Good Value from Shared Values: A fraud and risk perspective

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ABSTRACT Corporate scandals in the last decade have led to renewed focus by auditors and regulators on fraud, risk assessments, and governance reforms. Hernandez (2007) documents auditor perceived associations between risk indications or concerns on dimensions of management ethics and compensation, performance, governance and fraud across auditor risk assessments performed during the continuance stage of an audit at a 'Big Four' firm (from 2002 to 2004). Running three separate sets of ordinal regressions, this study notes that assessed risk of fraud, perceived corporate performance risks, and corporate governance risks are independently associated with each other, as well as positively affected by management ethics and integrity concerns perceived by auditors and the pressure and balance of financial and non-financial goal-setting targets in management compensation contracts. This suggests that managers and entities focused by ethics, values, and sustainable goals (lower integrity concerns, less profits pressure) may present themselves with lower audit risk and benefit investors, reducing contracting and agency risks, which may be by simultaneously associated with fraud, governance, and overall entity performance risks. I extend this result into a theoretical model where the entity and its customers, suppliers, regulators, and other stakeholders ('Five Forces') share corporate values, lowering audit (and entity contracting) risks, resulting in higher entity value.

RELEVANCE FOR PRACTICE Auditors appear to consider management integrity concerns and the balance of financial and non-financial goal-setting in management compensation contracts as important elements affecting the risks of fraud, performance, and governance. This study highlights the important benefits that can be achieved in broader governance and audit settings from focusing on manager (and corporate) ethics and values.

1 Introduction

This report aims to empirically evaluate the factors in an organization that auditors perceive to influence corporate misconduct, management integrity, consistency in performance and sustainable goals. Such a broad area of investigation is bound to have severe measurement limitations, with only the most remote possibility to reliably capture or observe such issues and concerns. Auditors, however, are trained in understanding, evaluating, and addressing risks in the performance of a financial statement audit and have incentives to do so effectively (Zimbelman and Waller, 1999). The auditor risk assessments will be reviewed as a proxy for variables that may capture concerns and issues that audit partners observe or perceive at their clients. More specifically, results from auditor risk assessments performed during the continuance evaluation stage of an audit, approved by audit partners at a 'Big Four' accountancy firm in the Netherlands between the years 2002 through 2004 will be discussed.

Research concepts and propositions will be presented that may further our understanding on matters of integrity, corporate governance, sustainability, and corporate misconduct. The central proposition provided here is that relationships between auditor-observed risk factors may provide important insights that may be helpful in further understanding organizational conditions of heightened concern from an integrity, sustainability, performance, and corporate governance perspective. Specifically, an attempt will be made to identify and evaluate a common set of risk factors that auditors observe or perceive to have an influence in corporate misconduct, governance, and volatile past performance. Accordingly, a link with current developments in the fields of ethics and compliance is proposed which includes a potential 'Five Forces' model depicting how 'good value' may accrue to various stakeholders from a subscription by various constituents to a set of 'corporate values' and principles.

This study reflect on results from my dissertation which consisted of an in-depth analysis of auditor risk factors documented during the client acceptance and continuance stage of an audit (Hernandez, 2007). The focus of the dissertation included insights on the various factors that auditors appear to associate with fraud risks. Results indicated three core findings. First, the "attitude" of a company's management toward engaging in fraudulent activity may be the single most important "leg" of the fraud triangle (*i.e.*, more important than the other two legs "motivation" and "conditions") from the perspective of the partners of the accounting firm providing the data. This was an intuitively appealing finding since top managers will almost always face a variety of motives to misstate earnings and can probably override any controls that may or may not be in place – if they are willing to do so. Second, auditors consider that pressures placed on talented managers to achieve higher profits, consistently achieve performance targets, and conform with organizational practices as important factors associated with fraudulent managerial intentions. Third, the dissertation presented evidence to suggest that auditors consider the integrity and ethics of senior management as the single most important fraud red flag (Hernandez, 2007).

In order to establish the importance of managerial and corporate ethics in auditor assessments of fraud, corporate governance, performance and target-setting risks, I extend initial findings to investigate various auditor risk factors across various risk dimensions. This study is particularly focused on the effect of management ethics and the balance of financial and non-financial goal-setting targets in management compensation contracts. Additionally, the risk factors that auditors perceive to be associated with volatility in past corporate performance and governance variables as well as the effect of institutional variables such as a link to the US regulatory system or response to major external (fraud) event are investigated. Section 2 addresses the empirical study design, followed by section 3 which is a discussion on the results and study methods. This article closes (section 4) with a theoretical model on the interplay of 'Five Forces' (regulators, suppliers, customers, stakeholders, and the corporation) for good value and shared values.

2 Empirical Study Design

The literature has broadly documented an association between financial reporting fraud and weaknesses in corporate governance, poor financial reporting control quality, and earnings management (Beasley, 1996, 2000; Carcello, 2000; Dechow et al., 1996; McMullen, 1996). The sources of the incentives or situations that lead to various fraud opportunities have been extensively investigated. Inadequate or inconsistent profitability and emphasis on earnings projections have often been associated with fraud (Loebbecke et al., 1989; Baucus, 1994; Bell and Carcello, 2000); the need to act fraudulently occurs when firms lack the resources to meet performance goals or to survive, and when managers attempt to cope with urgent demands (Baucus, 1994); the focus on targets and meeting thresholds creates pressure, which start from the need to first, report a profit, second, support an increase in profits, and third, meet analysts' forecasts (Degeorge et al., 1999); and management incentives have been found important in rationalizing the desire to engage in earnings management, especially to beat a benchmark (Dechow and Skinner, 2000). Although, problems such as sustainability, management integrity and governance concerns appear to be associated with each other and a common set of risk factors, often they are studied independently and not as a whole.

Detecting unethical managers or fraud is difficult, perhaps because frauds are rare events (Loebbecke et al., 1989; Nieschwietz et al., 2000). Additionally, unethical fraudulent actions may be perpetrated by highly motivated, clever teams of knowledgeable managers who find ways to report fraudulently to remain undetected (Nieschwietz et al., 2000). Such talented managers have the capacity for considerable political persuasion and intimidation of both their own employees and their auditors. Managers who have been involved in fraud or restatements are penalized by being subject to criminal or civil court actions and by suffering reputation damage and facing diminished job prospects. The punishments for misconduct are not insignificant: Doeringer (1991) found that the perceived fairness of the compensation system will contribute to the ethical climate of a company; and Desai et al. (2006) found that 60% of restating firms experience a turnover in at least one top manager within 24 months of the restatement, compared to only 35% among age, size, and industry-matched firms. Further, 85% of the displaced managers of restatement firms are unable to secure comparable employment afterwards, indicating that the labor markets impose significant penalties for accounting violations (Desai et al., 2006). Dealing with such talented managers makes the work of an Audit Committee or Supervisory Board that much more challenging in protecting the interests of the corporation and its shareholders. In an audit setup, management integrity assessments and concerns have been shown to impact the persuasiveness of evidence sought and the auditor's assessment of management integrity improved the likelihood of detecting misstatements (Kizirian et al., 2005). Further, CFO integrity has been associated with changes in auditor risk judgments and to recommendations for increasing audit extent and fees (Beaulieu, 2001). Generally, there is little research bridging financial reporting risk variables with elements of performance, integrity, and governance and therefore the following hypothesis is suggested:

H1: Auditors consider the risk of intentional misstatements to be associated with conditions of management integrity, consistent entity profitability, sustainable management compensation goals, and governance quality.

There is a significant body of literature that addresses the various capital market and compensation incentives that may blind manager judgments or lead to fraud: Erickson et al. (2004) found that a one standard deviation increase in the proportion of stock-based compensation increases the probability of an accounting fraud by approximately 68%; the likelihood of a misstated set of financial statements increases greatly when the CEO has a sizable amount of stock options in-the-money (Efendi et al., 2007); and, generally, capital market incentives, such as equity holdings and stock-option plans, produce performance pressures which may induce managers to exert productive effort, but also to engage in financial misstatements in order to increase senior executive payout (Goldman and Slezak, 2003; Bartov and Mohanram, 2004). More broadly, from an illegal act perspective, studies have identified a significant positive association between the likelihood of securities fraud allegations and executive stock option incentives (Johnson et al., 2003; Denis et al., 2006). Within the Netherlands, it is unclear what effect of extra-territorial institutional variables may have on Dutch companies (such as a link to the US regulatory system) or response to an external event (e.g., introduction of Sarbanes-Oxley and the Ahold accounting fraud of $880 Million reported in 2003), and therefore propose the following hypothesis:

H2: Institutional variables and external regulatory events affect auditor risk assessments.

Empirical research has provided some insights on the importance of relationships and various 'players' in the 'governance mosaic', including the Audit Committee, Board of Directors, Internal and External Auditors, and management, in addition to outside stakeholders (Cohen, 2004). Yet there is little research on how such 'mosaic' pieces fit together and/or whether having adequate governance leads to increased performance or vice-versa. I hypothesize that within this governance mosaic, there may be a self-selection and inherent forces where governance variables are associated with better performing companies and, conversely, better performing companies have higher quality managers and more sustainable goals and governance. In turn, hypothesis 1 is re-expressed where governance and past (observed) performance (as a proxy for future expected performance) are considered functions of risk variables observed by auditors at their clients.

H3: Auditors consider that corporate governance quality is associated with conditions of management integrity, consistent management performance, and sustainable management compensation goals.

H4: Auditors consider that past corporate performance is associated with conditions of management integrity, sustainable management compensation goals, and governance quality.

3 Data, Results and Conclusions

This study is possible due to the availability of a large private database of over 4,957 actual client audits conducted in the Netherlands between 2002 and 2004. This database captures auditor cues and risk judgments at the continuance stage of the audit. The questions and framed response possibilities are standardized globally by the Big 4 audit firm, and the questions used as our research instrument stemmed directly from the standard, five framed risk levels of Likert-type choices made and approved by audit partners: lowest risk, low risk, some risk, high risk, highest risk (Appendix 1). Additionally, certain binary indicator and control variables are used as well. Audit standards are explicit about the auditor's responsibilities to assess the risk of fraud (AICPA, 2002; IFAC, 2004), auditors have incentives to identify such risks (Zimbelman and Waller, 1999), and auditors tend to have a multi-year mandate which allows them to incorporate their experiences with their clients in their annual continuance assessments.

Three groups of ordinal regressions are executed to examines the factors and relationships that audit partners observe and perceive at their audit clients, consistent with the following functions (Hernandez, 2007):

1. IntentMisstate = IntegrityEthics + SustainableGoals + PastPerformance + CorpGovernance + SECRules + ListedCompany + PostSOX2002 + PostAhold2003

2. PastPerformance = IntegrityEthics + SustainableGoals + CorpGovernance + SECRules + ListedCompany + PostSOX2002 + PostAhold2003

3. CorpGovernance = IntegrityEthics + SustainableGoals + PastPerformance + SECRules + ListedCompany + PostSOX2002 + PostAhold2003

In testing Hypothesis 1, results suggest that auditors consider the risk of intentional misstatements to be associated with conditions of management integrity, consistent management performance, sustainable management compensation goals, and governance quality, all significant results at the 99% level. Surprisingly, the statistics do not show any significance for institutional variables nor significant regulatory and other events. However, companies appearing to report under a US GAAP framework did appear to be more conservative perhaps attributable to the more elaborate rules framework and enforcement considerations (providing some support for H2) on critical fraud areas such as revenue recognition and expense capitalization. Overall, the results suggest that risk factors of management integrity, consistency in past performance, balanced goals, and corporate governance contribute to auditor fraud risk considerations.

The second set of ordinal statistics test Hypothesis 3 and results suggest that auditors consider that corporate governance quality to be associated with conditions of management integrity, consistent management performance, and sustainable management compensation goals, all significant results at the 99% level. Interestingly, institutional variables such as the company being listed led to lower perceived corporate governance risk, with no difference in whether the Company had to meet SEC criteria. Similarly, there is a mixed result on external events on corporate governance, with the introduction of Sarbanes-Oxley being significantly negatively associated with corporate governance risk, with no significant effect stemming from the Ahold scandal. All this suggests that the regulatory shock from the United States may have heightened awareness on the importance of governance in the Netherlands.

The last set of ordinal regressions test Hypothesis 4 and results suggest that audit partners at the sampled Big 4 accounting firm consider that past corporate performance is associated with conditions of management integrity, sustainable management compensation goals, and governance quality. In addition, major external events such as the introduction of Sarbanes-Oxley and the Ahold scandal appear to have negatively affected consistency in performance, perhaps due to uncertainty in the capital markets surrounding these events. US GAAP reporting, listed company status or being an SEC registrant did not appear to be variables affecting consistency in corporate performance, which suggests the model is robust.

Overall, I consider these results encouraging in that they demonstrate that there are robust and important associations between risk factors related to dimensions of management integrity, corporate performance, sustainable goals, corporate governance, and fraud. Further, there is evidence suggesting that institutional variables and external events do alter risk considerations (and audit partner perceptions) and hence can be used to influence auditor assessments (and, potentially, actual company actions themselves). This study presents evidence that suggest that audit partner risk assessments of fraud, perceived corporate performance risks, and corporate governance risks are independently associated with each other, as well as positively affected by management ethics and integrity concerns perceived by auditors and the pressure and balance of financial and non-financial goal-setting targets in management compensation contracts. A potential corollary may be that that managers and entities focused on ethics, values, and sustainable goals (lower integrity concerns, less profits pressure) may present themselves with lower audit risk and benefit investors by reducing contracting and agency risks, which may be simultaneously associated with lower fraud, governance, and overall entity performance risks. This may be good news because 'investments' in corporate and manager ethics as well as focusing on sustainable goals may 1) reduce audit risks and 2) form key elements towards an agenda of integrity, sustainability and good governance.

4 Future Perspectives: A 'Five Forces' Model on Good Value and Shared Values

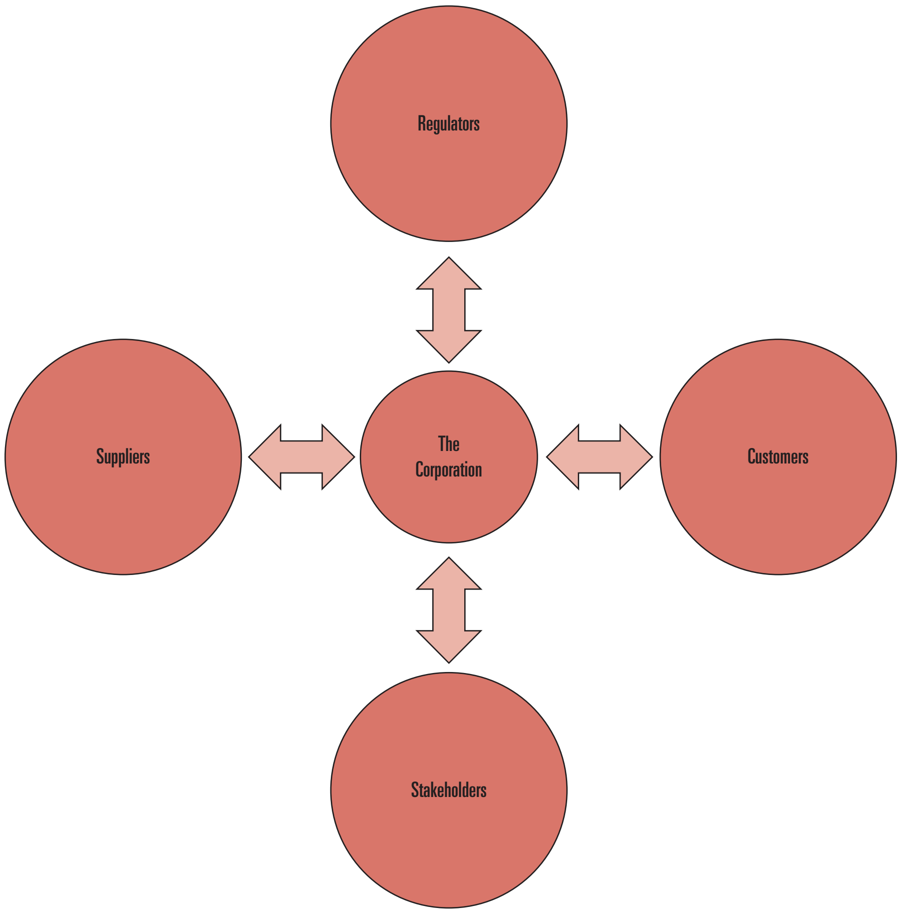
This next section bridges empirical insights with the literature and regulatory considerations today. From the academic perspective, models for corporate illegal behavior (e.g., Baucus, 1994) consider that pressure, opportunities, and predisposition conditions at a corporation interact with individual characteristics to produce illegal corporate behavior and corporate crimes. From an auditor's perspective (e.g., IFAC, 2004, 2009), internally within a corporation, three groups of risk factors are considered to be generally present when material financial reporting misstatements due to fraud occur covering incentives/pressures, opportunities, and attitudes/rationalizations.

From a regulatory perspective, there is consensus that an adequate set of internal controls are a necessity to safeguard against fraud and protect investor interest, where control frameworks are used as guidance (e.g., COSO internal control or enterprise risk management frameworks). Further, American regulatory authorities have had great experience in dealing with corporate misconduct and suggested on how to deal with such corporate illegal matters (e.g., through the United Federal Sentencing Guidelines [FSG] Manual and various cases where Deferred Prosecution Agreements [DPA] are utilized). The major principles of internal control are consistent with COSO but they highlight specific matters that often do not get sufficient attention: exclude from positions of substantial authority any individual that the company knows, or should know, is engaged in illegal or unethical activities; monitor, audit, and evaluate the corporate ethics and compliance program, as well as provide a mechanism for anonymous or confidential reporting; promote and enforce the program through appropriate incentives and disciplinary measures; and, respond appropriately to criminal conduct that is detected and act to prevent further similar conduct. All of this alludes to the importance placed by US regulators on matters of ethics, which would appear to coincide with auditor perspectives presented in this study.

Further, DPAs go further and require "appropriate due diligence requirements pertaining to the retention and oversight of agents and business partners"; "[p]romulgation of compliance standards and procedures ... [to] agents, consultants, representatives, distributors, teaming partners and joint venture partners"; and "[s]tandard provisions in agreements, contracts, and renewals thereof with all agents and business partners which are designed to prevent violations of ... laws, which provisions may, depending upon the circumstances, include: (A) anti- corruption representations and undertakings relating to compliance... (B) rights to conduct audits of the books and records of the agent or business partner to ensure compliance with the foregoing; and (C) rights to terminate an agent or business partner as a result of any violation ..." Such a focus on external third parties suggests that illegal conduct cannot be 'outsourced' from a corporation to a third party, but rather standards of business conduct should be embraced across the supply and distribution chain akin to the manner in which safety standards are embedded into the automotive or food sector.

This study shows that managers and entities focused on ethics, values, and sustainable goals may present themselves with lower audit risk and may benefit investors. Considering that governance, controls, and business contracts have the common purpose of aligning goals and mitigating agency and contracting risks for a corporation, and regulators and stakeholders have vested interests in

Figure 1 Five Forces on how Shared Value creates Good Value



managing the impact (and risks) of a corporation for society, then using a competition model such as Michael Porter suggested a 'Five Forces' can visualize the exponential benefit of having 'shared values.' Should it be true that 'shared values' across the 'five forces' can lead to lower agency and contracting costs, then there may be untapped synergies and good value that can accrue to all stakeholders when they communicate and invest in having promoting or sustaining such a 'shared values' understanding. Certain entities may choose to tap on this additional entity value, using a platform of 'shared values' based on ethics, integrity and sustainability agenda. There could be an economic and societal benefit that can be achieved when leading entities achieve a balance across the 'Five Forces' by analyzing, gathering consensus, and promulgating 'shared values' that, in turn, may produce more 'value' to all constituents. I conclude this paper with a suggestion that there may exist a model that reduces corporate illegality, enhances customer experience, and builds a greater sense of corporate sustainability (and responsibility) through the 'Five Forces' on How Shared Value creates Good Value' visualized in Figure 1. As Vaclav Havel once said: "Without commonly shared values and widely entrenched moral values and obligations, neither the law, nor democratic government, nor even the market economy will function properly." And, this is yet to become ever more complex in the age of communication (Facebook, Twitter), multinationals becoming more global, reshaping of global economies from emerging market forces, the 'rise' of sustainability and non-governmental initiatives, with many other trends that are expected to persist. Therefore, this theoretical 'Five Forces' model depicting the interplay between regulators, suppliers, customers, stakeholders, and the corporation may be the way to move forward by promoting shared values, enhancing shareholder value and minimizing fraud risk. ■

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Appendix 1 Variable Definition (Hernandez 2007)

VARIABLE	*Verbatim* question and framed-response options within Continuance Risk Assessment	Dimensions Captured
IntentMisstate	Management inclination to intentionally misstate financial reporting: • Lowest Risk: Management attaches great importance to achieve fair and accurate financial statement presentation. • Low Risk: Management makes a reasonable effort to achieve fair and accurate statement presentation. • Some Risk: Management is not particularly interested in financial statement presentation but there has been no evidence of intentional misstatement. • High Risk: Management sometimes shows a disregard for fair and accurate financial statement presentation. • Highest Risk: Management has in the past attempted to distort or hide information relevant to the entity's financial condition or operating results.	Variable functions as a dependent variable, as a proxy for risk of fraud perceived by audit partners and potential indication of corporate misconduct. Likert-scale is used to code the variable, with Lowest Risk assigned a value of '1' and Highest Risk a value of '5'.
PastPerformance	Past Performance: • Lowest Risk: The entity has a long track record of accomplishing its goals and has adapted well to changing circumstances. • Low Risk: The entity has been successful in accomplishing its goals and seems able to adapt to changing circumstances. • Some Risk: The entity has had mixed success in accomplishing its goals and in adapting to change. • High Risk: The entity has often missed its goals and has not adapted well to change. • Highest Risk: The entity has rarely accomplished its goals and often seems to engage in crisis management.	This variable is used as a dependent variable in one set of ordinal regression analysis. It also functions as an independent variable capturing the consistency with which an auditee achieved its past performance goals. Likert-scale is used to code the variable, with Lowest Risk assigned a value of '1' and Highest Risk a value of '5'.
CorpGovernance	Governance and oversight of management: • Lowest Risk: There is an independent supervisory board with broad and deep expertise and experience. It takes an active role in the entity's strategic direction, and receives detailed information to monitor closely the performance of management. There is an audit committee with well-qualified supervisory board members, and it has the authority and resources to provide vigilant oversight of financial matters • Low Risk: There is an independent supervisory board with good expertise and experience, and it receives timely information with which to monitor management performance. There is an audit committee with well-qualified supervisory board members that provides oversight of financial matters. • Some Risk: There are some supervisory board members, who are independent of management, and they have average expertise and experience. The supervisory board has adequate information with which to monitor management performance. There is an audit committee/supervisory board meets regularly and responds to issues that are raised with it. • High Risk: Senior management comprises a single person or a small group. Only a minority of board members are independent of management. The outside board members are relatively passive and are provided with only limited information with which to monitor management's performance. There is no audit committee, or there is one but it is not effective. • Highest Risk: Senior management comprises a single person or a small group. The supervisory board is made up of people who lack expertise, information or independence to do anything other than rubber stamp approval of management's decisions. There is no audit committee.	This variable is used as a dependent variable in one set of ordinal regression analysis. It also functions as an independent variable capturing overall quality and oversight by the Supervisory Board and respective committees. Likert-scale is used to code the variable, with Lowest Risk assigned a value of '1' and Highest Risk a value of '5'.

VARIABLE	***Verbatim* question and framed-response options within Continuance Risk Assessment**	**Dimensions Captured**
IntegrityAndEthics	Integrity and Ethics: • Lowest Risk: Management has an excellent reputation for integrity and ethics. High ethical standards are evident –for example, a code of conduct exists and fully communicated and is enforced throughout the organization. • Low Risk: Management has a good reputation for integrity and ethics. • Some Risk: There is no reason to question management's integrity and ethics. • High Risk: Management's commitment to integrity and ethics is in some doubt. • Highest Risk: There are indications based on employee allegations, regulatory inquiries, adverse publicity, or other sources that management has engaged in unethical activity.	This variable captures indications or concerns on management integrity and ethics perceived or noted by the audit partner. Likert-scale is used to code the variable, with Lowest Risk assigned a value of '1' and Highest Risk a value of '5'.
SustainableGoals	Incentive for intentional Misstatements in financial reporting • Lowest Risk: Incentive compensation is balanced between financial and non-financial measures and limits the opportunity for extraordinary gain or hardship. Management's performance goals appear achievable. • Low Risk: Incentive compensation system is balanced between financial and non-financial measures. Management's performance goals are high but achievable. • Some Risk: Incentive compensation system is focused on accounting-based measures. Management is under some pressure to achieve targeted results. • High Risk: A substantial portion of management compensation is dependent on accounting-based measures. Management is under substantial pressure to achieve targeted results. • Highest Risk: Poor performance threatens either the viability of the enterprise or management's continued employment with it.	This independent variable captures the level incentives for intentional misstatements framed around the balance of financial and non-financial metrics within management compensation arrangements. Likert-scale is used to code the variable, with Lowest Risk assigned a value of '1' and Highest Risk a value of '5'.
SECRules	Is your Client or has your client become a [Big 4 Firm] SEC Audit client, or the Parent, Subsidiary or "Affiliate" of a SEC Client (whether or not audited by [the Big 4 Firm])? . . . -Yes -No	This binary variable notes whether the audit client is covered under SEC reporting rules. A binary scale is used to identify an SEC client, with Yes represented by a value of '1'.
ListedCompany	Is the company listed itself? -Yes -No	This binary variable notes whether the audit client is a listed company itself (rather than just a subsidiary of a listed company). A binary scale is used, with Yes represented by a value of '1'.
PostSox2002	[Continuance assessments performed on Year 2 of this study]	This binary variables captures the second year of the continuance assessment of the study.
PostAhold2003	[Continuance assessments performed on Year 3 of this study]	This binary variables captures the third year of the continuance assessment of the study.
BaseYear	[Continuance assessments performed on Year 1 of this study]	This binary variables captures the first year of the continuance assessment of the study.

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Men abonneert zich voor de gehele jaargang.
Dat kan via www.mab-online.nl.
Verschijnt 10x per jaar.
Jaarabonnement € 94 exclusief btw.
De verzendtoeslag voor België bedraagt € 6,00, voor Europa € 33,60 en voor de rest van de wereld € 66,24.
Studentenabonnement € 38,32 exclusief btw, mits men is ingeschreven bij een universiteit.

Abonnementen lopen automatisch door, tenzij uiterlijk 30 dagen voor de vervaldatum bij onze klantenservice wordt opgezegd via telefoonnummer 0314-358358. Kies de optie 'vraag over het abonnement' en vervolgens de optie 'abonnement opzeggen'. Ook voor informatie over uw lopende abonnement kunt u contact opnemen met onze klantenservice.

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