the stock market crash of 1929; the National Commission on Fraudulent Financial Reporting formed in 1985, chaired by James C. Treadway (the Treadway Commission), (Minter 2002); etc. In 1991 the American Institute of Certified Public Accountants (AICPA) formed the Special Committee on Financial Reporting, later deemed the Jenkins’ Committee since it was chaired by Edmund Jenkins, then a partner
LITERATURE REVIEW

Identification of corporate malfeasance in this study was obtained through analysis of accounting irregularities or other announced inappropriate financial activity for a company, i.e. bribes. Fraud and accounting errors are included in this operationalization of corporate malfeasance. While it is difficult to interpret whether accounting errors and or misstatements are intentional or unintentional, they exist under management’s jurisdiction and as such are management’s responsibility. Therefore, these and other accounting irregularities are included as corporate malfeasance for purposes of this discussion. Other studies have addressed this in a similar manner. Dechow and Skinner (2000) made a distinction between fraud and earnings’ management. They defined earnings’ management as within-GAAP choices that are used to obscure or mask true economic performance (management intent). Whereas, they defined fraud as a clear intent to deceive using accounting practices that violate GAAP. Palmrose et al (2002) agreed with their definition of fraud. But, they also maintained that "it is difficult for researchers, regulators and courts to distinguish empirically between unintentional errors, aggressive accounting (resulting in non-GAAP reporting) and fraud." While Dechow and Skinner (2000) define all non-GAAP reporting as fraud, they discussed in their article the difficulty expressed by Palmrose et al. (2002) of distinguishing intent. Hence, corporate malfeasance in this study contains all accounting irregularities including fraud. This studies approach to examining corporate accounting malfeasance includes accounting errors, accounting misstatements and/or any other accounting irregularity similar to the approach utilized by the GAO (2002) in their study. Here the focus is placed on corporate malfeasance and not fraud to address business reporting concerns. The number of restatement companies and the magnitude of restatement dollars have been increasing significantly since the mid 1990s, whether examining the number of restatements filed or the number of restatements announced. However, the number of SEC public registrants has been decreasing. Wu’s (2002) examination indicated that announced restatements increased from 56 in 1994 to 153 in 2001 – a 273% increase. The GAO study...
(2002) also reflected a similar growth in announced restatements with 92 announced restatements in 1997 and the volume increasing to 225 in 2001. Huron Consulting (2003) provided data that indicated restatements filed in 2002 (330) increased 285% over the number filed in 1997 (116). Results of these studies and the 1998 Levitt speech denote that the increase in corporate malfeasance reached significance even before the Enron and WorldCom scandals in late 2001. Wu’s 2002 study also highlighted this effect as it showed the number of restatements filed, between 1977 and 1997, were small relative to the number of public companies registered with the SEC. Corporate malfeasance usually requires a restatement of previously issued financial statements.

In past studies (Kinney and McDaniel 1989, Feroz et al 1991, Gerety and Lehn 1997), results indicated that restatement companies (1976-1984) were smaller, less profitable and slower growing than their industry or control counterparts etc. However, recent studies (Huron 2003, Wu 2002, Palmrose et al. 2002, etc.) found that trend had changed. As the Huron report (2003) indicated, there had been a shift from small company (less than $100M) to large companies requiring more restatements. Their study revealed that 58%, of the companies filing restatements in 2002, have revenue over $100M and 22% have revenue over $1B. Although most restatements are announced before they are filed, as noted by Wu (2002) the time difference between when a restatement is announced and when it is actually filed can result in a lag of one to eighteen months or longer. However, the volume difference between announced and filed restatements is not just a timing difference as not all announced restatements result in filed restatements. Some companies become delisted or go bankrupt and no filing is required or can be made. As restatements have increased, the SEC Auditing and Accounting Enforcement Releases (AAER) have also risen. Although the increase in the number of AAERs is not proportional to restatements, it is related since an announced or filed restatement can be the result of an AAER or can trigger an SEC investigation that may result in an AAER. But all restatements for accounting irregularities do not have a corresponding AAER. AAERs are issued by the SEC only after an investigation.

SEC investigations are conducted to see if registered companies or persons associated with registered companies have complied with SEC regulations for accounting principles, auditing standards and/or fiduciary responsibilities. Violations of these regulations or other forms of corporate malfeasance result in AAERs. While a company or an individual may receive multiple AAERs as the SEC uncovers different violations, a company may announce or file only one restatement that contains correction of several irregularities (Callen et al 2002). From 1982 to 1995 the SEC had issued 675 AAERs to companies and individuals (Bonner et al 1998). As of July 30, 2001, they had issued over 1480 AAERs (SEC 2003). The corresponding number of announced restatements issued during those time periods was 475 and 1208 respectively. However, this includes multiple AAERs for the same restatements and those for individuals associated with other SEC violations. For example, Dechow et al. (1996) noted that 165 of 436 AAERs from 1982-1992 were issued for actions against auditors for violations of auditing standards. In examining AAERs, we found as did Bonner et al. (1998) that AAERs corresponding to the restatement provided a more detailed description of the corporate malfeasance than can be detected from other sources. Note: From July 30, 2001 to January 30, 2006, the number of AAERs issued increased by almost 1000 to over 2300 (SEC, 2006). As malfeasance increased, so has the impact on market value of the related companies. Buckster (1999) pointed out that $31B in market value was lost from January 1997 to January 1998 due to corporate malfeasance. Our initial study indicated almost a trillion dollar impact for 100 companies. Most market studies use a 1 to 3 day window for market reaction (Wu 2002, Palmrose et al 2002, etc.). GAO analyzed a market impact using a 1 day window and a 30 day window before and after the announcement date (GAO 2002). As noted by Wu (2002) the market starts to exhibit the decline ahead of the announcements'. Possible explanations provided are that early warnings, missing analysis forecast, or SEC formal or informal investigation, could precede restatement announcement.

Studies (Wu 2002; Palmrose et al 2002; and Dechow et al 1996) found that the most significant decline of value is during the initial announcement windows. Dechow et al. (1996) found that the average
stock price dropped approximately 9% at the initial announcement of alleged earnings manipulation. Although Palmrose et al. (2002) used a 2 day window to test market reaction and sample of announced restatement companies from 1994-1999, and Wu (2002) used a 3 day window for companies that announced restatements from 1977-2Q2002, similar results were observed. Both studies found that the market reacts to some measure of materiality, and there is a penalty or punishment for the company when no dollar amounts are given with the announcement. We used a 6 month window for our study.

Market reaction noted by Palmrose et al (2002), commented that "substantial portion" of the restatements examined (1995-1999) were due to in process research and development (IPR&D), but there was only mild market reaction to these restatements. While IPR&D was a major restatement item for companies 1999 and prior Palmrose 2003), Huron (2003) found that only 3 of 833 restatements filed from 2000 through 2002 reflected IPR&D as an explanation for restatements. (Additional guidance on IPR&D was provided in 2000 by the AICPA in the form of a practice aid.)

With the accounting scandals of the late 20th and early 21st centuries, public interrogrations continue - where was the board? Where were the auditors? In some cases of malfeasance, the answer resonates: they (the board and the auditors) were there, but they were part of the problem (SEC AAER 1996-2003). Beasley (1996) and Abbott et al. (2000) had conflicting results regarding characteristics of the board of directors and their relationship to financial misstatements. Characteristics examined included independence, director tenure, shareholdings, etc. Beasley found these characteristics were related to financial misstatements and Abbott et al. (2000) found that they were not. Gordon and Henry (2004) found a negative relationship between industry-adjusted returns and related party transactions, which supports the perceived conflict of interest between the management board/ and the shareholders.

Other studies (Farber 2005, Frankel et al 2005, etc.) have also examined the association between fraud and various components of corporate governance addressing board independence, audit committee make-up and the auditor type (Big 4 or other). Frankel et al (2005) found that in the year prior to the announced fraud, consistent with prior research, that the fraud firms had poor governance relative to his control sample. Dunn (2004) also had similar results. Frankel et al (2005) also found that board independence shapes the quality of earnings. We also tested our initial sample of malfeasance companies with matched non-malfeasance companies for similar associations. Farber (2005) examined companies from 1982-2000 and Frankel et al (2005) examined companies from 1988-2002, while our study examined companies from 1996-2002. Other interesting work on the topic of malfeasance and restatements include Lynch and Gomaa (2002) discussion on technology and fraud using Ajzen's theory of planned behavior (1985) and Kohlberg's theory of moral reasoning (1981). The behavior for this type of fraud may or may not involve financial reporting, but it is the type of analysis used to determine if separation of duties, job rotation, time off from job, and or business reporting, etc. will be useful as a control to prevent or detect fraud in this area. However, this paper addresses whether or not business reporting, as suggested by Jenkins, would have reduced the opportunity or exposed the malfeasance.

Gillett and Uddin’s (2005) study of CFO intent found CFOs of large companies were more likely to commit fraud than CFOs of smaller companies. While the intent of the Jenkins Committee recommendations (AICPA 1994) was not to address fraud directly, but to address the underlying concept of accounting as relevant, reliable, and timely business reporting. They focused on making the company more transparent through disclosures and had two major categories of recommendations, 1) Improving the type of information in business reporting (comprehensive model) and 2) Improving the financial statements and related disclosure. Further analysis of the detailed requirement of their comprehensive business reporting model indicated that significant disclosure is also required in those recommendations also. Several of these recommendations were user driven. Users were concerned about the relationship between management, shareholders, directors and auditors. Users wanted any transactions or relationship issues among major shareholders, directors, management, suppliers, customers, competitors and the
company to be disclosed. One of the Jenkins’ model element requests that “information about management and shareholders,” include the disclosure of the nature of any disagreements between management and directors, independent auditors, bankers, and lead council that are no longer affiliated with the company. Disagreements could point out additional items that the company did not disclose, that the disagreeing party thought should have been disclosed. Regardless of the resolution of the disagreement, information regarding the disagreement would make the company more transparent to users. Auditor disagreements should be documented in the auditor’s work papers and resolved to the auditor’s satisfaction before the audit report is issued.

If not, the disagreement may impact the type of audit report issued by the auditors, depending on the nature and extent of the disagreement. In some cases, auditor disagreements will cause management to change auditors. In these cases, where disagreements result in management firing the auditor or the auditor resigning, the reason for the auditor change has to be provided to the SEC. Changing auditors is not something that is done lightly since it must be reported. While there are many good reasons for changing auditors (upgrading to a bigger audit firm, changing to an industry specialty firm, etc.) changing due to disagreement over accounting practices or reporting requirements is not that common since most disagreements are resolved between auditor and management or directors. Changing auditors is an expensive process for the company and for the audit firm. There are significant start-up costs on both sides when new auditors are engaged. While it has been discussed that usually the initial fee for audit engagements may be low to get the audit client, (“low balling”) that is not the focus of this paper. Here the focus is on whether or not an auditor change occurred for a malfeasance company during the 5 years prior to the announced malfeasance. Then, the reason for the change will be determined, if the information is accessible. Since the Jenkins’ report (AICPA 1994) was published, there have been some actions taken to strengthen the board of directors from the shareholder’s perspective, such as the requirements from the Blue Ribbon Committee. Interestingly, Jonas and Blanchet (2000) were concerned about the Jenkins’ Committee and recommendations from other committees.

Their concern was that recommendations were either user needs motivated (the focus of the Jenkins’ recommendations, the FASB Conceptual Model and the Earnings persistence Model) or shareholder/investor protection motivated (the focus of the Kirk recommendations, SEC, Blue Ribbon recommendation #8 and SAS 61.) They maintained that quality financial reporting should encompass both user needs and investor protection. The Jenkins Committee did not address other services or specific issues relating to the auditor’s association with the company as does SOX (2005). However, Kinney et al. (2003) found that there did not appear to be evidence to support that audits were less independent due to performance of other services. Kinney et al. (2003) they did find some positive association between “other services and restatements. As in previous studies, the quality of the audit was also an issue. Therefore, Big 4 or non-big 4 auditor differences were tested.

DATA AND METHODOLOGY

In order to assess whether or not the Jenkins Committee recommendations (AICPA 1994) would have an impact on corporate malfeasance, this study focused on 100 companies to 1) validate previous conclusions, 2) determine what additional conclusions could be made, and 3) evaluate the relationship of the Jenkins’ recommendations to the accounting irregularity. A small sample of 100 companies was selected to address Dechow and Skinner’s (2000) concern that academics’ samples are usually too large and too general to show an impact on investors. The 100 malfeasance companies were selected based on publicized malfeasance over the late 2001 to early 2003 time period, and prior related companies discussed in the announcement articles for the selected companies. Forty-nine of the companies were selected from Rutgers University’s “Cooking The Books” seminar. In addition, the 16 companies with detailed history were selected from the GAO report (2002), and the balance of the companies was then selected from the SEC AAERs (2002-2003). These companies were selected from these sources without
regard to size, auditor, malfeasance activity or other criteria other than an announced accounting malfeasance event as discussed above to ensure the group would be diverse. Sources, of the accounting irregularity and for the details of the accounting irregularity, were taken from various business news articles and regulatory filings. These media were examined to obtain as much detail as possible regarding the malfeasance, the dollar impact of the malfeasance, the financial statement account(s) impacted and the earliest announced date of the irregularity. In some cases, multiple accounting irregularities were described for a company.

In addition the announcement date of the corporate malfeasance activity for each company was used to obtain stock price information to determine the market impact of the stock price change for each company where possible. The primary difference, between this and other studies, is the association of the dollar impact of the accounting irregularity with the market impact and the cataloging of the malfeasance items according to Jenkins’ recommendations. The objective was to see it were possible to associate a dollar value of corporate malfeasance with specific Jenkins’ recommendations for business reporting. Since a direct connection to the malfeasance activity and the recommendations were not made, the Jenkins recommendations were summarized in two major categories as noted in the study results. The rest of this section discusses initial sample selection and other data used to determine the accounting and market impact and methodology. This is followed by the matching sample and data selection and methodology.

Detailed standard industry classification indicated that the initial companies were in the following industries: 29 manufacturing; 25 services, 14 transportation and public utilities; 12 retail trade; 11 finance, insurance or real estate; 5 wholesale trade; 2 mining, 1 agriculture and 1 company not classified due to the fact that it was closely held. Descriptive financial information is in table 1 and malfeasance information is included in tables 2 for these companies. As included in table 2, there were 180 observations of malfeasance activity for the 100 companies selected. Fifty one of the malfeasance companies were listed as fortune 500 companies at the time of the malfeasance activity according to COMPUSTAT. Fifty-three of the 100 companies included in this study were also included in the GAO study (GAO 2002). In addition, 61 of the companies had been issued at least one Accounting and Auditing Enforcement Release by the SEC (SEC 2005) with 43 of the malfeasance companies being included in both the GAO study and the SEC AAER database. There were 20 companies included in this study that were not in the GAO study nor at the time of this dissertation, had been issued an AAER.

Table 1: Financial Summary Description of Malfeasance Companies ($ in billions)

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>TotAsst</td>
<td>99</td>
<td>0.016</td>
<td>902.21</td>
<td>29.989</td>
<td>100.63</td>
</tr>
<tr>
<td>Sales</td>
<td>99</td>
<td>0.001</td>
<td>11.183</td>
<td>13.470</td>
<td>22.090</td>
</tr>
<tr>
<td>NetInc</td>
<td>99</td>
<td>-13.356</td>
<td>13.519</td>
<td>0.1702</td>
<td>2.955.8</td>
</tr>
<tr>
<td>Valid N (listwise)</td>
<td>99</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This table shows the summary statistics for 99 of the 100 companies. The data includes total assets, total nets sales and net income. (One of the companies in the sample was closely held and we could not obtain this detailed information.)

The details of the accounting irregularity was further reviewed and categorized according to a detailed accounting taxonomy (Appendix A). This taxonomy was based on the taxonomies from other studies (Bonner et al 1998, Wu 2002 and Huron 2003), but modified for this study. The accounting taxonomy classified the malfeasance activity of the 100 companies into 5 major categories as they related to the company’s financial statements and/or type of fraud: 1) Revenue; 2) Expense; 3) Income Inflation (including asset and liabilities impacts); 4) Theft-misappropriations (endogenous); and, 5) Exogenous (bribes, insider trading, etc.). Each of the major categories further segregated the malfeasance activity according to type. These categories were used to group the accounting and market dollar impacts (results
of this analysis are summarized in table 3 and table 5) and discussed in the accounting and market assertions/results. Two coders were used to categorize the details of the accounting malfeasance and in cases where there were differences; a third coder was used to determine the applicable taxonomy category.

Table 2: Malfeasance by Announcement Year for Firms ($ in billions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Firms</th>
<th>Number of Observations</th>
<th>Dollar Amount</th>
<th>Observation Mean by Firm</th>
<th>Firm Dollar Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>6</td>
<td>14</td>
<td>1.159</td>
<td>2.33</td>
<td>0.193</td>
</tr>
<tr>
<td>1998</td>
<td>8</td>
<td>23</td>
<td>2.954</td>
<td>2.88</td>
<td>0.369</td>
</tr>
<tr>
<td>1999</td>
<td>11</td>
<td>17</td>
<td>4.190</td>
<td>1.55</td>
<td>0.381</td>
</tr>
<tr>
<td>2000</td>
<td>8</td>
<td>19</td>
<td>4.692</td>
<td>2.38</td>
<td>0.587</td>
</tr>
<tr>
<td>2001</td>
<td>18</td>
<td>32</td>
<td>6.388</td>
<td>1.78</td>
<td>0.355</td>
</tr>
<tr>
<td>2002</td>
<td>45</td>
<td>70</td>
<td>119.75</td>
<td>1.56</td>
<td>2.661</td>
</tr>
<tr>
<td>2003</td>
<td>4</td>
<td>5</td>
<td>1.232</td>
<td>1.25</td>
<td>0.308</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>180</td>
<td>140.37</td>
<td>1.80</td>
<td>1.403</td>
</tr>
</tbody>
</table>

This table shows the number of firms in the study and the number of malfeasance observations for these firms by announcement year. It includes dollars amount (accounting impact) of the observations for the firms by year. The observation mean is the number of observations divided by the number of firms by year. The firm dollar mean is the dollar amount divided by the number of firms by year. *Some firms had multiple observations therefore the means will not total.

The earliest located public announcement date of the malfeasance was also used to assess market reaction. In most cases, the earliest announcement date was taken from the business article. For two companies, the announcement date was taken from the GAO report and for one company from the SEC AAER. To ensure the decline for the market reaction was captured in this study, the announcement date was used as day zero and we retrieved the common stock price for the announcement date, 3 months prior to the announcement date and 3 months subsequent to the announcement date for each company. (If the calculated date was on Saturday, the previous Friday’s stock price was used and if it was on Sunday, the following Monday’s stock price was used.) The S&P 500 price for each day was also obtained and each company's stock price was indexed using the S&P 500 price. The company stock price was taken from yahoo finance (http://finance.yahoo.com) and the S&P Daily Stock Price Record for each stock exchange for the appropriate time period.

The volume for common stock outstanding, for each company, was taken from the SEC form 10K or Daily Stock Price Record for the stock price announcement window chosen. From the historical analysis of Jenkins’ Committee recommendations (AICPA 1994) and the exploratory study above, identification was made although indirectly, of the Jenkins’ recommendations that addressed the types of accounting malfeasance in this study’s selected sample. The identified Jenkins’ recommendations include: events related to off-balance sheet and other innovative financial arrangement; director and management information; business segment reporting and unconsolidated entities. (10% of the malfeasance companies had accounting irregularities that included related party transactions and compensation issues involving management and directors.) These items were also included in either SOX (2002) or EBRC (2005) requirements/proposals. Since the Jenkins’ recommendations were not implemented, this study continued by testing characteristics of the malfeasance companies that related to a Jenkins’ recommendation, SOX (2002) requirement, or EBRC (2005) proposed framework: more disclosure, more board independence, and less related party transactions between board members, officers and the corporation. Secondly, corporate governance, auditor characteristics and a financial condition proxy were examined comparing each malfeasance company selected for our initial study to a matched non-malfeasance company and tested using a logistic regression. This follow-up study examined corporate governance as an internal monitoring tool; and, the financial analysis and auditor characteristics as an external monitor tool.

The following five hypotheses were utilized during this follow-up study to address the internal monitoring activities of the companies:
H1: Company malfeasance is positively associated with board size (the number of directors on the board).

H2: Company malfeasance is negatively associated with the number of independent directors on the board.

H3: Company malfeasance is negatively associated with the number of independent directors on the audit committee.

H4: Company malfeasance is positively associated with staggered terms of the directors on the board.

H5: Company malfeasance is positively associated with the number of officer/or director related party transactions

To examine the external monitoring activities of the companies we test auditor quality and change and financial leverage. Concerns regarding the quality of the audit (whether or not the audit was performed by a “Big 4” auditor or not) and whether or not there was a change in auditors following the malfeasance was also examined utilizing the following two:

H6: Company malfeasance is negatively associated with the brand of the auditor (Big 5 or non-big 5)

H7: Company malfeasance is positively associated with auditor change in the five years prior to the announced malfeasance.

Malfeasance companies were not expected to be highly leveraged due to utilization of the appearance of a “healthy” financial position to continue to obtain cash from investors through the market. Therefore it is contended that malfeasance companies, are not any more leveraged than other companies (due to their malfeasance), but may not have as much cash or cash equivalent assets as non-malfeasance companies. We use hypothesis 8 to test this contention.

H8: Company malfeasance is negatively associated with firm leverage.

For the follow-up study, an attempt was made to match each malfeasance company from the initial study with a non-malfeasance company based on the malfeasance company’s 4-digit SIC and size (total assets). Since one of the companies was a closely held corporation and detailed financial information was not available, it was excluded from the follow-up study. For the remaining 99 malfeasance companies COMPSTAT Research Insight was used to gather this historical data. Initially, the 4-digit SIC was used for the sample companies to retrieve the total assets for all companies with the specified SIC. In most cases the number of companies retrieved for a specified SIC was too large to easily isolate a match, therefore, a range based on the sample company’s size (total assets) was used to narrow the company volume for that 4-digit SIC. If no comparable size company was found in the 4-digit group, then the SIC code was narrowed to 3 digits, then 2 digits, then 1 digit or finally for 3 companies; they were matched simply on size as the remaining non-malfeasance companies in their SIC (even one digit) were too small.

After a comparable match was determined, the matched companies were each checked for malfeasance using the same sources used for the sampled companies, news media, professional/business journals and publications, google.com and yahoo.com as well as the GAO study and SEC AAERs. After the initial match, 15 of the 98 non-malfeasance companies were eliminated (due to malfeasance) and the matching process repeated to select another non-malfeasance company. After the date of the initial matching process, several other companies (5) deemed to be non-malfeasance companies committed some type of accounting malfeasance and were replaced by repeating the matching process. Therefore, the matching non-malfeasance sample had a cut-off of no known malfeasance as of May 2005.
Proxy statements were examined to ensure they included director information. When the proxy statements were not available, the 10K director information was used. For foreign companies listed in the U.S., the 20-F required by the SEC was used. In cases where the data from a wholly owned subsidiary was used, the proxy for the parent company was employed to capture the director information.

No SEC filings or information could be located for three matched companies’ board of directors. These were foreign companies who apparently did not file any reports with the SEC. There were no indications that a 20-F, 10K, or even a Williams Report had been filed in the last 10 years. COMPSTAT did however have financial data for these companies. To keep the matching as similar as possible, these companies were replaced in both the financial analysis and corporate governance section with 3 other companies using the matching process described above. In addition, 2 other matching companies were replaced during the proxy search due to malfeasance activity by their parent company and in one instance, the company had recently changed its name, seemingly due to an accounting malfeasance issue under its previous name. The announcement date, for the selected malfeasance sample, was used as the focal point not only for the initial study, but also for the follow-up study data retrieval for the testing of malfeasance characteristics. The company’s annual financial data in the year prior to the announcement was utilized for analysis in this study. For example, if the malfeasance announcement was made in 2002, then data for the year 2001 was used. Financial statement data for each malfeasance company (the sample) was taken from COMPSTAT data using the Wharton Research Database System (WRDS) based for the year prior to the announcement date. However for 3 of the sample companies, no data was available in the year prior to the announcement, so data for the previous prior year prior was used, i.e., announcement year minus two. This approach (announcement year minus one) was also applied to the selection of the non-malfeasance firms for hypotheses testing.

The characteristics tested for internal monitoring were the size of each company’s board of director; the number of independent directors on the board; whether or not the audit committee was independent; the terms (staggered or same) for the board of directors; and the existence of more than one related party transaction (directors or officers). The characteristics tested for external monitoring were the brand of auditor (Big 4 or other) and auditor change in the last five years. An examination was conducted of the company’s financial position by examining the firms leverage – total liabilities to total assets. It was hypothesized that malfeasance would be positively associated with board size, classified (staggered) board terms, related party transactions and auditor change and negatively associated with board independence, independent audit committees, auditor brand and leverage.

RESULTS

Classification of the malfeasance activity of the 100 companies resulted in a total of 180 accounting items for the 100 companies with an accounting impact of $140 billion (tables 2 & 3). The reported malfeasance was further categorized in this study according to the Jenkins’ recommendations referring to the reporting model and the recommendation referring to disclosures (Jenkins’ chapter 5 & 6 – AICPA 1994). Although not able to directly link each malfeasance event with a Jenkins recommendation (26 of 180 events/activity or 14% were directly linked), there was an indirect link with each item. This resulted in the total accounting dollars ($140B) related to malfeasance events and activities being allocated between the two major recommendation categories with $122B (87%) to the first category, “Improving the Type of Information in Business Reporting (comprehensive model) and $18B (13%) to the second category, Improving the Financial Statements and Related Disclosure. However, there is overlapping of the dollars and the recommendations since both of these recommendations focus on making the company more transparent through disclosures.

We developed a taxonomy (Appendix A)based on the taxonomies from other studies (Bonner et al 1998, Wu 2002 and Huron 2003), but modified for this study. The accounting taxonomy classified the
malfeasance activity of the 100 companies into 5 major categories as they related to the company’s financial statements and/or type of fraud: 1) Revenue; 2) Expense; 3) Income Inflation (including asset and liabilities impacts); 4) Theft-misappropriations (endogenous); and, 5) Exogenous (bribes, insider trading, etc.). The income inflation category was further expanded to capture Inflated Income, Overstated Assets and Non-disclosure/Understated Liabilities. The accounting taxonomy (appendix A) breakout of the $140.4 billion malfeasance (accounting irregularities) indicated that $53.20B (38%) was Revenue related; $7.50B (5%) was Expense related; $16.10B (11%) was Income related; $62.60B (45%) was Assets or Liabilities related; $0.04B (.03%) was Theft and $1B (.7% was Exogenous).

Table 3: Malfeasance Taxonomy Classification ($ in billions)

<table>
<thead>
<tr>
<th>Category</th>
<th>Number Firms</th>
<th>Number Observations</th>
<th>Dollars Amount</th>
<th>Firm Dollar Mean</th>
<th>Observation Dollar Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>1- Revenue</td>
<td>48</td>
<td>67</td>
<td>53.174</td>
<td>1.108</td>
<td>0.794</td>
</tr>
<tr>
<td>2 - Expense/Cost</td>
<td>27</td>
<td>27</td>
<td>7.468</td>
<td>0.277</td>
<td>0.277</td>
</tr>
<tr>
<td>3-A Income</td>
<td>33</td>
<td>39</td>
<td>16.109</td>
<td>0.488</td>
<td>0.413</td>
</tr>
<tr>
<td>3-B Asset</td>
<td>12</td>
<td>15</td>
<td>54.438</td>
<td>4.537</td>
<td>3.629</td>
</tr>
<tr>
<td>3-C Liabilities</td>
<td>12</td>
<td>14</td>
<td>8.133</td>
<td>0.678</td>
<td>0.581</td>
</tr>
<tr>
<td>4 - Theft</td>
<td>4</td>
<td>4</td>
<td>0.042</td>
<td>0.011</td>
<td>0.011</td>
</tr>
<tr>
<td>5 - Exogenous</td>
<td>13</td>
<td>14</td>
<td>1.008</td>
<td>0.078</td>
<td>0.072</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>180</td>
<td>140.37</td>
<td>1.403</td>
<td>0.794</td>
</tr>
</tbody>
</table>

This table shows the number of firms in the study and the number of malfeasance observations for these firms by malfeasance type using our taxonomy in appendix A. It includes the dollars amount (accounting impact) of the observations for the firms’ observations and the firm mean (dollar amount / number of firms) and the observation mean (dollar amount / number of observations) by malfeasance type. *Some firms had multiple observations therefore the means will not total.

A more specific and direct connection of the accounting malfeasance event(s) of the 100 companies selected to the Jenkins’ recommendations indicated that: 15 had malfeasance involving off-balance sheet financing and innovative financial instruments; 10 had malfeasance involving executive management and director information; and, 1 company’s malfeasance activity included a one-time gain on the sale of real-estate as continuing operating income. Other malfeasance activity did not readily lend itself to association with a specific recommendation from the Jenkins’ Committee. Therefore, the rest of the results focused on validating previous accounting and market impact conclusions, assessing additional conclusions and examining other information such as, corporate governance, auditor information, and the overall financial condition of the company later comparing malfeasance and non-malfeasance companies.

The summarized accounting impact was $140 billion (tables 2 & 3), but the market impact, using a 6 month window, for 96 of the 100 firms was over $857 billion (table 4). Results of this initial study were similar to other studies and also revealed some differences during examination of the Jenkins recommendations categorization. Similarities included that: The majority of the restatements due to accounting irregularities (over 95%) reduced earnings for the restating company; Revenue recognition was the most common form of corporate malfeasance; loss of market value is significantly greater than the magnitude of the accounting dollar loss; actual theft or physical loss is the least of corporate malfeasance items; and the growth in the dollar magnitude of the loss/restatement from initial announcement to final restatement increased significantly; Restatements, particularly those related to the “Big Bath” concept, will result in an increase in earnings if restated for the current period in some cases. For example, correction of misstatements that previously created “reserve” earnings for a future period (“cookie jar” reserves) will increase earnings in the current period. Results also indicated that several of the malfeasance companies had undisclosed liabilities, special purpose entities or other off-balance sheet arrangements that should have been included on the face of the balance sheet as a liability. It was noted that 15% of the companies had violations in this area with the bulk of the problem relating to special purpose entities (SPEs) cited the most often. Listed below are conclusions from this research and related prior studies, and/or ongoing work on the assertions.
Assertion #1: Most of the malfeasance occurred in the revenue and revenue recognition area (49 of the 100 companies had revenue as an impacted account).

GAO (2002) results indicate that 39% of the restatements included revenue recognition. Palmrose and Bonner’s (1998) findings also showed that revenue was the most common variety of fraud. Palmrose and Scholz (2002) also found that revenue misstatements are the most frequent reason for restatement (37%) and their evidence indicated that revenue restatements are associated with significantly higher payments by defendants. The SEC issued Staff Accounting Bulletin 101 in 1999 to provide further guidance on Revenue Recognition. Both the FASB and the IASB have revenue recognition projects underway. But as the Jenkins’ Committee (1994) and others have reiterated, more information, beyond GAAP revenue, is needed to help project future earnings and cash flows.

Assertion #2: Actual dollar adjustments for malfeasance restatements are often significantly larger than initially announced.

The dollar magnitude, of the final restatement actually filed, is usually larger than the initial or other (sometimes several announcements before restatement) prior announced restatement dollars for accounting irregularity. (i.e. WorldCom accounting dollar concerns grew from the initially announced $2.9B to a possible net income overstatement of over $11B in improper bookings). Once a restatement is required, companies often use this opportunity to more closely examine their accounting records and processes. Swieringa (1984) and Levitt (1998) considered this phenomenon as "accounting magic” and “big bath” respectively. The dollar amount of a restatement grows larger as more items are revealed that will require restatement. Again, it is difficult to determine what was accounting malfeasance and/or what was an unintentional mistake. Most of the accounting entries included in a “Big Bath” can be done in accordance with GAAP since GAAP requires that estimated costs (current and future) associated with restructuring be charged against income in the year in which the decision to restructure is made (Swieringa (1984). This was also seen in several studies even during profitable years as companies smoothed earnings. Other examples of increasing the final restatement include:

a. Although the initially announced restatement may have been due to revenue overstatement, the final restatement may include increases in expenses for the restatement period thereby further reducing income.

b. Large expenses are sometimes set aside into 'restructuring' reserves reducing income. Later these reserves are deemed excessive and returned to the income statement thereby increasing income for the then current period.

c. Asset write-downs or write off (asset cumulative impairment) are also common during this time.

Assertion #3: Theft is the least likely malfeasance item for restatements in most large public companies.

Out of the estimated $140.4B accounting dollars related to the malfeasance for the 100 companies studied, only $0.4B (less than .5%) was attributable to direct theft. The evidence indicates that it’s not about stealing; it's about manipulating the books or creating opportunity for manipulation of the market price. The preponderance of this type of white-collar fraud occurs in the manipulation of accounting dollars to obtain market reaction/value. Additional fraud occurs through the misappropriation of assets (e.g. purchase art for CEO) or incurrence of liabilities (e.g. guarantee loan) on behalf of officers or directors of the company.

The CFE Report (2002) noted that over 80% of occupational fraud involved asset misappropriation, 13% were corruption schemes, and 5% were fraudulent statements. The results of this study showed that the smaller the company, the greater the median loss. This concurs with this study’s results that actual theft is usually not material relative to the size of most public companies and therefore not usually cited as the reason for restatement.
Results (Table 4) indicate that there was an overall market impact of $857B ($655B indexed to S&P 500) for 96 of the 100 companies in the initial study. It was also found, as did other studies (Palmrose et al 2003, GAO 2002 and Wu 2002), that there was a more negative market reaction to restatements involving revenue recognition than any other type.

Table 4: Stock Price Change and Market Impact ($ in billions)

<table>
<thead>
<tr>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Sum</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>prminus3</td>
<td>96</td>
<td>0.0011</td>
<td>0.1695</td>
<td>3.0389</td>
<td>0.0317</td>
</tr>
<tr>
<td>AnnPrice</td>
<td>96</td>
<td>0.0001</td>
<td>0.1029</td>
<td>2.1816</td>
<td>0.0227</td>
</tr>
<tr>
<td>Prplus3</td>
<td>96</td>
<td>0.0001</td>
<td>0.0845</td>
<td>1.6227</td>
<td>0.0169</td>
</tr>
<tr>
<td>Gainloss</td>
<td>96</td>
<td>-0.1285</td>
<td>0.0045</td>
<td>-1.4162</td>
<td>-0.0148</td>
</tr>
<tr>
<td>Gnlspere</td>
<td>96</td>
<td>-0.0010</td>
<td>0.0025</td>
<td>-0.0464</td>
<td>-0.0004</td>
</tr>
<tr>
<td>SpS500chg</td>
<td>96</td>
<td>-0.0003</td>
<td>0.0030</td>
<td>-0.0018</td>
<td>-0.0002</td>
</tr>
<tr>
<td>InX%chg</td>
<td>96</td>
<td>-0.0727</td>
<td>0.0198</td>
<td>-0.1385</td>
<td>-0.0014</td>
</tr>
<tr>
<td>InXPrChg</td>
<td>96</td>
<td>-0.1354</td>
<td>0.0083</td>
<td>-1.2411</td>
<td>-0.0129</td>
</tr>
<tr>
<td>Numshrs</td>
<td>96</td>
<td>0.0060</td>
<td>7.3240</td>
<td>58.606</td>
<td>0.6105</td>
</tr>
<tr>
<td>Mktnlos</td>
<td>96</td>
<td>-80.845</td>
<td>7.3541</td>
<td>-601.15</td>
<td>-6.2620</td>
</tr>
<tr>
<td>absMktgl</td>
<td>96</td>
<td>0.0027</td>
<td>80.845</td>
<td>655.42</td>
<td>6.8273</td>
</tr>
<tr>
<td>GrossMkt</td>
<td>96</td>
<td>-104.224</td>
<td>3.5825</td>
<td>-857.41</td>
<td>-8.9314</td>
</tr>
</tbody>
</table>

This table provides the statistics for the stock prices of the firms, and indicates the market dollar impact for these firms as a result of the change in stock prices using the 3 months before and the 3 months after firm stock price relative to the malfeasance announcement date. The change in individual stock price was indexed to the S&P 500 for that time period to control for overall market change.

Assertion #4: The loss of market value of a company due to malfeasance allegations is significantly higher than the accounting value of the direct effects on the financial statements. Adjusted market value change is about 20 times larger than net income effect.

While the approximately 20 multiplier mirrors the P/E ratio, the results are more direct and broadly reflective than the PE ratio (Table 5). Although the accounting dollar amounts may not have been provided in the initial announcement of restatement/malfeasance, the news itself, that the dollars would have to be restated and/or an investigation (internally or SEC), was enough to cause a reaction in the market. The market reaction is more pronounced if the announcement mentions an effect on revenue or net income.

Table 5: Accounting/Market Dollar Relationships ($ in billions)

<table>
<thead>
<tr>
<th>Market Impact</th>
<th>Gross (GrossMkt)</th>
<th>Indexed (absMktgl)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Market - 96 Firms</td>
<td>$857.41</td>
<td>$655.42</td>
</tr>
<tr>
<td>Market Mean (96 Firms)</td>
<td>$ 8.931</td>
<td>$ 6.828</td>
</tr>
<tr>
<td>Accounting Impact/Market</td>
<td>Gross</td>
<td>Indexed</td>
</tr>
<tr>
<td>Accounting Total/ Market Total</td>
<td>0.1637</td>
<td>0.2142</td>
</tr>
<tr>
<td>Revenue/ Market</td>
<td>0.0620</td>
<td>0.0811</td>
</tr>
<tr>
<td>Expense/ Market</td>
<td>0.0087</td>
<td>0.0114</td>
</tr>
<tr>
<td>Income/Market</td>
<td>0.0188</td>
<td>0.0246</td>
</tr>
<tr>
<td>Asset &amp; Liabilities/Market</td>
<td>0.0730</td>
<td>0.0955</td>
</tr>
<tr>
<td>Theft /Market</td>
<td>0.0000</td>
<td>0.0000</td>
</tr>
<tr>
<td>Exogenous /Market</td>
<td>0.0012</td>
<td>0.0015</td>
</tr>
</tbody>
</table>

This table indicates the relationship of the accounting dollars to the market impact. It shows the effect of dividing the accounting dollar impact (table 3) using the malfeasance taxonomy categories develop for the study by the total market dollar impact (table 4) sum for the gross and indexed amount. The total accounting to market impact is approximately 20% which is usually similar to the Price/earnings ratio.
Assertion #5: The market reacts more to changes in values that are presented/disclosed in the financial statements than to missing items/events that should have been included or disclosed. While there has been much discussion about disclosure, the malfeasant sample seems to indicate much larger effects in account over/under statement than the known absence of disclosure (information that should have been included in the financial statements). Dollars related to actual accounting errors, erroneous accounting activity, or questionable use of GAAP which impacted the accuracy and/or reliability of the financial statements were more common in the 100 malfeasance companies selected for this study. Items requiring disclosure had fewer dollars which could be indicative of the lack of information available to determine a more accurate impact. However additional disclosure on inaccurate accounting information for malfeasance companies would also be inaccurate and therefore not useful for decision making.

The results from our examination of internal and external monitoring of malfeasance and non-malfeasance companies to see if there was any difference in the control variables were not conclusive. The dependent variable in this study is a dichotomous variable: either the company has malfeasance or it does not. Therefore, logistic regression was used for the testing. But, the resulting regression only had an adjusted R-square of .02. The only significant variable in the correlation matrix was company size as expected since this was one of the parameters for matching. Regression equation:

\[ Y = 0 + .117X_1 + .072X_2 + .323X_3 - .018X_4 + .057X_5 + .165X_6 - .129X_7 - .203X_8 - .049X_9 \]

Where:

| \( X_1 \) = lev = debt amount and debt to equity ratio |
| \( X_2 \) = bdsize = board size |
| \( X_3 \) = bdind = board member independence |
| \( X_4 \) = bdtrans = board member related party transactions |
| \( X_5 \) = audchang = auditor change |
| \( X_6 \) = audind2 = audit committee independence |
| \( X_7 \) = stag = staggered board |
| \( X_8 \) = auditor = brand name auditor |
| \( X_9 \) = cosize = company size |

No correlation was found in this study between board independence, auditor type and corporate malfeasance. The test of the control variables (above) shows no statistical difference between malfeasance and non-malfeasance firms (R-square of .065, adjusted R-square of .02). Although results differ for this research than previous studies (Farber 2005, Frankel et al 2005, etc.), it may be due to the years included in these studies. Although results differ for this research, it may be due to the years included in these studies. Farber (2005) examined companies from 1982-2000, Dunn (2004) examined companies from 1992-1996, and Frankel et al (2005) examined companies from 1988-2002, whereas this study examined companies from 1996-2002. The recommendation of the Blue Ribbon Committee (1999) influenced the make-up of the board of directors and board committees. Results of this research did not show any statistical difference except for auditor change. Since several of the auditor changes were from Arthur Andersen LLP to another audit firm in 2002, this pinpoints further examination in a future study.

CONCLUDING COMMENTS

Our intent in this paper was to examine 100 companies with announced accounting malfeasance to determine if the accounting irregularities resulting in the accounting malfeasance could be identified to a Jenkins' Committee recommendation (AICPA 1994) and provide a dollar accounting and market impact. We also wanted to conduct a follow-up empirical study of some of the internal and external monitoring characteristics of the malfeasance companies and a matched non-malfeasance company to determine if there was a difference between the companies. Overall, these studies sought to examine corporate malfeasance and some of the business reporting elements as recommended by Jenkins’ or required by SOX (2002) and the level of the corporate accounting malfeasance experienced in today’s society. It is acknowledged that this is difficult, if not impossible to determine, therefore this paper identifies and quantifies accounting malfeasance activity and the resulting market impact and associates the activity with the Jenkins’ recommendations/SOX requirement where possible.

For purposes of these studies, we defined corporate accounting malfeasance as the use of false or
misleading accounting information or omission of these entries in the financial reporting process (announcements, filings, etc.) that later requires a restatement. This approach to restatements includes accounting errors, accounting misstatements and/or any other accounting irregularity similar to the approach utilized by the United States General Accounting Office (GAO) in their restatement study (GAO 2002). 100 companies were selected with publically announced accounting malfeasance. The descriptive information regarding the type of malfeasance and the related dollar impact was obtained from various public mediums for the 100 companies and categorized into accounting categories based on our developed taxonomy (Appendix A) and Jenkins’ recommendations (AICPA 1994). The stock prices were also obtained using a 6 month window for 96 of the 100 companies. The stock prices were indexed to the S&P 500 to control for overall market noise. Data was not available for the 4 other companies.

Results of the initial study indicated that there were 180 accounting malfeasance observations for the 100 companies with an accounting impact (table 3) of over $140 billion (overlapping) and a market impact (table 4) of over $857 billion using the 6 months window for 96 of the 100 companies. Tables 2, 3, 4 and 5 summarize the dollar impact of the observation association with Jenkins’ recommendations and the accounting and market outcomes. Summarization of the findings were similar to other studies in that revenue recognition was the most common form of corporate malfeasance; loss of market value is significantly greater than the magnitude of the accounting dollar loss; actual theft or physical loss is the least of corporate malfeasance items; and, the growth in the dollar magnitude of the restatement from initial announcement to final restatement (“Big Bath” or “Cookie Jar”).

For the empirical study testing internal and external monitoring characteristics, each malfeasance company (from the initial study) was matched with a comparable non-malfeasance company based on their standard industry classification (SIC) code and size (total assets). Data was not available for two of the companies so only 98 companies were matched for the monitoring study. The 4 digit SIC code was used where possible, the 3 digit, and so-on until all included companies were matched. For the final phase, financial and corporate governance data for the sampled and matched companies were extracted and tested to determine if there was a statistical difference in the characteristics between malfeasance and non-malfeasance companies as the changes in business reporting recommendations and SOX requirements implied. Financial and auditor data, for these companies, was retrieved from COMPUSTAT and the corporate governance data were extracted from the proxy statement or 10-K for each company.

The characteristics used in the empirical study to test for internal monitoring consisted of the size of each company’s board of director; the number of independent directors on the board; whether or not the audit committee was independent; the terms (staggered or same) for the board of directors; and the existence of more than one related party transactions (directors or officers). The characteristics tested for external monitoring were the brand of auditor (Big 4 or other) and auditor change in the last five years. The company’s financial position was examined by carefully scrutinizing the firms leverage – total liabilities to total assets. It was hypothesized that accounting malfeasance would be positively associated with board size, classified (staggered) board terms, related party transactions and auditor change; and, accounting malfeasance would be negatively associated with board independence, independent audit committees, auditor brand and leverage.

Findings during this research revealed no correlation between board independence, auditor type and corporate malfeasance. The test of the control variables showed no statistical difference between malfeasance and non-malfeasance firms (R-square of .065, adjusted R-square of .02). Although these results differ from other studies (Faber 2005, Frankel et al 2005, etc), this may be due to the years included in our studies. The recommendation of the Blue Ribbon Committee (1999) influenced the make-up of the board of directors and board committees. The results did not reflect any statistical difference except for auditor change during this study. Several of the auditor changes were from Arthur Andersen LLP to another audit firm in 2002. Consequently, this will be examined through a future study. The primary limitation of this study was that the initial 100 accounting malfeasance companies were not selected in a random manner from one population. However, there was also no bias in their selection. Although this limitation and other occurred, they did not hinder the contribution of this research to the
contemporary accounting literature.

Although malfeasance is a behavioral issue, enhanced business reporting and penalties for non-adherence to reporting requirements are attempts to reduce and change that behavior. Will it work? As the SEC now has more staff and, therefore, will be conducting more investigations and reviews of public companies’ financial filing, future opportunities will enable studies of the SEC’s results and assess what’s working and what’s not working. Other future studies could include a follow-up study of the status of the 100 selected malfeasance companies and their matches for a period of time to assess survivors, merger, bankruptcies, etc. would be an opportunity for future research. Future accounting issues on corporate malfeasance could include an assessment of whether malfeasance firms have more book value or market value than comparable non-malfeasance companies. Future work, pertaining to corporate governance, could include whether firms with malfeasance are more likely to have a higher percentage of interlock directors than non-malfeasance firms. It could also compare the number of other directorships held by directors of malfeasance firms as compared to a control group of firms with no announced malfeasance.

REFERENCES


The Blue Ribbon Committee. 1999. Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. New York Stock Exchange and National Association of Securities Dealers


Announcements. Working paper


APPENDIX A - MALFEASANCE TAXONOMY

1) Revenue

1-1: Fictitious Revenue – Revenue created through fictitious sales transactions or revenue created through cooperative/collusion with another company to increase both company’s financial profile.

1-2: Revenue Timing – A valid sales transaction recognized as complete in a different accounting period than when the actual transaction was completed. This overstates revenue in one period and understates it in another.

1-3: Revenue Misclassification & Other Improprieties – Recognition or misclassification of sales transactions that are not valid sales transaction due to terms being incomplete and/or other contingent information.

2) Expense

2-1: Expense/Cost Classification – Misclassification, non-recognition or unauthorized expenses of the appropriate period.

2-2: Big Bang Theory – The process of recordings more costs and expense during an accounting period than normal when 1) a restatement resulting in lower income is required to be filed or 2) a significant loss has occurred for the reported period.

3) Income Inflation-Assets-Liabilities

3A: Inflated Income – Income inaccurate in announcement, but the specific revenue or expense impact or detail was not available. Only income impact is announced.
3B1: Assets overstated – Any situation where the specific revenue or expense detail was not available, but the resulting asset(s) or liability impact was announced.

3B2: Disclosures & Understated Liabilities – Any situation where the specific revenue or expense detail was not available, but the resulting liability impact was announced.

4) Theft – Misappropriation or misuse of company assets by company officers or employees.

5) Exogenous – Related party transactions, insider trading bribery or other conflict of interest or illegal activities resulting in non-company employee benefiting in an inappropriate manner.

BIOGRAPHY

Liz Washington Arnold is an Associate Professor of Accounting at the Citadel, the Military College of South Carolina with over 25 years experience in corporate accounting. She currently serves as a volunteer in many community and service organization including the South Carolina Association of Certified Public Accountants’ Financial Literacy Committee and various church mission projects. Her research appears in journals such as the Southeast Case Research Association Journal, Business Education Innovations and U.S. – China Education Review. She can be reached at The Citadel, 171 Moultrie Street, Charleston, SC 29445, liz.arnold@citadel.edu.

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