

Review of Recent Literature on Pressure on CFOs to Manipulate Financial Reports

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Introduction

Financial statement misreporting continues to be a significant problem for companies, shareholders, regulators, and internal and external auditors. According to the Committee of Sponsoring Organizations of the Treadway Commission (COSO) sponsored study, *Fraudulent Financial Reporting: 1998–2007* (Beasley, Carcello, Hermanson, and Neal, 2010), Chief Executive Officers (CEOs) and/or Chief Financial Officers (CFOs) are involved in the vast majority of the cases of financial reporting fraud in public companies. The involvement of CFOs is of particular concern given the CFO's central role in financial reporting and his/her formal access to the financial records, which contributes to the CFO's capability to commit fraud (Wolfe and Hermanson, 2004).

CFOs face a variety of pressures that can cause them to manipulate financial results. Executives under such pressure must decide how to respond in a scenario from a number of alternatives that include alerting the audit committee, discussing the issue with the audit partner or head of internal audit, blowing the whistle to external authorities, or unfortunately, in some cases, succumbing to the pressure and manipulating the financial statements. This article reviews selected recent studies to provide insight into why some CFOs misreport financial results, including consideration of the specific pressures that can influence their decision-making. These studies suggest that a CFO may misreport financial results and participate in accounting fraud due to various internal and external pressures, including: 1) pressure from the CEO; 2) pressure to hit earnings benchmarks; 3) pressure to retain his/her job; 4) pressure to maintain the stock price; and 5) pressure to cover financial downturns. We also provide a number of questions for external and internal auditors to consider that may reveal undue pressure on the CFO.

Background

Pressure to misreport is one of the three conditions (along with opportunity to misreport and the ability to rationalize misreporting) associated with fraudulent financial reporting (FFR) according to the fraud triangle. For external auditors, Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, 2002), highlights the importance of the fraud triangle in understanding why people fraudulently misreport. More recent research (Boyle, DeZoort, and Hermanson, 2015) suggests a “new fraud triangle” that highlights pressure, opportunity, and a third side reflecting rationalization, attitude, and “capability”—the skills needed to commit fraud.

FFR involves an intentional misstatement or omission, and is usually perpetrated by top management (Beasley et al., 2010). When assessing inherent risk, control risk, and fraud risk, auditors must consider factors related to FFR. The pressures faced by CFOs and other members of top management represent a common condition in FFR. Accordingly, the specific pressures faced by CFOs are critical risk factors in auditors' assessment of the likelihood of fraudulent financial statements.

As the primary decision makers in financial reporting decisions, CFOs have access to accounting records. Thus, CFOs typically have the opportunity to misreport. As a result, the potential pressures or motivational factors leading CFOs to engage in fraudulent behavior have been an issue of concern. Some degree of pressure has the potential to improve corporate governance (i.e., incentivize management to exert effort, maximize firm value,

and make choices in accordance with shareholders' goals). However, inappropriate or excessive pressure can result in dysfunctional behavior, including financial misreporting.

In fact, CFO involvement in financial statement fraud is substantial and increasing, suggesting that CFOs are under increased pressure. CFOs were implicated by the SEC in sixty-five percent of the financial statement fraud cases in the COSO-sponsored study, *Fraudulent Financial Reporting: 1998–2007* (Beasley et al., 2010). CFO involvement is up approximately fifty percent over the previous ten-year period, when the SEC cited CFOs for involvement in forty-three percent of the SEC fraud cases (see the COSO study, *Fraudulent Financial Reporting: 1987–1997*; Beasley, Carcello, and Hermanson, 1999).

Recent research has attempted to identify specific pressures associated with CFO misreporting. In this article, we review selected studies over the past half-decade (2011–present) that address pressures facing CFOs, with a primary focus on accounting manipulation or misreporting, as opposed to merely earnings management. Some of the pressures addressed in these studies are directly focused on the CFO, such as a CEO directive or request to manipulate results. Other pressures relate to the overall management team (including the CFO), such as pressure to maintain a high stock price.

Research Findings

Five recent research studies (listed in Exhibit I) help to describe the pressures that can contribute to CFO financial misreporting. These studies examine CFOs' opinions on types of pressures faced, CEO pressure versus compensation pressure, types of CEO pressure on the CFO, optimistic bias leading to intentional misstatements, and influencing the stock price.

CFOs' Opinions on Types of Pressures Faced

Dichev, Graham, Harvey, and Rajgopal (2013) provide an overall view into CFO pressures by asking CFOs about a variety of issues related to earnings quality. Insights into actual public company CFOs' financial reporting decisions and motivations provide auditors with a rare look into management's motivations and thought processes. While Dichev et al., (p. 1) found that "about fifty percent of earnings quality is driven by non-discretionary factors such as industry and macro-economic conditions" (factors beyond the CFO's control), CFOs believed that (p. 26) "motivations for companies that use earnings to misrepresent economic performance" primarily related to pressures to hit earnings targets and influence the stock price. Other reasons included pressures to influence executive compensation and career concerns.

Dichev et al., conducted surveys of 169 public company CFOs and interviews of twelve CFOs. They first asked CFOs to provide their opinions regarding why firms misrepresent their performance. The results reveal that the primary reason identified was "to influence stock price" (93.5 percent). The types of outside pressures included pressures to hit earnings benchmarks (92.9 percent) and to smooth earnings (69.1 percent). The types of inside pressures included inside pressure to hit earnings benchmarks (91.0 percent), pressure to influence executive compensation (88.6 percent), and career concerns (80.4 percent).

Further, the CFOs identified red flags related to misrepresenting performance, including: inconsistencies between GAAP earnings and cash flows; deviations from peer or industry norms; signals from meeting/beating benchmarks; frequent/large one-time items; abnormal accruals; and smooth earnings patterns. Other signals reflected problems with management character and firm culture.

The results also highlighted certain areas of accounting as common settings for misrepresenting financial performance, including: accounting for acquisitions (large provisions reversed in subsequent years); subsidiaries reported as off-balance entities; revenue recognition; and real earnings management (opportunistic cuts to R&D, maintenance expenses, and marketing expenditures for earnings purposes rather than for business purposes).

CFOs are the primary decision makers in financial reporting, and based on the COSO studies, they are increasingly involved in financial misreporting. Thus, CFOs' views and opinions regarding motivations, the red flags, and common settings of these decisions can assist auditors in audit planning, risk assessments, and fraud brainstorming activities. Dichev et al., provide a broad view of CFO pressures. The next papers explore specific pressures that CFOs face.

CEO Pressure versus Compensation Pressure

Feng, Ge, Luo, and Shevlin (2011) investigated evidence of two types of pressure: CEO pressure and compensation pressure. They conclude that CFOs become involved in accounting manipulation due to CEO pressure, rather than from personally instigating accounting manipulations to reap personal financial gains. In their paper, they investigated two competing alternatives for CFO involvement. In the “CFO as instigator” hypothesis, CFOs direct manipulation schemes for their immediate personal gain. For example, in a 2003 *60 Minutes* interview, HealthSouth CEO Richard Scrushy blamed his former CFOs for instigating the HealthSouth fraud of over \$2.5 billion and attributed their motive to bonuses, stock options, etc. The alternate “CFO pressured” hypothesis reflects CFOs’ frequent claims that intense and unrelenting pressure from their CEO leads to their decision to engage in improper accounting. Five former HealthSouth CFOs and several other executives testified against CEO Richard Scrushy.

To investigate these alternative scenarios, Feng et al., examined SEC enforcement actions against manipulating firms. They documented the various costs and benefits experienced by the CFOs to identify the most likely explanation for their involvement. The SEC implicated the CFOs in about sixty percent of the cases. Although the charged CFOs did not enjoy increased equity incentive compensation in comparison to CFOs in the control sample of non-manipulating firms, they faced substantial penalties such as criminal prosecution, fines, and employment restrictions. In contrast, CEOs were more likely than CFOs to be named the orchestrator of the accounting manipulation. Also, manipulating firm CEOs were more powerful and were more likely to benefit from higher equity incentives than CEOs of non-manipulating firms. Taken together, their evidence leads the authors to attribute CFO accounting manipulations to CEO pressure, rather than to CFO financial incentives.¹

The SEC implicated CEOs and/or CFOs in eighty-nine percent of the fraud cases in the most recent COSO study (Beasley et al., 2010). Feng et al., point to the importance of considering how CFOs are influenced by their CEOs in financial reporting manipulations and misreporting. The influence of powerful, charismatic, confident, and narcissistic CEOs can be overpowering. As Dichev et al., (2013) pointed out in the first paper, management’s character and firm culture can be red flags for misrepresenting performance. In particular, auditors should evaluate the tone at the top and the CEO’s ability to negatively influence others. The next paper further experimentally evaluates CEO pressure on the CFO.

Types of CEO Pressure on the CFO

Bishop, DeZoort, and Hermanson (2017) provide evidence from public company CFOs indicating that CFOs are susceptible to two types of pressure from CEOs. Their findings suggest that compliance pressure (a request from the CEO) and obedience pressure (a demand from the CEO) are equally effective in getting some CFOs to change their initial estimate in accordance with the CEO’s wishes. CFOs feel less pressure from the CEO when asked to change an estimate than when told to change an estimate. In addition, the authors find that CFO accounting experience is negatively related to the CFO’s willingness to revise an accounting estimate. Thus, more experienced CFOs may be better able to resist formal or informal pressure.

In an experiment, sixty-nine public company CFOs evaluated a hypothetical case involving a proposed inventory adjustment that is being finalized. The experiment compared the judgments of three groups of CFOs who faced different experimental conditions. One group of CFOs in the study faced no pressure from the CEO, a second group of CFOs faced compliance pressure from the CEO (the CEO asked the CFO to change the estimate to allow the company to meet its earnings target), and the third group of CFOs faced obedience pressure from the CEO (the CEO told the CFO to change the estimate to allow the company to meet its earnings target).

Bishop et al., suggest that compliance pressure may be a particularly notable form of pressure, since CFOs do not report feeling much pressure when the CEO requests their help, but they respond similarly to the harsher demand found in obedience pressure. Accordingly, auditors should be aware that CFOs may face pressure from

¹ Jiang, Petroni, and Wang (2010) examine related issues in the “softer” context of earnings management (i.e., accruals management and meeting or beating analyst forecasts). They find evidence that CFO equity incentives are more strongly related to earnings management than are CEO equity incentives.

CEOs or other members of management who ask them to help the company achieve goals, or be part of the team. In addition, auditors should be alert for inexperienced CFOs, who may be more susceptible to CEO pressure.

The first three papers provide evidence of the various internal and external pressures to manage earnings, including specific pressure from the CEO. Next, it is important to look more broadly at other manager- or firm-level pressures potentially influencing earnings quality.

Optimistic Bias Leading to Intentional Misstatements

Schrand and Zechman (2012) conclude that most financial misreporting begins with an initial optimistic bias that starts a manager down a “slippery slope” toward significant misreporting. Their evidence suggests that SEC cases often begin with a small, and possibly unintentional, optimistically biased misstatement by a manager. Although the initial misstatement was not necessarily intentional, the subsequent managerial decision to misreport was an intentional misstatement for a larger amount. Further, consistent with the emergence of a “capability” component in contemporary fraud models (Boyle et al., (2015) and Wolfe and Hermanson (2004) highlight the variety of personal characteristics and traits needed to commit fraud), Schrand and Zechman’s analysis indicates that the character trait of overconfidence is associated with optimistically biased executives who misreport.

Schrand and Zechman examine the circumstances surrounding SEC enforcement actions to evaluate why firms misstate earnings. They focus on non-fraudulent cases—those that do not involve a managerial intent to achieve personal gain that damages other shareholders. Their sample of non-fraudulent SEC enforcement action cases includes thirty-six firms. They also examine a broader sample of firms to investigate the trait of overconfidence.

Schrand and Zechman’s findings that overconfidence leads to optimistic biases and misreporting raise a challenge for auditors as well as board members. Executive confidence is an important trait with many positive benefits to firm performance. But, Schrand and Zechman demonstrate the danger of overconfidence in the scenario of a subtle creep from a small, unintentional, optimistically biased misstatement to larger, purposeful misstatement. The board of directors and auditors should be attuned to recognizing narcissistic overconfidence in executives and closely monitoring management’s financial reporting decisions for such optimistic biases.

Influencing the Stock Price

Dechow, Ge, Larson, and Sloan (2011) investigate the financial characteristics of firms that have materially misstated their financial statements and develop a prediction model to signal the likelihood of such misstatements. Misstating firms are characterized by: low accrual quality; deteriorating financial and nonfinancial measures; existence and use of financing activities, and off-balance sheet activities; and management’s sensitivity to their firm’s stock price.

Dechow et al., find that (p. 77) “misstatements appear to be made with the objective of covering up a slowdown in financial performance in order to maintain high stock market valuations”. Using the characteristics of misstating firms, Dechow et al., develop a screening measure (*F*-score) to serve as a red flag in identifying misstatements. Their analysis shows that fifty percent of misstating firms have *F*-scores or 1.4 or greater, while only twenty percent of all public firms have an equivalent *F*-score. Additionally, they document an increase in average *F*-score up to three years before misstatement followed by a rapid decline in the subsequent period.

Dechow et al.’s *F*-score may be a powerful tool for auditors to quantify the possibility of misstatement in a firm. This may be an important addition to auditors’ toolbox, particularly in the planning and risk assessment phases of the audit.

Implications

In summary, the research literature suggests three insights related to CFO pressure:

1. CFOs may participate in accounting manipulation/misstatement due to various internal and external pressures, including: pressure from their CEOs; pressure to hit earnings benchmarks; pressure to retain their jobs; pressure to maintain the stock price; and pressure to cover financial downturns.

2. CEO pressure on the CFO may take the form of a request (compliance pressure) or a demand (obedience pressure). These two types of pressure appear to be equally effective in influencing some CFOs to acquiesce to the desires of the CEO.
3. Accounting misstatements may begin with an optimistic bias on the part of overconfident executives that later leads to a slippery slope of growing, intentionally misstated earnings.

CFOs face a variety of pressures to present the financials as favorably as possible. These pressures may be overt, such as a demand from the CEO, or they may be subtle, such as the CFO understanding that the accounting choices he/she makes will have a direct impact on the stock price. While it appears that most CFOs effectively deal with such pressures, some do not, leading to severe consequences. CFOs may participate in financial statement manipulation or fraud as a result of powerful pressures to distort financial results, combined with opportunity to commit and conceal misreporting or fraud. Detering and detecting financial misreporting is primarily management's responsibility, but the audit committee, board of directors, management, and others also share that responsibility.

Ultimately, the issue of pressure on the CFO motivates two key questions. First, "How can key governance groups (e.g., external auditors, internal auditors, and audit committee members) become aware of such pressure?" Auditing standards require external auditors to address the risk of misstatement due to fraud, including financial reporting fraud perpetrated by management. As external and internal auditors assess financial results, audit evidence, and fraud risk, they should consider incentives/pressures, opportunities, and capabilities/attitudes/rationalizations from the perspective of financial misreporting by management (also see Boyle, DeZoort, and Hermanson, 2015).

The following questions may be useful during client acceptance decisions, audit planning, brainstorming sessions, and risk assessment procedures as auditors consider the CFO's incentives or pressures:²

1. Is the CFO under pressure due to an imbalance of power between the CEO and CFO, as indicated by:
 - An overly domineering, powerful, charismatic, confident, or narcissistic CEO who is able to dominate/intimidate the CFO's financial reporting decision making; and/or
 - Disproportionately large CEO pay in comparison to CFO pay?
2. Is the CFO under pressure due to expectations regarding the firm's financial performance, including:
 - Optimistic, unrealistic, or aggressive earnings expectations on behalf of external parties, such as investors, creditors, or analysts, with the perception that missing targets would result in adverse consequences for the CFO;
 - Optimistic, unrealistic, or aggressive earnings expectations created by the CEO, with the perception of adverse consequences for missing earnings targets;
 - Undue sensitivity to changes to the firm's stock price on the part of management or others; and/or
 - Pressure to minimize or obscure a financial downturn or deteriorating financial performance?
3. Is the CFO under pressure due to personal financial pressures, including:
 - Career concerns that create pressure to retain his/her job; and/or
 - A compensation structure that is linked to the firm's financial performance and is overly reliant on bonuses and stock options?

Both external auditors and internal auditors should evaluate these and other factors as they perform their risk assessment duties and adjust their audit procedures accordingly. The audit committee chair, external audit partner, and Chief Audit Executive should be well attuned to the variety of pressures facing the CFO that can undermine financial reporting quality.

The second key question is, "What can be done to alleviate the pressure on CFOs to misreport?" Executives clearly work in pressure-packed environments, but steps can be taken to minimize the pressure and related reporting risks. Some ideas to consider include:

² See AICPA (2005, p. 14–15) for related questions that audit committee members should consider when assessing pressure on management.

- Formally making the audit committee a resource/sounding board for the CFO to share his/her concerns about any sources of pressure.
- Having the CFO meet privately with the audit committee on a regular basis. The CFO can share concerns, and the audit committee can directly ask the CFO about pressures faced.
- Encouraging audit committee members, external auditors, and internal auditors to explicitly inquire about and discuss, on a regular basis, apparent sources of pressure on the CFO.
- Having the board and audit committee consider the potential for greater CEO pressure on the CFO when the CFO is relatively new to the position, or when the CEO is especially powerful or experienced.
- Having the board and audit committee explicitly convey their expectations about financial reporting to the CFO and CEO, including their view of the CFO as a key guardian of the company's reputation for ethical reporting. There should be very clear lines of authority regarding financial reporting decisions.
- Having the compensation committee monitor financial reporting risks created by executive compensation plans. Is there evidence that too much incentive exists to manipulate earnings and commit fraud? Are the relative weights of equity and stock options reasonable and appropriate?
- Enhancing the organization's whistleblower hotline to encourage all employees to report inappropriate pressure and explicitly addressing inappropriate pressure in the Code of Conduct.
- Ensuring that the stated policies above are consistent with actual practice in the organization (i.e., ensure that, if adopted, the ideas above are truly in place in a meaningful way).

Conclusion

External auditors, internal auditors, and audit committee members should actively work to understand the sources, nature, and magnitude of pressure on the CFO. Further, these key governance groups should assess the CFO's ability to deal with such pressures and have honest discussions about the pressures and ways to manage them (also see Boyle, Carpenter, and Hermanson [2012] for additional insights and resources). Research suggests that CFOs have an inherently difficult job that can be complicated by powerful pressures to manipulate financial results. These pressures may come from the CEO or from broader internal and external forces affecting the company. Ultimately, a key to managing the problem of pressure on the CFO is for auditors and audit committee members to understand, appreciate, and react to signals of undue pressure on the CFO. Longer-term, greater focus on these issues is needed in graduate and undergraduate accounting curricula so that future CFOs and auditors are better prepared for the challenges that may lie ahead.

Exhibit I:

Selected Recent Research Examining Pressures on CFOs to Manipulate Financial Reports

1. Dichev, I. D., J. R. Graham, C. R. Harvey, and S. Rajgopal. (2013). Earnings quality: Evidence from the field. *Journal of Accounting and Economics*, 56 (2/3 Supplement), 1–33.
2. Feng, M., W. Ge, S. Luo, and T. Shevlin. (2011). Why do CFOs become involved in material accounting manipulations? *Journal of Accounting and Economics*, 51 (1/2), 21–36.
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5. Dechow, P. M., W. Ge, C. R. Larson, and R. G. Sloan. (2011). Predicting material accounting misstatements. *Contemporary Accounting Research*, 28 (1), 17–82.

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