ACCOUNTING & AUDIT

Does Misreporting Financials Pay Off for CEOs and CFOs?

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Deterring improper behavior starts with implementing consequences that outweigh the risks. But in the world of financial reporting misconduct, new research that examines the most serious cases of misreporting finds that nearly 26 percent of perpetrators experience an overall net benefit – even after they get caught.

Given that the risk of detection is also only 25 percent, then more than half of perpetrators – most often the CEOs and CFOs of major companies – could find it beneficial to commit financial reporting misconduct, according to research from Columbia Business School Professors Shiva Rajgopal and Dan Amiram and researcher Serene Huang. The new study, "*Does Financial Reporting Misconduct Pay Off Even When Discovered?,"* tackles major episodes of financial misconduct since a 2003 shift in enforcement and compares the costs and benefits of getting caught.

"With more than half of perpetrators potentially benefiting, the numbers speak for themselves. Top senior managers of large companies will certainly see that the odds are in their favor even if they get caught cooking the books," said Shiva Rajgopal, Kester and Byrnes Professor of Accounting and Auditing at Columbia Business School. "Unless regulators improve their processes, research shows that financial reporting misconduct will continue to be an attractive option."

In the article, Rajgopal, Amiram, and Huang focus on financial reporting misconduct cases after 2003 – an era marked by a shift in enforcement and punishment priorities that eased the consequences for reporting misconduct. To determine their findings, researchers analyzed 237 cases of financial misconduct between 2003-2015 from three specific datasets: U.S. Securities and Exchange Commission (SEC) enforcement actions, securities class-action lawsuits, and financial restatement announcements that triggered negative stock market reactions.

The researchers then hand-collected data on perpetrators and compared "benefits from misconduct" – which include salary bonuses and stock and options gains – to the "costs of getting caught" – which include disgorgements and fines as well as forgone earnings for perpetrators who lose their jobs. For those perpetrators who get caught, the researchers compared the "costs of getting caught" to other offsetting income – such as severance pay a perpetrator might receive upon resignation or earnings from a new job.

Their findings include:

- **Out of a job, but not for long:** The researchers conclude that 39 percent of perpetrators in the 237 cases were fired upon revelation of misconduct. But of those fired, 64 percent went on to get a new job, usually in small private companies

- **Nearly one in three perpetrators who misreported company earnings benefited:** Researchers found that 25.9 percent of the perpetrators in the 237 cases experience an overall gain even after getting caught: 2.7 percent from the SEC sample, 24.1 percent from the lawsuits sample, and 32.1 percent from the restatements sample. Benefits come mainly through lower forgone earnings and lower unrealized losses on their stockholdings. In fact, only 7 percent of this group of perpetrators were fired around the revelation of the misconduct.

- **Stock market losses are an effective deterrent:** Analysis shows that the average cost of getting caught amounts to $26.7 million, with the notable hits coming via stockholding and forgone earnings, suggesting that the stock market and the labor market are generally effective at punishing perpetrators

The study, "*Does Financial Reporting Misconduct Pay Off Even When Discovered?*," is available online at: https://www8.gsb.columbia.edu/researcharchive/articles/25784

To learn more about the cutting-edge research taking place at Columbia Business School, please visit www.gsb.columbia.edu. More information on Professor Shiva Rajgopal is available here and information on Professor Dan Amiram is available here.

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