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## Abstract

### PREDICTABILITY OF FRAUDULENT FINANCIAL REPORTING

The intent of this research was to create a model for predicting fraudulent financial reporting (FFR) tendencies, more specifically violations of Generally Accepted Accounting Principles (GAAP). The most common activities include asset and revenue overstatement, concealment of liabilities and expenses, improper revenue recognition, and inadequate disclosures.

Five financial ratios were utilized in the past to predict FFR, as has size as measured by Tobin's Q, but currently the Gov\_Score index (Brown & Caylor) has not. This research aimed to connect the quantitative ratios with the Gov\_Score index to predict FFR membership.

Corporate governance is a topic of interest due to the increased emphasis in corporate fraud cases, SOX 2002, and new accounting fraud guidelines (SAS 99 & PCAOB #5). Existing corporate governance research focused on the qualitative attributes and current research has created quantitative analysis of corporate governance but the findings are correlated with firm value and whether one structure provides greater returns to stockholders. Fraud theory research has found three conditions are present when financial fraud occurs; opportunity, pressure, and rationalization; commonly called the fraud triangle. This research contributes to the body of literature by concentrating on opportunity.

A sample of annual financial data for an estimated 2,000 firms was collected for the years 2002, 2003 & 2004 based on the availability of Brown and Caylor's (2006) Gov\_Score. The financial data was collected from CRSP for the years 2001-2005. To identify FFR violations a search of the Security and Exchange Commission's Accounting and Auditing Enforcement Releases (AAER) from 2001 to 2006 (AAER 1600 – 2399) was conducted. Logistical regression was utilized. The findings were not statistically significant except for the data in the

year 2004. The sales growth index and Gov\_Score were statistically significant. If the sales growth index increased by one unit then a firm is more likely to be coded as non fraud than fraud and if the Gov\_Score increased by one unit the firm is more likely to be coded as fraud than non fraud. The reason for the insignificant predictability is due to the limited sample years. The financial data used in this research was only for the firms which had a published Gov\_Score which limited the data years. Logistical regression found in combination and individually each of the seven variables, except sales growth and the Gov\_Score in 2004, did not have statistical significance in predicting fraudulent financial tendencies.

In summary, the contribution to the literature is the theoretical connection between fraud theory of opportunity, connecting opportunity to stockholder theory, and to corporate governance measures. Though Gov\_Score was statistically significant in only one year, further research with a greater range of data years could yield results which are significant and more predictive.