PROVIDING INCENTIVES TO CHEAT: HOW FIRM COMPLEXITIES INFLUENCE FINANCIAL REPORTING FRAUD

Great attention has been placed on corporate governance, particularly as it relates to the board of directors' role in monitoring managerial behavior. Despite this, a number of high profile cases of fraudulent financial reporting have been identified in which CEOs, in particular, have been highlighted as perpetrators of fraudulent financial reporting activity designed to enhance their own wealth. Recent research in the *Journal of Management* illustrates how some managers take advantage of complex firm environments in which management has greater information than the board of directors and other firm stakeholders regarding performance. These situations provide opportunities to cheat because they make fraud more difficult to discover.

Key Takeaways:

- Complexity of a firm's operations and its industry environment increases the likelihood firms will engage in financial reporting fraud.
- Financial reporting fraud is more likely in complex firms when audit committee oversight is weak or CEOs have many unexercised stock options.

To examine a company's likelihood of committing financial reporting fraud, the researchers analyzed 906 companies, of which half were listed in the 2006 report to Congress by the Government Accountability Office as firms that had committed fraud. Companies were more likely to commit financial reporting fraud when their level of diversification was high (creating company complexities), and their industry was not concentrated in a few large competitors (creating industry complexity). Furthermore, in diversified, complex firms, financial reporting fraud was even greater when the audit committee had poorer oversight (fewer meetings in a year) or when the CEO had a higher number of unexercised options (more temptation). The researchers suggest their results are indicative of situations where CEOs are provided both motive and opportunity to cheat.

In summary, highly complex firm environments provide an opportunity for CEOs to engage in financial reporting fraud that is more difficult to detect. This opportunity is enhanced when there is less board oversight or when the CEO has greater unexercised options. Boards of firms in complex environments need to understand the importance of strong audit committee oversight of management, as well as shifting stock option pay to other forms of remuneration.

Source: Ndofor, H.A., Wesley, C., & Priem, R.L. (2015). Providing CEOs with Opportunities to Cheat: The Effects of Complexity-Based Information Asymmetries on Financial Reporting Fraud. *Journal of Management*, 41: 1774-1797.