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A Forensic Accounting Examination of Financial Reporting Fraud at the Segment Level

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Segment reporting—the disclosure of information by (complex) corporations that allows financial statement users to assess the performance of particular, more or less narrowly defined, subdivisions of a corporation (Scherer 1979)—is not new to the business community.

The purpose of this study is to assess various financial reporting frauds that occurred at the segment-level. From a fraud perspective, segment reporting has been an overlooked topic in both practice and academia. This paper provides an analysis of fraud at the segment level at nine major corporations. Unfortunately, many times fraud at the segment levels are bundled together with firm-level fraud cases without specific reference to any wrong doing that occurred at the segment level. Understandably, the primary goal of the Securities Exchange and Commission (SEC) is to ensure that firm-level earnings are truthfully reported, therefore segment-level reporting, although compliant with Generally Accepted Accounting Principles (GAAP), may be a secondary goal in SEC investigations since segment fraud rolls up into firm-level fraud.

This study describes firm characteristics, types of fraudulent, and some of the financial effects the fraud had on these firms. We also provide details of various types of manipulations employed to perpetrate these frauds. This study focuses only on segment financial reporting fraud that has led to the issuance of an Accounting and Auditing Enforcement Release (AAER) that specifically referenced fraud at the segment level. We describe the types of fraudulent transactions more likely to occur at the segment level. Last, we discuss the fines and penalties imposed on firms and management following the SEC investigation of the fraud.

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Since one of the objectives of segment financial reporting is to increase the transparency of overall financial reporting, this study has implications for investors, auditors, and regulators alike. For example, our findings may encourage auditors to increase their sampling size in cases where bill and hold transaction occur more regularly. Regulators may choose to allocate more resources to reviewing segment-level financial reporting compliance than expended in the past, thereby improving the regulators understanding of the firm. Evaluating a firm from the bottom (i.e., at the segment level) up should provide more insight in to company operations and possible misconduct.

Segment Reporting and its Importance

The Financial Accounting Standards Board (FASB) began the reassessment of segment reporting in 1993 after financial statement users raised concerns over the quality of segment reporting under Statement of Financial Accounting Standard (SFAS) No. 14. The American Institute of Certified Public Accountants (AICPA) Committee on Financial Reporting, and the Association for Investment Management and Research (AIMR), both stressed the importance of segment information and the shortcomings of SFAS No. 14 (AIMR 1993; AICPA 1994). These groups argued that it was important for a company to present segment data in the same way it organizes and manages its business, and criticized SFAS No. 14 for being too vague and easy to circumvent. For example, in the AIMR position paper, *Financial Reporting in the 1990s and Beyond*, financial analysts indicate that the "needs of analysts for disaggregated financial data…is more than 'necessary,'…it is vital, essential, fundamental, indispensable, and integral to the investment analysis process." If segment data is not provided in public documents, analysts often search out this information in discussions with management (prior to regulation Full Disclosure), competitors, and others. Disaggregated information is essential to estimating future

cash flows of an enterprise—the ultimate goal of all financial analysts (AIMR 1993). Additionally, investors require information about the relative profitability of different divisions and product lines to have a basis upon which to make predictions (Copeland et al. 1971). Purposely distorted segmented financial statements hinder analysts (and investors) who forecast the future activities of a diversified firm. Gross margins, growth rates, and other measures ordinarily used for financial analysis are often difficult to determine from consolidated (i.e., firm-level) financial statements.

As outlined above, segment data is vital in providing information about opportunities and risks related to a company's diverse operations. If all aspects of a company's activities have similar opportunities and risks, segment reporting offers little to no incremental benefit over aggregated data for the company. On the other hand, for a diversified company, users should be able to project earnings or cash flows more effectively on a segment-by-segment basis than for the company as a whole. Thus, rather than the SFAS No. 14 segment-reporting regime, derived from the notion of industry and geographic segments, SFAS No. 131, released in 1997, introduced a new model for segment reporting termed the 'management approach'. This new approach focuses on the way the chief operating decision-maker organizes segments within a company for making operating decisions and assessing firm performance. It is based on a FASB assumption that one of the primary objectives of financial reporting is to help investors, creditors, and others assess the amount and timing of prospective cash flows (FASB 1978). This change in reporting requirements was expected to provide financial statement users with a better understanding of a firm's overall performance, thereby improving their ability to predict future cash flows (FASB 1997; AIMR 1993; AICPA 1994).

Specific implementation issues and potential problems arising from the disclosure requirements of SFAS No. 131 are (1) identification of the chief operating decision-maker, (2) identification of the internal reports to use, (3) application of aggregation criteria, (4) assessment of the competitive harm resulting from too much disclosure, (5) comparability, and (6) development of comparative figures from year to year. In addition to these six potential problems, the SEC continues to raise concerns about compliance issues. For example, the SEC continues to see cases of inappropriate application of the standard and attempts to ensure that segment disclosure requirements are a central focus of SEC staff reviews (Bayless 2001; Turner 1999). This study focuses on examples that the SEC has deemed significant enough to issue an enforcement action (e.g., ELR or AAER).

Segment Financial Reporting Fraud

Segment information is difficult for outsiders to observe and monitor due to the inconsistent compliance among reporting companies under SFAS No. 131 (Paul and Largay 2005; Reason 2001). The wider discretion permitted under SFAS No. 131 has led to concerns that regulators have opened the floodgates for accounting manipulation. Some studies conclude that management discretion harms earnings quality and predictability, while others conclude that it improves earnings predictability (Ewert and Wagenhofer 2005). Many early segment reporting studies focused on the change in the number of reported segments or the change in the degree of disaggregation upon adoption of SFAS No. 131 (Ettredge et al. 2000; Hermmann and Thomas 2000; Street et al. 2000), and subsequent changes in analyst forecasts accuracy (Venkataraman 2001; Berger and Hann 2003; Botosan and Harris 2005). However, much of the existing research provides little insight into managerial decisions that result in deliberate fraud at the segment level.

Since it is difficult to discern all firms that have committed fraud at the segment level, it is difficult to determine the true extent of segment financial fraud occurring within firms. Despite the identification issues outlined above, this study provides insights into areas of segment reporting that are more susceptible to fraud than others, based on our examination of firms with alleged, and later proven, cases of segment fraud.

We define fraudulent segment financial reporting as intentional misstatements or omissions of amounts or disclosures in financial statements, employed to deceive financial statement users. The term is sometimes used interchangeably with 'accounting irregularities'. There is a technical difference between fraud and irregularities in that with fraud, it must be shown that a reader of financial statements (in this case, specifically segment financial statements), that contained intentional and material misstatements, relied on those financial statements to his or her detriment. In this study, accounting practices are not alleged to be fraudulent until deemed so by an administrative, civil, or criminal proceeding, such as that of the SEC.

Enron, although not in our final sample due to post-fraud data limitations, is an egregious example of fraudulent reporting at the segment level in which firm management used discretion to manipulate segment earnings. Richard Causey, former CEO of Enron, and other Enron employees, concealed massive losses for the Enron Energy Services (EES) division by fraudulently manipulating Enron's business segment reporting. At the close of the first quarter of 2001, Enron, with Causey's approval, reorganized its business segments and moved a large portion of EES's business into Enron North America (ENA), part of Enron's wholesale energy business segment. The reorganization was fraudulently designed to conceal hundreds of millions of dollars of losses at EES, Enron's heavily touted retail energy trading business, which it would

otherwise have disclosed (SEC v. Richard Causey, Civil Action No. H-04-0284). Enron is a prime example of how a firm's segment financial information can significantly distort the appearance of comprehensive firm performance, thereby reducing firm transparency.

The remainder of this paper is organized as follows: Section II discusses the sample selection and provides a description of the fraudulent behavior at each of the sample firms; Section III reports the empirical findings; and Section IV summarizes and concludes the paper.

I. SAMPLE SELECTION AND FRAUD DESCRIPTION

Sample Selection

We identify firms specifically cited for segment financial reporting fraud by the SEC between 2000 and 2009. The referenced frauds occurred between the years 1997 and 2003. Our sample selection procedure starts with a search on the SEC website using keywords such as 'fraud and segment', 'fraud and division', and 'segment and restatement'. For the purpose of this study, we focus on Accounting and Auditing Enforcement Releases (AAERs). Our sample selection criteria drastically reduces our sample size, mainly because most enforcement actions do not make specific reference to segment level fraud even when it occurred. Since segments roll up into firm-level consolidated earnings, the SEC may tend to focus more effort on consolidated (i.e., overall) rather than segment financial reporting, due to financial and staffing constraints. Any fraud related to revenue that occurs within a segmented firm is happening at one or more segment levels. It is unlikely that the fraud is prevalent amongst all segments of the firm, which our limited sample reveals. The initial sample search reveals 44 firms for which the SEC has issued AAERs which specifically reference segment fraud. Twenty-four of these firms are eliminated because of missing restatement data. Five firms are not covered in the Compustat

annual file, two firms are eliminated because of missing financial variables in Compustat, and four more firms are eliminated because financial data is not available in all three periods evaluated: the pre-fraud, actual fraud, and post-fraud periods. The final sample yields nine firms for which the SEC issued enforcement releases that specifically indicated fraud occurred at the segment level of the firm, and with financial information available for all three periods of evaluation previously mentioned. The sample selection procedure is summarized in panel A of Table 1. Panel B of Table 1 provides a list of the nine firms that comprise the final sample. Seven out of nine firms reference only one specific segment that committed fraud, while Cutter & Buck Inc. and the El Paso Corp. were cited by the SEC for engaging in segment fraud across multiple divisions. Panel C of Table 1 reports the industry distribution for the sample firms. We follow the industry classification used in Barth et al. (2001). There is one firm in retail, one in financial institutions, one in utilities, three in durable manufacturers, two in textiles, printing, and publishing, and one in diversified machinery.

Fraud Description

We review the AAER for each sample firm to identify the type of fraud occurring at the segment level. Appendix A summarizes our findings. Three out of nine firms involve bill and hold sales transactions, and violations of revenue recognition principles in which a firm delivers goods to customers without a customer order. These types of transaction are often accompanied by a 'side letter' agreement indicating the customer's option to return all unsold merchandise without obligation (Shilit & Perler 2010). These types of bill and hold arrangements occurred at ConAgra Foods' agricultural products segment, Raytheon's aircraft segment, and at multiple Cutter & Buck, Inc. sales divisions. The magnitude of these bill and hold transactions is

significant.Ffor example, forensic auditors at ConAgra Foods indicated that 40 percent of sales from 1998 to the second quarter of 2001 were improper bill and hold sales (SEC Litigation Release No. 20206, 2007).

Additional segment fraud included in our sample reveals several interesting accounting schemes. At Brightpoint Inc., executives created a fictitious insurance policy (with the assistance of the American International Group (AIG) to offset losses associated with closing their trading division. Cutter & Buck, Inc. masked inventory returns connected to the bill and hold transactions indicated above. In addition to bill and hold transactions at ConAgra's agricultural products segment, the segment failed to record sufficient bad debt reserves; furthermore, the division recognized vendor rebates related to the bill and hold transactions. In other words, ConAgra created receivables for vendor rebates on bill and hold sales that would only be collected if the sales were actually completed at the customer's request.

Raytheon's aircraft division engaged in three fraudulent schemes. First, Raytheon transferred (without disclosure) $14 million of surplus pension income into the division to mask losses. This arrangement persisted from the third quarter of 2000 through 2004 (AAER No. 2449, 2006). Second, the firm deferred recognition of certain aircraft-related impairments for several years by pooling aircraft for impairment testing purposes. The firm then used the events of September 11, 2001, to recognize the delayed impairments. Third, between 1997 and 2001, Raytheon Company and certain members of its senior management made false and misleading disclosures and used improper accounting practices that operated as a fraud by masking the declining results and deteriorating business of Raytheon Aircraft Company and inaccurately reporting the company's operating results on both a segmented and consolidated basis.

Tyco International reduced expenses at its ADT Security Services division via the use of a fee charged to suppliers of security monitor contracts (titled a 'connection fee', which was set at $200 per contract) that was instantly refunded to the supplier. The fee charged to suppliers was recognized as a reduction in expenses; however, the offsetting vendor refund was amortized over ten years. This arrangement effectively increased operating income by $567 million over a four-year period and cash flow from operations by $719 million during the same period (AAER No. 2603, 2007).

In the case of BISYS, at the behest of the vice president of finance for the Insurance and Education Services group, BISYS's income and revenue were materially overstated. On the other hand, the book value of inventory was approximately $15-18 million over the physical inventory in the Components Division of the NCI Building Systems, Inc. Two subsidiaries of El Paso Corporation, El Paso CGP Company LLC and El Paso Exploration & Production Co. inflated the company's natural gas and oil reserves in violation of federal securities laws. El Paso Corp. had a material weakness in its internal controls which led to inadequate control over the booking of its oil and gas reserves, system access, documenting policies and procedures, and monitoring compliance with existing policies and procedures. At Zomax Ireland, a division of Zomax, Inc., the general manager and the controller concealed losses by making false journal entries to overstate the sales accrual account, to capitalize spare machine parts that should have been expensed, and to understate accruals for employee holiday pay. These phony journal entries concealed the division's fraudulent behavior by providing fictitious Zomax Ireland financial information to Zomax, Inc.

In each of the nine cases, the SEC cites firm management as engaging in reckless conduct that resulted in material misstatements. The SEC only provides details of the discovery in the

case of Brightpoint Inc., ConAgra Foods Inc., and NCI Building Systems, Inc. Brightpoint's fraudulent reporting was discovered after auditors reviewed the insurance transaction following an SEC inquiry. At ConAgra, a management change prompted the discovery. NCI Building Systems's fraudulent reporting was discovered by its own senior management. The motivation of fraudulent reporting is mentioned in AAERs regarding BISYS, Conagra Foods, and Zomax. The fraudulent reporting at BISYS was to meet aggressive, short-term earnings targets; at Conagra Foods it was to overstate division's operating results; and at Zomax it was to hide the declining performance of Zomax Ireland during 2004.

As reported in Appendix B, the senior management of Brightpoint, Inc., Conagra Foods, and Cutter & Buck, Inc. committed fraud directly. Former senior executives at Conagra's United Agri-Products UAP division participated in a scheme to overstate UAP's operating results. Martin Julien Marks, the former President and Chief Operating Officer of Cutter & Buck, Inc. participated in improperly overstating the company's revenue. Athena Diaz, the former controller of Cutter & Buck, Inc., assisted Cutter's management in fraudulently boosting its financial results. David Andrew Hilton, the former Chief Financial Officer and former Regional Sales Vice President, respectively, of Cutter & Buck, Inc., caused Cutter to fraudulently inflate its financial results.

The general management of BISYS Group, Tyco International, El Paso Corp., Raytheon and NCI Building Systems knew of or ordered the fraud at the segment level. David Blain, one of three directors of finance in the Insurance Services division of BISYS Group, Inc., participated in a variety of improper accounting practices for the Insurance and Education Services group. Two former executives of Tyco International Ltd., Richard D. Power and Edward Federman, inflated Tyco's operating income through a sham transaction. Richard J.

"Skip" Heger, a third former Tyco executive, aided and abetted Tyco's violations of the reporting and recordkeeping provisions. El Paso Corporation and its subsidiaries El Paso CGP Company LLC and El Paso Exploration & Production Co provided fraudulent financial reporting. Employees involved include Rodney D. Erskine, the former president of El Paso's Exploration and Production Business Segment, Randy L. Bartley, the former senior vice president of El Paso's Exploration and Production Business Segment, and Steven L. Hochstein, John D. Perry, and Bryan T. Simmons, former vice presidents of El Paso's Exploration and Production Business Segment.

NCI Building Systems' senior management first questioned the Components Division about its inventory level on the books and approached the accounting department of the Components Division. The accounting personnel confirmed a large variance between the book and physical inventory numbers. The controller acknowledged that he was aware of the erroneous book inventory and that the inventory system was recording certain transactions improperly. Raytheon Company and its senior company management committed this fraud by masking declining operating results on both a segmented and consolidated basis.

The managers of the segments in Zomax, because of pressure from senior management, were directed to fraudulently report Zomax financial results. Tom Shanahan, the former general manager of Zomax Limited (Zomax Ireland) and Clem Hannon, the former financial controller of Zomax Ireland, engaged in a scheme to fraudulently inflate the financial results of Zomax Ireland and caused Zomax, Inc. to file with the SEC financial statements that materially misrepresented its true financial condition for at least the first three quarters of 2004.

In all cases, fines were imposed on the executives involved in the fraudulent reporting, and in most cases the executives were barred from acting as an accountant or taking an executive

role at publicly traded companies. Appendix C documents the fines and penalties imposed on each of our sample firms. In three out of the nine cases, fines were imposed directly on the firm. They ranged from $450,000 at Brightpoint Inc., to $50 million (and a $1 disgorgement fee) at Tyco International Ltd. In six out of nine cases, the SEC imposed fines on individual company officers. These ranged from as low as $25,000 (levied against a regional sales officer at Cutter & Buck Inc.) to $70 million for Tyco's former President and CEO. In all cases except for NCI Building Systems, the cited individuals were barred from future employment with publicly traded companies in some form.

II. DATA AND EMPIRICAL FINDINGS

Table 2 presents the sample descriptive statistics. The variables are defined as follows: ROE is income before extraordinary items over average equity (compustat #18 / average compustat #216 at t and t-1); CFO is cash flow scaled by total assets (compustat #18 – TACC) / compustat #6); LOGSIZE is log of total assets (log of compustat #6); NSEG is the number of segments of the firm; EARN is earnings before interest and taxes (compustat #178) scaled by firm total assets (compustat #6); GROWTH is a firm's sales growth (compustat #12 - lag(compustat #12)) / lag (compustat #12); MB is the market-to-book ratio (compustat #199*compustat #25 / compustat #60); ROA is return on assets (compustat #18 / average compustat #6 at t and t-1); LEVERAGE is leverage ratio defined as long-term debt over total assets (compustat #9 / compustat #6); TACC is total accrual scaled by total assets (compustat #4-lag(compustat #4)) - (compustat #5 – lag(compustat #5)) - (compustat #1 – lag(compustat #1)) + (compustat #34 – lag(compustat #34)) – (compustat #14 / compustat #6); SALES is firm's sales scaled by total assets (compustat #12 / compustat #6); CHSALES is the change of sales

((compustat #12 – lag(compustat #12)) / compustat #6); NSALES is net sales (Compustat #12)/10,000[1].

As reported in panels A, B, and C of Table 2, we find that from the year before the fraud to the year after the fraud, sample firms generally reported declining earnings, growth, accruals, market-to-book, return on equity, and return on assets. These same firms reported an increase in leverage, number of segment, and operating cash flows. Figures 1 and 2 provide an illustrative view of the firms' characteristics that change from the year before the fraud, to the fraud period, to the year after the fraud. The size of sample firms increases from the year before the fraud to the year(s) during the fraud and remain the same at least until the year after the fraud. Net sales for sample firms increase from 0.5909 to 1.1623 from the pre-fraud period to the fraud period, then decrease slightly to 1.0573 in the post-fraud period. Hence, the changes in firm size and net sales follow the same trend from period to period. Sample firms have the highest sales relative to firm size (1.238) in the pre-fraud period. However, in the fraud period, even though both firm size and net sales become larger, sample firms have lower sales relative to firm size (1.1801), which does not change much after the frauds have occurred (1.1829). Changes in earnings, sales growth, market-to-book, ROA, and accruals all show a significant decline after the fraud occurring. As noted, the change in sales, measured by CHSALES, continues to decline from the pre-fraud period to the post-fraud period. That is, although sample firms try to maintain high values in sales and firm size, the change in sales still decline. In other words, these firms may try to hide declines in sales using overstated sales or total assets (i.e., firm size). This suggests that managers may have embarked on their fraudulent transactions as a means to initially boost the appearance of their performance. The post-fraud declines are most likely a reflection of the true state (or something close to it) of the company at the time of the fraud.

[1] For presentation purposes, we divide net sales by 10,000.

We identify a group of control firms, matched by industry and firm size, in the year prior to the fraud year. The nine control firms are Choicepoint Inc., Dentsply Internal Inc., Dorman Products Inc., Kimberly-Clark Corp., Northeast Utilities, Pechiney, Retail Ventures Inc., Salant Corp., and Norsk Hydro. We compare firm characteristics of the control and sample group firms. The results are summarized in panels A, B, and C of Table 2. Our empirical findings indicate that, in the year before the fraud, firms in the control group have higher operating cash flows and are larger in size relative to firms committing fraud at the segment level. Whereas, firms in the sample group have higher values of ROE, EARN, GROWTH, MB, ROA, LEVERAGE, and TACC. In the pre-fraud period, firms in the control group have 2.3333 segments, whereas firms in the sample group have 2.8889 segments on average.

As reported in panel B of Table 2, during the period in which the sample firms committed fraud, firms in the control group have higher values of ROE, NSEG, CFO, EARN, ROA, and TACC. During this period, the sample firms report a smaller number of segments relative to the control firms. The size of the sample firms becomes much bigger than the control firms. The control firms have lower values of GROWTH, MB, and LEVERAGE. As summarized in panel C of Table 2, in the year after the fraud, the control firms have higher values in ROE, CFO, EARN, GROWTH, MB, ROA, and TACC. After the fraud, control firms have relatively lower values in size and leverage. After the fraud, control firms and sample firms have same values in the number of segment.

Figure 3 illustrates the differences in firm characteristics between firms in the control group and firms in the sample group in the pre-fraud, fraud, and post-fraud periods. Control firms have lower GROWTH, CHSALES, and MB relative to sample firms in the pre-fraud and fraud periods, but have higher GROWTH, CHSALES, and MB relative to sample firms in the

post-fraud period. It indicates that firms committing segment fraud cannot maintain this growth rate when compared to non-fraudulent firms.

As shown in Figure 3, control firms are smaller in size relative to sample firms in both fraud and post-fraud periods. The net sales of sample firms are bigger than that of control firms by 0.095 in the pre-fraud period, the difference becomes largest (0.5840) in the fraud period, then drops to 0.3818 after fraud. The differences between groups in firm size and net sales before fraud may indicate that sample firms have higher sales relative to firm size in the pre-fraud period. Managers in these firms may have incentives to 'maintain' a healthy financial position fraudulently. That is, during the fraud period, sample firms have larger firm size and larger net sales, and maintain a higher value in SALES (sales relative to assets). However, after fraud, sample firms become less 'superior' relative to control firms, as shown by the little difference in SALES between two groups, 0.0007.

Control firms also have fewer segments in the pre-fraud period, but have more segments in the fraud period relative to sample firms. Interestingly control firms and sample firms have the same number of segments after fraud. This may indicate that firms with fraudulent reporting at the segment level may also deliberately manage the number of reported segments, especially during fraud. Control firms have higher ROE (ROA) in fraud and post-fraud periods, but lower ROE (ROA) in the pre-fraud period. The change in ROE (ROA) may indicate that firms carrying out segment fraud have higher ROE (ROA) in the year just before committing fraud. However, these firms cannot maintain the same level of ROE (ROA), which may constitute a motivation for such firms to commit fraud at the segment level.

Control firms have higher CFO in all three periods. Although firms can increase reported earnings with fraudulent reporting behavior, it seems they cannot increase CFO to the level of control firms. Control firms have less leverage relative to sample firms in all three periods.

Panel A of Table 3 reports the number of years restated for segment fraud. Firms restated their annual financial statements for segment information for anywhere from two to five years. Panel B of Table 3 reports the number of years it took to detect the fraud cited by the SEC. We found that while it took one year to detect the fraud and for Zomax, Inc. to restate its fraudulent financial reports, it took Raytheon nine years to do so. In 2007, Raytheon restated its fraudulent financial reports for its 1997 fiscal year.

Panel A of Table 4 reports both original segment and restated segment sales, and original segment and restated segment net income. All firms restated segment sales downward, except for Cutter & Buck, Inc. in 2001, Tyco International in 1998, and Zomax Inc. in 2003. In the case of Tyco International, the firm did not restate their sales or net income at the segment level, but rather only restated its financial information at the consolidated firm level. In the Cutter & Buck case, the firm did not restate segment sales, but restated segment earnings. Both segments involved in fraud at El Paso Corp. restated its segment sales. Panel B of Table 4 reports both original and restated net income. Most firms report and restate segment net income. ConAgra Foods and Brightpoint, Inc. report and restate segment operating profit. El Paso Corp. restated the income in the 10-k of subsidiaries involved in fraud (S1 and S2). In all restatement cases (except for Brightpoint, Inc. in 1999 and 2000, and El Paso Corporation S1 in 2002 and S2 in 1999 and 2000), firms restate segment income downward.

III. SUMMARY AND CONCLUSIONS

Although one of the primary objectives of segment reporting is to increase the transparency of the firm, most of the emphasis on financial reporting is at the consolidated level. From the SEC's perspective, this may have been partly due to staffing constraints in the past. However, as the analysis provided in this paper suggests, a more thorough examination at the segment level may uncover fraudulent transactions in a more timely manner. For example, we find that bill and hold transactions accounted for some of the fraud cases cited by the SEC in our sample. We also find that during the fraud period our sample firms (i.e., firms with AAERs) appear to be performing better on average than comparable firms. This is not to say all above-average performing firms are committing fraud, but rather suggesting it could be one of many indicators that fraud may be occurring. Additional fraud indicators that could be explored in future research.

Appendix A
Descriptions of Fraudulent Behavior at Each Firm

Firm	Description of Fraudulent Behavior	Discovery	Motivation
BISYS GROUP INC	Materially overstated BISYS's revenue and income	N/A.	Meeting earnings targets.
BRIGHTPOINT INC	Created retroactive insurance policy with AIG's aid to offset closure of trading division	Auditors.	N/A.
CONAGRA FOODS INC	Bill and hold sales, advanced vendor rebates, inadequate bad debt reserves	Management change.	Overstate operating results
CUTTER & BUCK INC	Bill and hold sales, masked inventory returns	N/A.	N/A.
EL PASO CORP	Inflated the companies' proved natural gas and oil reserves in violation of the federal securities laws.	N/A.	N/A.
NCI BUILDING SYSTEMS INC	Book inventory approximately $15-18 million over the physical inventory.	NCI senior management	N/A.
RAYTHEON CO	Bill and hold sales, deferred impairment, improper intercompany transfers	N/A.	N/A.
TYCO INTERNATIONAL LTD	Vendor rebates	N/A.	N/A.
ZOMAX INC/MN	Conceal Zomax Ireland's losses by making false journal entries to overstate the sales accrual account, to capitalize spare machine parts that should have been expensed, to understate accruals for employee holiday pay, and then to conceal the fraudulent conduct by sending false Zomax Ireland financial information to Zomax.	N/A.	To hide the declining performance.

Appendix B
Who were Responsible for Segment Frauds

Firm	Who Did it?
BISYS GROUP INC	Director of Finance of the segment participated in improper accounting practices at the behest of the Vice President.
BRIGHTPOINT INC	Brightpoint's then corporate controller and director of risk management covered an unanticipated losses rather than disclose them.
CONAGRA FOODS INC	Former senior executives at the fraud division participated in a scheme to overstate the division's operating results.
CUTTER & BUCK INC	The former President and Chief Operating Officer, controller, Chief Financial Officer and former Regional Sales Vice President fraudulently inflate its financial results.
EL PASO CORP	El Paso Corporation and its subsidiaries with the assistance of a couple of former employees, provide fraudulent financial reporting.
NCI BUILDING SYSTEMS INC	The controller of the Components Division confessed that he knew the incorrect book inventory and that the MIS system was recording certain transactions inappropriately.
RAYTHEON CO	Raytheon and senior company management committed a fraud by masking the declining operating results on both a segmented and consolidated basis. Certain misconducts were undertaken by or with the knowledge of senior company officers.
TYCO INTERNATIONAL LTD	Former executives of Tyco International Ltd. inflated Tyco's operating income.
ZOMAX INC/MN	Former general manager and financial controller of Zomax Ireland fraudulently inflated the financial results of Zomax Ireland and caused Zomax to materially misrepresent its true financial condition.

Appendix C
Fines & Penalties at Each Firm

Firm	Company Fines & Penalties	Employee Fines & Penalties
BISYS GROUP INC		Respondent submitted an Offer of Settlement which the Commission accepted.
BRIGHTPOINT INC	Brightpoint fined $450k (AIG fined $10m)	$195k imposed on three officers
CONAGRA FOODS INC	$45m	$1.401m imposed on three officers and one employee
CUTTER & BUCK INC		$121k imposed on three officers
EL PASO CORP	El Paso consented to a judgment that permanently enjoins it from future violations of the provisions.	$40,000 civil penalty imposed on four officers, $75,000 imposed on one other officer
NCI BUILDING SYSTEMS INC	Respondent has submitted an Offer of Settlement which the Commission accepted. Respondent NCI cease and desist from committing or causing any violations and any future violations.	
RAYTHEON CO	Company submitted an Offer of Settlement without admitting or denying the allegations, which the SEC accepted	$1.421m imposed on two officers
TYCO INTERNATIONAL LTD	$50m (plus $1 in disgorgement)	$105.9m imposed on four officers (two officers combined total of $105m, remaining two officers combined total equals $925k); 2 key officers also repaid company $134m
ZOMAX INC/MN		Respondent has submitted an Offer of Settlement which the Commission accepted. Respondent cease and desist from committing or causing any violations and any future violations

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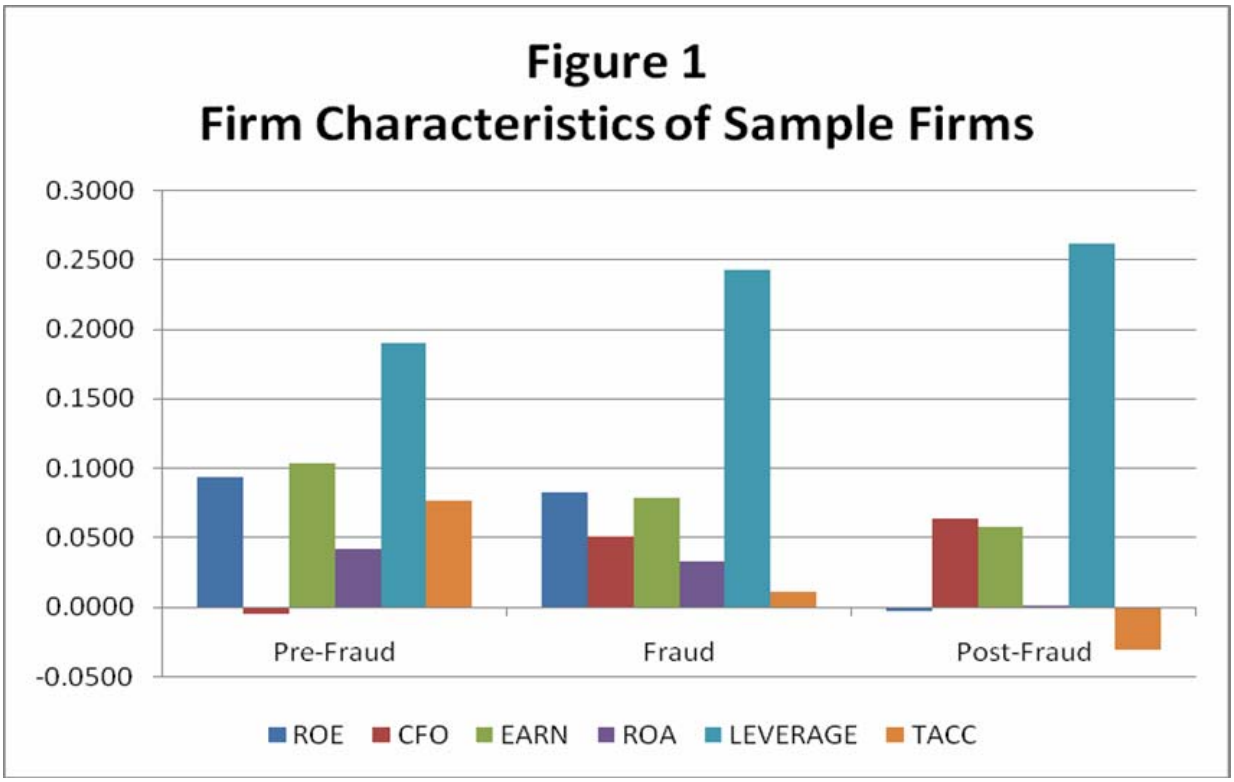

Figure 1 illustrates firm characteristics of sample firms.

ROE	= income before extraordinary items over average equity (compustat #18 /average compustat #216 at t and t-1);
CFO	= cash flow scaled by total assets ((compustat #18 – TACC) / compustat #6);
EARN	= earnings before interest and taxes (compustat #178) scaled by firm total assets (compustat #6);
ROA	= return on assets (compustat #18 / average compustat #6 at t and t-1);
LEVERAGE	= leverage ratio defined as long-term debt over total assets (compustat #9 / compustat #6);
TACC	= total accrual scaled by total assets (((compustat #4-lag(compustat #4)) - (compustat #5-LAG(compustat #5)) - (compustat #1 - lag(compustat #1)) + (compustat #34 - lag(compustat #34)) - compustat #14)) / compustat #6).

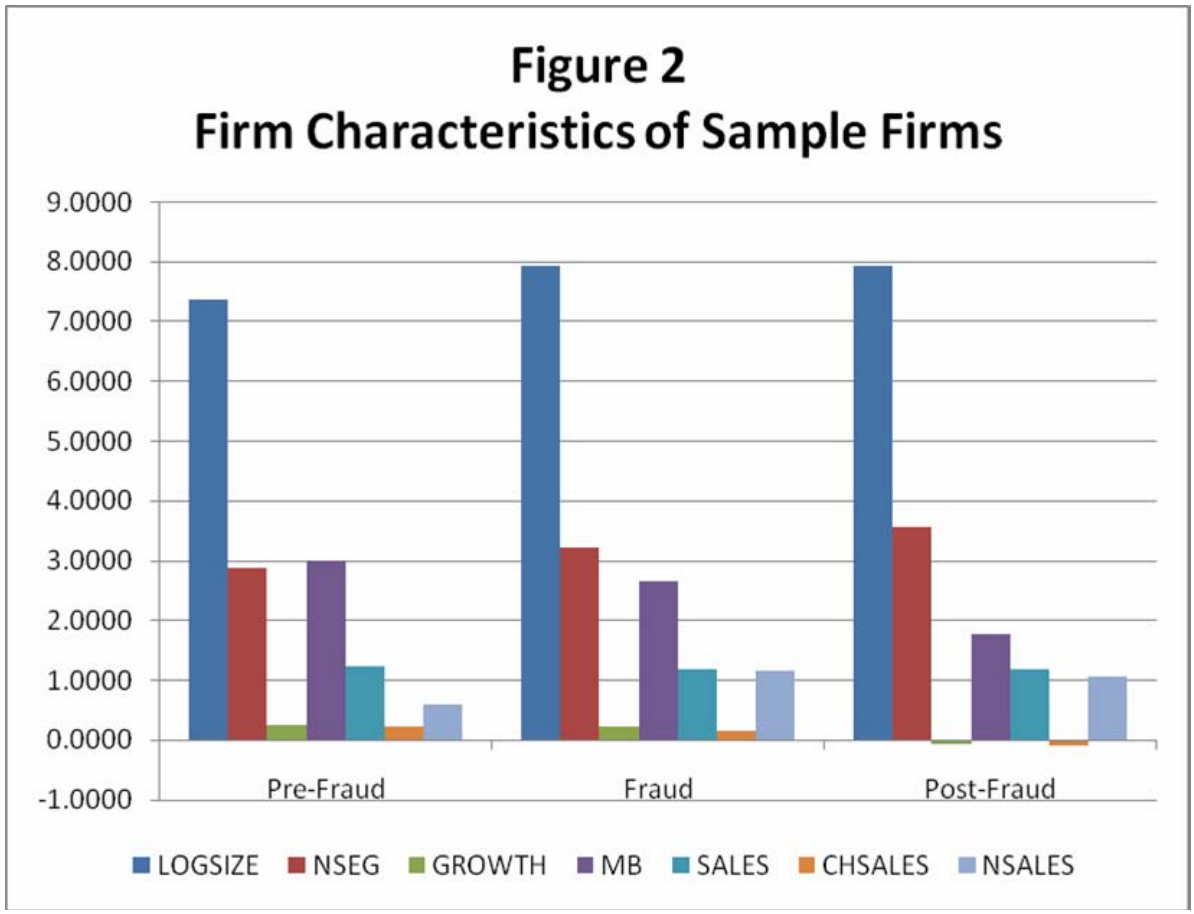

Figure 2 illustrates firm characteristics of sample firms.

LOGSIZE = log of total assets (log of compustat #6);
NSEG = the number of segments of the firm;
GROWTH = firm's sales growth ((compustat #12- lag(compustat #12)) / lag(compustat #12);
MB = the market-to-book ratio (compustat #199*compustat #25/ compustat #60);
SALES = firm's sales scaled by total assets (compustat #12 / compustat #6);
CHSALES = the change of sales ((compustat #12 – lag(compustat #12)) / compustat #6);
NSALES = net sales (Compustat #12)/10,000.

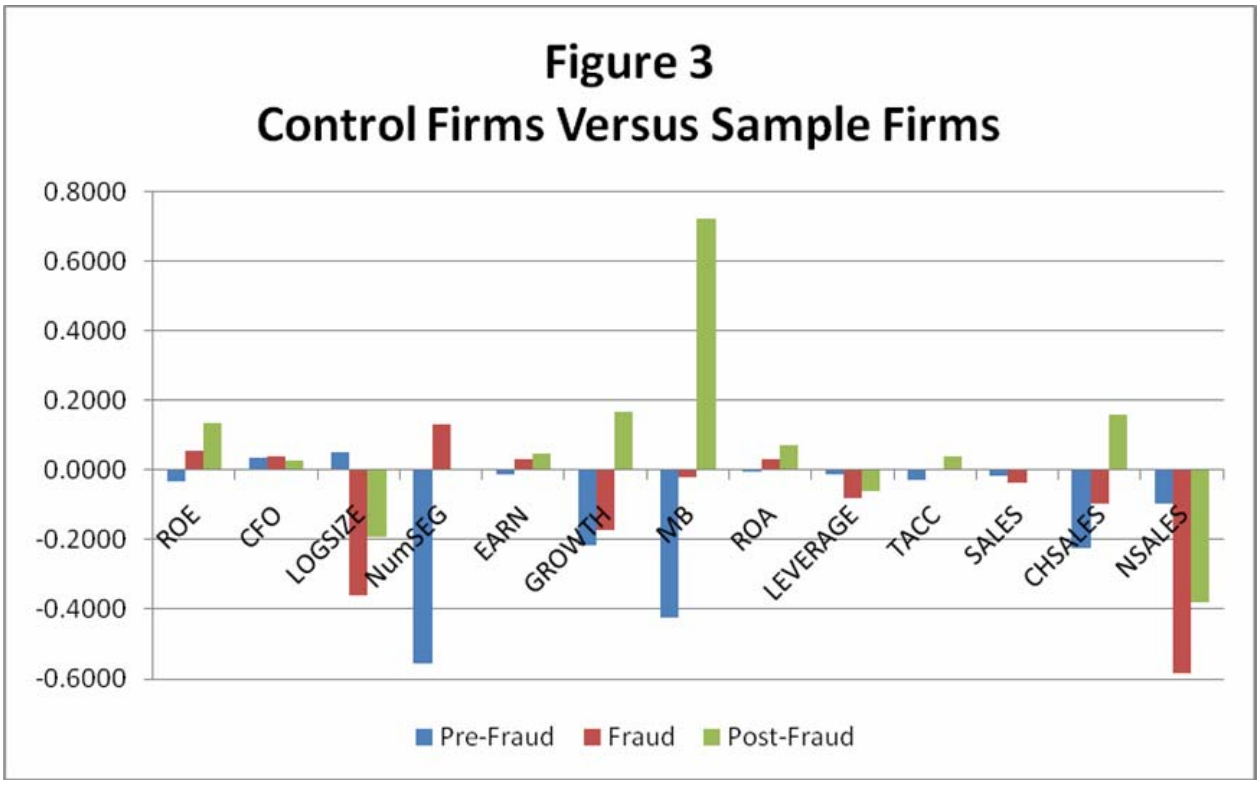

Figure 3 illustrates the differences of firm characteristics between control firms and sample firms.

ROE = income before extraordinary items over average equity (compustat #18 /average compustat #216 at t and t-1);
CFO = cash flow scaled by total assets ((compustat #18 – TACC) / compustat #6);
LOGSIZE = log of total assets (log of compustat #6);
NSEG = the number of segments of the firm;
EARN = earnings before interest and taxes (compustat #178) scaled by firm total assets (compustat #6);
GROWTH = firm's sales growth ((compustat #12- lag(compustat #12)) / lag(compustat #12);
MB = the market-to-book ratio (compustat #199*compustat #25/ compustat #60);
ROA = return on assets (compustat #18 / average compustat #6 at t and t-1);
LEVERAGE = leverage ratio defined as long-term debt over total assets (compustat #9 / compustat #6);
TACC = total accrual scaled by total assets (((compustat #4-lag(compustat #4)) - (compustat #5-LAG(compustat #5)) - (compustat #1 - lag(compustat #1)) + (compustat #34 - lag(compustat #34)) - compustat #14)) / compustat #6);
SALES = firm's sales scaled by total assets (compustat #12 / compustat #6);
CHSALES = the change of sales ((compustat #12 – lag(compustat #12)) / compustat #6);
NSALES = net sales (Compustat #12)/10,000.
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Table 1
Sample Selection and Industry Distribution

Panel A: Sample Selection Procedures

	Number of Sample Firms
Firms with segment fraud covered in AAERs	44
Eliminate firms without restated segment sales or earnings	(24)
Eliminate firms not covered in Compustat Annual File	(5)
Eliminate firms with missing financial variables	(2)
Eliminate firms without three windows (pre-fraud, fraud, post-fraud)	(4)
Total	**9**

Panel B: Fraud-Involved Segment

Company Name	Fraud-Involved Segment
BISYS GROUP INC	Insurance Services division
BRIGHTPOINT INC	Trading division
CONAGRA FOODS INC	Agricultural products segment
CUTTER & BUCK INC	Multiple sales divisions
EL PASO CORP	El Paso CGP Company LLC and El Paso Exploration & Production Co.
NCI BUILDING SYSTEMS INC	Components Division
RAYTHEON COMPANY	Aircraft
TYCO INTERNATIONAL LTD.	ADT Security Services, Inc.
ZOMAX INC/MN	Zomax Limited ("Zomax Ireland")

Panel C: Industry Distribution

Company	Industry
BISYS GROUP INC	Financial institutions
BRIGHTPOINT INC	Retail
CONAGRA FOODS INC	Textiles, printing and publishing
CUTTER & BUCK INC	Textiles, printing and publishing
EL PASO CORP	Utilities
NCI BUILDING SYSTEMS INC	Durable manufactures
RAYTHEON CO	Durable manufactures
TYCO INTERNATIONAL LTD	Diversified Machinery
ZOMAX INC/MN	Durable manufactures

Table 2
Sample & Control Firm Characteristics Before, During and After the Fraud

Panel A: Firm Characteristics in the year right before fraud

	Sample Firms					Control Firms				Control Minus
Variable	**N**	**Mean**	**Median**	**Minimum**	**Maximum**	**Mean**	**Median**	**Minimum**	**Maximum**	**Sample**
ROE	9	0.0934	0.1543	-0.2894	0.2160	0.0620	0.1154	-0.2172	0.2732	-0.0314
CFO	9	-0.0052	0.0516	-0.2937	0.0828	0.0302	0.0733	-0.3596	0.1697	0.0354
LOGSIZE	9	7.3735	6.7517	4.7753	9.4048	7.4266	6.7565	4.8024	9.5557	0.0531
NSEG	9	2.8889	3.0000	1.0000	5.0000	2.3333	1.0000	1.0000	5.0000	-0.5556
EARN	9	0.1035	0.1107	0.0063	0.1921	0.0892	0.1042	0.0045	0.1701	-0.0142
GROWTH	9	0.2477	0.2089	-0.1444	0.7562	0.0303	-0.0175	-0.1737	0.3799	-0.2174
MB	9	3.0041	2.4727	1.0561	6.4172	2.5803	1.1791	0.3181	7.2765	-0.4238
ROA	9	0.0421	0.0558	-0.1079	0.1324	0.0355	0.0440	-0.0515	0.1024	-0.0065
LEVERAGE	9	0.1903	0.2094	0.0000	0.4641	0.1757	0.1690	0.0000	0.3341	-0.0146
TACC	9	0.0770	-0.0050	-0.0445	0.3584	0.0485	0.0119	-0.0394	0.3875	-0.0285
SALES	9	1.2380	1.1083	0.5742	2.2677	1.2225	1.0522	0.3627	2.3893	-0.0155
CHSALES	9	0.2234	0.1643	-0.1872	0.9764	-0.0006	-0.0065	-0.4287	0.2652	-0.2240
NSALES	9	0.5909	0.1036	0.0152	2.4594	0.4961	0.1094	0.0216	1.3041	-0.0948

Table 2 (cont'd)
Sample & Control Firm Characteristics Before, During and After the Fraud

Panel B: Firm Characteristics during fraud period

	Sample Firms					Control Firms				Control Minus Sample
Variable	**N**	**Mean**	**Median**	**Minimum**	**Maximum**	**Mean**	**Median**	**Minimum**	**Maximum**	
ROE	9	0.0829	0.0757	-0.0429	0.1914	0.1364	0.1239	-0.0534	0.3486	0.0534
CFO	9	0.0506	0.0492	-0.0688	0.2367	0.0885	0.0972	0.0142	0.1614	0.0379
LOGSIZE	9	7.9368	6.9110	4.9625	10.6826	7.5761	6.7646	4.8717	10.0031	-0.3607
NSEG	9	3.2111	4.0000	1.0000	5.4000	3.3407	3.0000	1.0000	9.4000	0.1296
EARN	9	0.0787	0.0788	-0.0078	0.1504	0.1098	0.0913	0.0380	0.1891	0.0311
GROWTH	9	0.2358	0.2281	0.0516	0.6350	0.0654	0.0709	-0.1613	0.2755	-0.1705
MB	9	2.6552	2.5802	0.5820	6.5288	2.6346	1.3117	0.2542	6.7418	-0.0206
ROA	9	0.0329	0.0285	-0.0118	0.1061	0.0643	0.0655	-0.0135	0.1340	0.0313
LEVERAGE	9	0.2425	0.2790	0.0000	0.4309	0.1607	0.1644	0.0000	0.3440	-0.0819
TACC	9	0.0111	0.0164	-0.1092	0.1301	0.0129	0.0044	-0.0100	0.0727	0.0018
SALES	9	1.1801	1.0883	0.5941	2.6419	1.1437	1.0267	0.5848	2.1510	-0.0365
CHSALES	9	0.1461	0.1299	0.0574	0.4504	0.0510	0.0613	-0.3069	0.4674	-0.0952
NSALES	9	1.1623	0.1782	0.0171	3.0540	0.5783	0.1699	0.0208	1.7129	-0.5840

Table 2 (cont'd)
Sample & Control Firm Characteristics Before, During and After the Fraud
Panel C: Firm Characteristics in the year right after fraud

	Sample Firms					Control Firms				Control Minus
Variable	**N**	**Mean**	**Median**	**Minimum**	**Maximum**	**Mean**	**Median**	**Minimum**	**Maximum**	**Sample**
ROE	9	-0.0030	0.0410	-0.3295	0.1914	0.1336	0.1478	-0.1220	0.2821	0.1367
CFO	9	0.0641	0.0540	-0.0139	0.2064	0.0926	0.1055	0.0005	0.1906	0.0284
LOGSIZE	9	7.9368	7.1278	4.5610	11.0595	7.7432	7.4945	4.9595	10.3981	-0.1936
NSEG	9	3.5556	4.0000	1.0000	6.0000	3.5556	3.0000	1.0000	7.0000	0.0000
EARN	9	0.0582	0.0744	-0.0404	0.1657	0.1045	0.1020	-0.0112	0.2049	0.0463
GROWTH	9	-0.0588	0.0089	-0.4496	0.2336	0.1079	0.1236	-0.1735	0.2689	0.1667
MB	9	1.7657	1.1573	0.5093	5.8481	2.4866	1.7832	0.4067	5.5174	0.7210
ROA	9	0.0005	0.0160	-0.0885	0.1030	0.0696	0.0912	-0.0321	0.1490	0.0691
LEVERAGE	9	0.2613	0.2596	0.0000	0.5467	0.1999	0.1316	0.0000	0.4024	-0.0613
TACC	9	-0.0303	-0.0259	-0.2055	0.0533	0.0102	0.0009	-0.0239	0.1102	0.0405
SALES	9	1.1829	1.1384	0.1810	2.9949	1.1836	0.9678	0.5367	2.6148	0.0007
CHSALES	9	-0.0798	0.0072	-0.4416	0.1316	0.0801	0.0843	-0.2660	0.3096	0.1599
NSALES	9	1.0573	0.1825	0.0132	3.6801	0.6756	0.2302	0.0250	2.5770	-0.3818

ROE = income before extraordinary items over average equity (compustat #18 /average compustat #216 at t and t-1);
CFO = cash flow scaled by total assets ((compustat #18 – TACC) / compustat #6);
LOGSIZE = log of total assets (log of compustat #6);
NSEG = the number of segments of the firm;
EARN = earnings before interest and taxes (compustat #178) scaled by firm total assets (compustat #6);
GROWTH = firm's sales growth ((compustat #12- lag(compustat #12)) / lag(compustat #12);
MB = the market-to-book ratio (compustat #199*compustat #25/ compustat #60);
ROA = return on assets (compustat #18 / average compustat #6 at t and t-1);
LEVERAGE = leverage ratio defined as long-term debt over total assets (compustat #9 / compustat #6);
TACC = total accrual scaled by total assets (((compustat #4-lag(compustat #4)) - (compustat #5-LAG(compustat #5)) - (compustat #1 - lag(compustat #1)) + (compustat #34 - lag(compustat #34)) - compustat #14)) / compustat #6);
SALES = firm's sales scaled by total assets (compustat #12 / compustat #6);
CHSALES = the change of sales ((compustat #12 – lag(compustat #12)) / compustat #6);
NSALES = net sales (Compustat #12)/10,000.

Table 3
Number of Years Restated

Panel A: Number of Years with Segment Fraud

Company Name	Number of Years
BISYS Group, Inc.	1
Brightpoint, Inc.	3
ConAgra Foods, Inc	2
Cutter & Buck Inc.	2
El Paso Corporation	4
NCI Building Systems, Inc.	1
Raytheon	5
Tyco International Ltd.	5
Zomax, Inc.	1

Panel B: Number of Years to Detect the Segment Fraud

Company Name	Fraud Year	Restatement Filing Date	Difference (in years)
BISYS Group, Inc.	2001	August 10, 2004	2.9
Brightpoint, Inc.	1998-2000	November 26, 2001	2.7
ConAgra Foods, Inc	1999-2000	June 22, 2001	1.8
Cutter & Buck Inc.	2000-2001	July 14, 2004	4.0
El Paso Corporation	1999-2002	October 12, 2004	4.6
NCI Building Systems, Inc.	2000	June 7, 2001	0.4
Raytheon	1997-2001	March 15, 2007	9.0
Tyco International Ltd.	1998-2002	July 29, 2003	4.6
Zomax, Inc.	2003	March 31, 2005	1.1

Table 4
Restatements of Financial Reports

Panel A: Restatement of the Segment Sales

Company Name	Fraud Year	Original Segment Sales	Restated Segment Sales	Difference (in dollars)
BISYS Group, Inc.	2001	164,737,000	131,619,000	(33,118,000)
ConAgra Foods, Inc.	1999	5,579,500	5,567,400	(12,100)
ConAgra Foods, Inc.	2000	5,150,100	5,042,900	(107,200)
Cutter & Buck Inc.	2000	152,453,000	145,491,000	(6,962,000)
Cutter & Buck Inc.	2001	171,068,000	172,853,000	1,785,000
El Paso Corporation (S1)*	1999	8,197,200,000	2,334,000,000	(5,863,200,000)
El Paso Corporation (S1)	2000	18,014,000,000	3,533,000,000	(14,481,000,000)
El Paso Corporation (S1)	2001	25,706,000,000	3,964,000,000	(21,742,000,000)
El Paso Corporation (S1)	2002	8,530,000,000	3,826,000,000	(4,704,000,000)
El Paso Corporation (S2) *	1999		498,000,000	
El Paso Corporation (S2)	2000		529,000,000	
El Paso Corporation (S2)	2001		604,000,000	
El Paso Corporation (S2)	2002		849,000,000	
NCI Building Systems, Inc.	2000	685,237,000	685,237,000	-
Raytheon Company	1997	2,446,000	2,336,000	(110,000)
Raytheon Company	1998	2,643,000	2,543,000	(100,000)
Tyco International Ltd.	1998	19,061,700	19,066,800	5,100
Tyco International Ltd.	1999	22,496,500	22,494,100	(2,400)
Tyco International Ltd.	2000	28,931,900	28,927,500	(4,400)
Tyco International Ltd.	2001	34,036,600	34,002,100	(34,500)
Tyco International Ltd.	2002	35,643,700	35,589,800	(53,900)
Zomax, Inc.	2003	35,938,000	36,084,000	146,000

* El Paso Corporation (S1) refers to the first segment involved in segment fraud at El Paso Corporation - El Paso CGP Company LLC.
* El Paso Corporation (S2) refers to the second segment involved in segment fraud at El Paso Corporation - and El Paso Exploration & Production Co.

Panel B: Restatement of the Segment Income

Company Name	Fraud Year	Original Segment Income	Restated Segment Income	Difference (in dollars)	Footnote of Income
BISYS Group, Inc.	2001	68,548,000	37,241,000	(31,307,000)	NI[3]
Brightpoint, Inc.	1998	41,486	28,829	(12,657)	OP[4]
Brightpoint, Inc.	1999	(52,750)	(47,262)	5,488	OP
Brightpoint, Inc.	2000	59,791	62,137	2,346	OP
ConAgra Foods, Inc.	2000	187,200	138,700	(48,500)	OP
Cutter & Buck Inc.	2000	10,629,000	8,193,000	(2,436,000)	NI
Cutter & Buck Inc.	2001	3,701,000	5,472,000	1,771,000	NI
El Paso Corporation (S1)[1]	1999	498,900,000	388,000,000	(110,900,000)	RS[5]
El Paso Corporation (S1)	2000	654,000,000	520,000,000	(134,000,000)	RS
El Paso Corporation (S1)	2001	(188,000,000)	(493,000,000)	(305,000,000)	RS
El Paso Corporation (S1)	2002	(283,000,000)	316,000,000	599,000,000	RS
El Paso Corporation (S2) [2]	1999	(202,000,000)	39,000,000	241,000,000	RS
El Paso Corporation (S2)	2000	140,000,000	152,000,000	12,000,000	RS
El Paso Corporation (S2)	2001		133,000,000		RS
El Paso Corporation (S2)	2002		303,000,000		RS
NCI Building Systems, Inc.	2000	87,838,000	75,691,000	(12,147,000)	NI
Raytheon Company	1997	239,000	185,000	(54,000)	NI
Raytheon Company	1998	257,000	225,000	(32,000)	NI
Tyco International Ltd.	1998	1,166,200	1,117,000	(49,200)	NI
Tyco International Ltd.	1999	985,300	873,700	(111,600)	NI
Tyco International Ltd.	2000	4,519,900	4,318,500	(201,400)	NI
Tyco International Ltd.	2001	3,970,600	3,464,000	(506,600)	NI
Tyco International Ltd.	2002	(9,411,700)	(9,179,500)	232,200	NI
Zomax, Inc.	2003	1,683,000	994,000	(689,000)	NI

[1] El Paso Corporation (S1) refers to the first segment involved in segment fraud at El Paso Corporation - El Paso CGP Company LLC.
[2] El Paso Corporation (S2) refers to the second segment involved in segment fraud at El Paso Corporation - El Paso Exploration & Production Co.
[3]NI represents net income.
[4]OP represents operating profit.
[5]RS represents the restatement occurred in the subsidiary.