

## Fraudulent Financial Reporting Characteristics of the Computer Industry Under a Strategic-Systems Lens

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This research seeks to predict fraudulent financial reporting accusations in the industry where it is most likely to occur. For the computer industry we apply a limited, industry-specific strategic-systems auditing lens to assist in the identification of common fraud characteristics in fifty-two companies accused of fraudulent financial reporting by the SEC's Accounting and Auditing Enforcement Division during the period from September 20, 1995 to April 5, 2002. We compare these to fifty-two other similarly situated not-accused companies and use these results to create a logistic model that identifies financial reporting variables useful in predicting those computer companies susceptible to the SEC accusation of fraud.

The model predicts nineteen of twenty out-of-sample accused companies and its overall prediction rate for the accused and not-accused companies for 460 quarterly reports is about 91 percent. From this and other analyses we do find as common all ten strategic lens-suggested fraudulent reporting expectations even though this industry of hardware and software providers is somewhat heterogeneous in its products. Unique to the accused are: 1) larger stock option tax benefits, and relative to sales, 2) lower research and development, 3) lower marketing expenditures, and 4) smaller changes in free cash flows. Computer companies accused by the SEC of fraud are likely to be so cash-starved they are unable to fund research and to promote sales. To raise cash they overstate sales and lower recorded expenses, thus achieving higher rates of return on assets, even though their actual sales relative to their receivables are declining. Confirmed by out-of-sample tests and based on data observed just before the passage of the Sarbanes-Oxley Act and changes in the stock options expense reporting, these results improve previous financial fraud modeling and add four more to the twelve analytical signals of potential fraud suggested by previous research and the AICPA's Statement on Auditing Standards No. 99.

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### INTRODUCTION

This research seeks to predict fraudulent financial reporting accusations in the industry where it is most likely to occur. The computer industry (hardware, software, semiconductors, computer-integrated system design, data processing and preparation, Internet and email