Deterring Financial Fraud: What Else Can Be Done?

July 16, 2015

Troubleshooting Tips
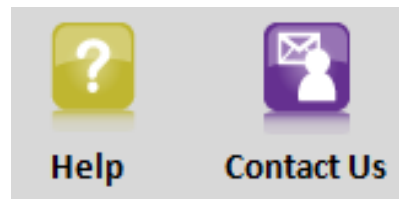
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Skill Specific

Panelists

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Today's Program

Goals of the program

- Explore lessons that can be learned from SEC enforcement actions

- Focus on problems that have a nexus to ineffective internal control over financial reporting (ICFR)

- Provide concrete steps that organizations can take to improve their financial reporting process

Accounting and Auditing Enforcement Releases (AAERs)

- Misconduct involving accountants and auditors

- Level of detail included in AAERs varies based on quality of evidence

- Incidents described will often lag initial public revelation of misconduct

Analysis of Recent AAERs

- Limited scope to AAERs issued between January 1, 2013 – March 31, 2015

- AAERs that mentioned internal control problems flagged for closer review

- Eliminated FCPA violations and those that were determined not to be ICFR-related

  - 207 AAERs reviewed, 42 met ICFR criteria
  - 37 issuer companies involved
    - 5 issuers were the subject of more than one AAER

Characteristics of Entities Included in Our Analysis

Company size, measured by revenue, varied:

- < $75 million = 6

- $75 million - $500 million = 15

- $500 million - $1 billion = 6

- > $10 billion = 5

- No revenue information available for 5 issuers

Characteristics of Entities Included in Our Analysis (cont'd)

Companies classified into 26 different industry sectors, based on SIC code:

- National and state commercial banks

- Computers/software-related companies

- Semiconductor industry

- Business services

- 20 different industries had a single case

Principal Accounting Areas

- Revenue recognition

- Loans

- Valuations

All of these areas require judgment on the part of management and are often vulnerable to stress

Revenue Recognition

Improper reporting of revenue

- Fictitious revenue accruals

- Fabrication of paperwork on contracts

- Fictitious invoices

Loans

Examples of issues investigated that involve ICFR over loans

- Improper classification of loans
- Misstated loan losses or past due loans
- Lack of controls to adequately track capital requirements
- Problem with portfolio segmentation

Accounting Policies and Procedures

- Inadequate policy or procedures

- Noncompliance with existing policies or procedures

- Management override

Chinese Issuers

Common themes found in the analysis of AAERs:

- Tone at the top

- Improper revenue recognition

- Related-party transactions

- Unjustified cash transfers

- Nonexistent ICFR

Suggested Areas of Focus to Improve Oversight

- What accounting areas are under stress?

- What is our accounting policy and documentation?

- Do we exercise discipline in applying accounting policy?

- Have we hired competent staff for the jobs they are asked to perform?

- Is the staff competently supervised?

- Are we communicating effectively?

- Do we maintain objectivity and skepticism?

Key Takeaways

- Focus on accounting policy and communication

- A commitment to internal control granularity and specificity is critical

- The best defense is a strong ethical culture complemented by a great tone at the top

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