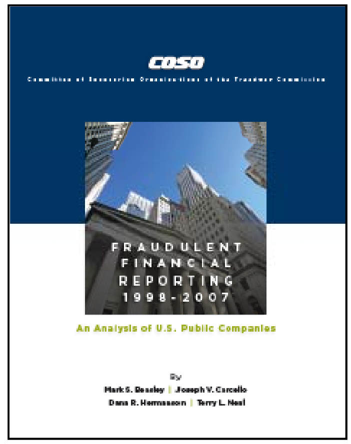
The Committee of Sponsoring Organizations of the Treadway Commission

"Fraudulent Financial Reporting: 1998-2007, An Analysis of U.S. Public Companies"

NASBA Annual Meeting
October 26, 2010

David Landsittel
COSO Chairman



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About COSO

- Formed in 1985
  - To sponsor the National Commission on Fraudulent Financial Reporting (i.e., Treadway Commission)
- A voluntary private sector organization
- Sponsors:
  - American Accounting Association (AAA)
  - American Institute of Certified Public Accountants (AICPA)
  - Financial Executives International (FEI)
  - Institute of Management Accountants (IMA)
  - The Institute of Internal Auditors (IIA)

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COSO's Mission

*"to provide **thought leadership** through the development of comprehensive frameworks and guidance on **enterprise risk management**, **internal control** and **fraud deterrence** designed to improve organizational performance and governance and to reduce the extent of fraud in organizations."*

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Summary of Major Publications

1. National Commission Report on Financial Fraud (1987)
2. Internal Control – Integrated Framework (1992)
3. Internal Control Issues in Derivatives Usage (1996)
4. Fraudulent Financial Reporting: 1987-1997 (1999)
5. Enterprise Risk Management – Integrated Framework (2004)
6. Internal Control over Financial Reporting – Guidance for Smaller Public Companies (2006)
7. Guidance on Monitoring Internal Control Systems (2009)
8. Fraudulent Financial Reporting: 1998-2007 (2010)

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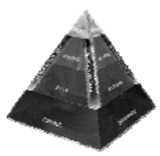
Timeline

1987: Treadway Commission Report

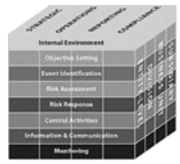
1992: Internal Control Framework



1996: Internal Control Issues in Derivatives

1999: Fraud Study I - Fraudulent Financial Reporting: 1987-1997

2004: Enterprise Risk Management Framework



2006: Guidance for Smaller Businesses on Internal Control over Financial Reporting

2009: Guidance on Monitoring Internal Control Systems

2010: Fraud Study II - Fraudulent Financial Reporting: 1998-2007

2010: Recent thought papers on current issues

1985 1990 1995 2000 2005 2010

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External Developments Affecting the Mission

- SOX Sec. 404 requirement – public reporting on internal control effectiveness
- Recent financial crisis focus on risk management inadequacies – pressure on boards to become more involved in risk management
- Ongoing concerns about fraudulent financial reporting

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Purpose of the Study

- To identify common attributes relating to companies involved in fraudulent financial reporting
- To examine findings for insights about the need for future research and guidance

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Research Approach

- Identified fraud cases from SEC's AAERs
  - AAERs issued January 1, 1998 – December 31, 2007
  - 347 companies allegedly involved in fraud, versus 294 in 1987-1997
- Analyzed AAERs for information
  - Nature of fraud – size, technique, length, etc.
  - Individuals involved – titles, motivations, etc.

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Research Approach

- Gathered information from F/S, proxies, and press
- Matched fraud companies with similar no-fraud companies (e.g. industry, size)
  - Compared governance characteristics
  - Compared subsequent consequences to companies and individuals

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Key Findings

- Nature of fraud companies
  - Varying sizes large and small
  - Variety of industries
  - Often under financial stress

Key Findings

- Fraud techniques
  - Revenue recognition
  - Overvaluing assets
  - "Cooking the books," not theft

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Common Financial Statement Fraud Techniques

Methods Used to Misstate Financial Statements	Percentage of the 347 Fraud Companies Using Fraud Method
Improper revenue recognition	61%
Overstatement of assets	51%
Understatement of expenses/liabilities	31%
Misappropriation of assets	14%
Inappropriate disclosure	1%
Other miscellaneous techniques	20%
Disguised through the use of related party transactions	18%
Insider trading also cited	24%

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Key Findings

- Alleged perpetrators
  - 89% of cases – CEO and/or CFO named
  - Motivations include meeting expectations, concealing deteriorating financial condition, preparing for debt/equity offering

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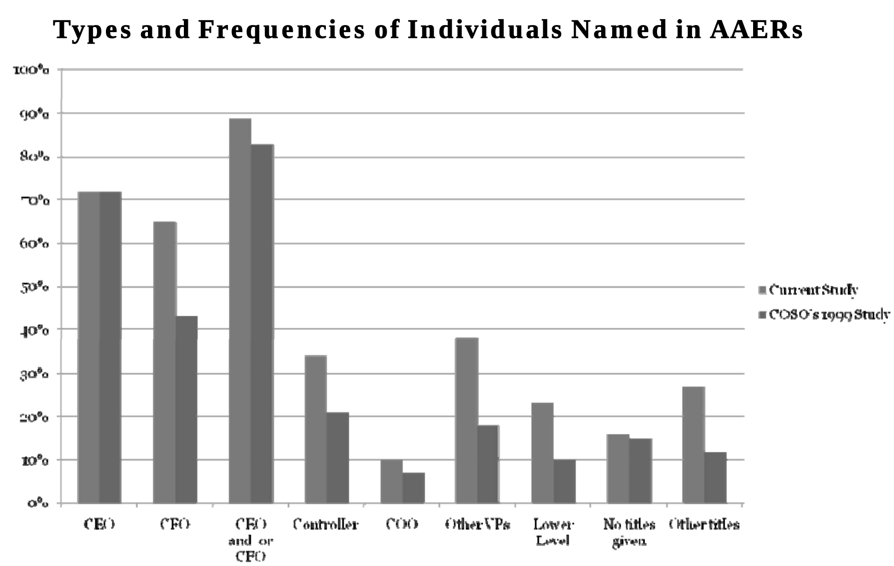

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Key Findings

- Role of board of directors
  - Overall, few major differences between fraud and no-fraud firms in measurable attributes
    - Boards were similar in size, percentage of outsiders
    - Almost all fraud companies had audit committees with similar size and similar number of meetings as no-fraud firms

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Board of Directors

	Fraud Sample	No-Fraud Sample
Number of Board members	7.7	8.0
Type of Board member:		
Grey director	10%	12%
Outside director	60%	63%
Board members with accounting or finance expertise	11%	9%
Companies with at least 1 accounting or finance expert on Board	57%	51%
Type of Board chair:		
Inside director	75%	70%
Number of Board meetings per year	7.7	6.6

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Audit Committee

	Fraud Sample	No-Fraud Sample
Existence of an audit committee	95%	98%
# of individuals on audit committee	3.1	3.2
Type of audit committee member:		
Outside director	84%	87%
# of audit committee meetings per year	3.5	3.7
Percentage of audit committees with at least 1 accounting or finance expert	34%	28%

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Key Findings

- Auditor characteristics
  - Mostly Big N auditors
  - Higher percentage of fraud firm audit reports were unqualified opinion with explanatory paragraph
    - 56% for fraud firms vs. 36% for no-fraud firms
  - Limited analysis of SOX 404 reports
  - Rate of auditor changes surrounding fraud period twice the rate of change for no-fraud firms

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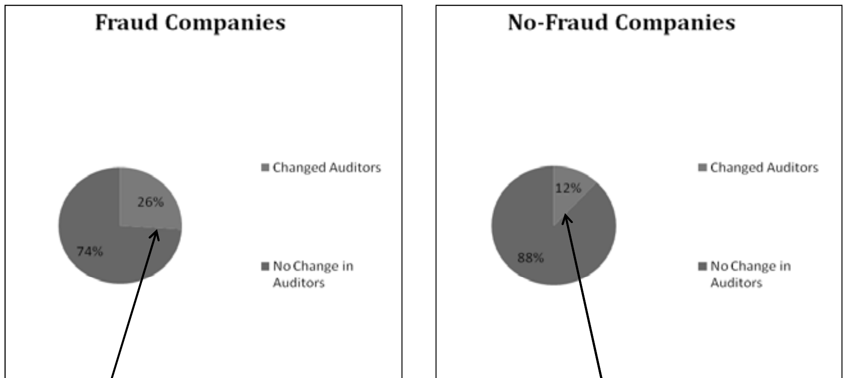
Auditor Changes



26% Changed Auditors

12% Changed Auditors

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Key Findings

- Consequences
  - Variety of SEC sanctions – bars, fines, disgorgements
  - 16.7%average negative abnormal stock return on initial fraud announcement
  - Fraud firms suffer higher rates of adverse financial outcomes than no-fraud firms – bankruptcy, delisting, material asset sales
  - Approximately 20% of fraud firm CEOs and CFOs were indicted, and over 60% of those indicted were convicted

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Insights

- Continued efforts to prevent, detect, and deter fraud are warranted
- More research needed to understand and evaluate control environment
- Closer examination of revenue recognition techniques and industry issues
- More research needed on organizational behaviors – e.g.
  - Board of director *processes*
  - Psyche of fraud perpetrators

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Insights

- Auditor issues
  - More research is needed to determine if there is any linkage between the occurrences of fraud and
    - Timing an nature of auditor changes
    - Issues triggering explanatory paragraph in audit report
  - More research to
    - Assist auditors in evaluations of the control environment, including the board of directors and senior management
    - Understand lessons learned from auditor involvement in 23% of cases where auditor is named
- More time to observe impact of SOX 404 reporting

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COSO Looking Ahead – A Recap of Our Challenges

- Research and guidance on the control environment
- Pursuit of behavioral and other "soft side" research – e.g. "rationalization" and overconfidence
- Extending fraud research study to get insights on SOX 404 effectiveness

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Questions or Comments?

David Landisttel