

# Addressing Challenges for Highly Subjective and Complex Accounting Areas



## Observations *and* Recommendations *from* Anti-Fraud Collaboration Workshops

# About the Anti-Fraud Collaboration

The Anti-Fraud Collaboration (Collaboration) was formed in October 2010 by the Center for Audit Quality (CAQ), Financial Executives International (FEI), the National Association of Corporate Directors (NACD), and The Institute of Internal Auditors (The IIA). The four organizations represent members of the financial reporting supply chain—external auditors (CAQ), company financial management (FEI), audit committees (NACD), and internal auditors (The IIA).

The goal of the Collaboration is to promote the deterrence and detection of financial reporting fraud through the development of thought leadership, awareness programs, educational opportunities, and other related resources specifically targeted to the unique roles and responsibilities of the primary participants in the financial reporting supply chain. The Collaboration defines financial reporting fraud in its most general sense, as a material misrepresentation in a financial statement resulting from an intentional failure to report financial information in accordance with generally accepted accounting principles.

The Collaboration's areas of focus include:

- ▶ Advancing the understanding of conditions that contribute to fraud
- ▶ Promoting additional efforts to increase skepticism
- ▶ Encouraging a long-term perspective so as to moderate the risk of focusing only on short-term results
- ▶ Exploring the role of information technology in facilitating the deterrence and detection of fraudulent financial reporting



**WE WELCOME YOUR FEEDBACK** Please send comments or questions to [info@antifraudcollaboration.org](mailto:info@antifraudcollaboration.org).

# Contents

<b>Foreword</b>	<b>2</b>
<b>Executive Summary</b>	<b>3</b>
<b>1 Introduction</b>	<b>5</b>
A Joint Effort to Improve ICFR	
Difficult Accounting Issues	
Workshops on ICFR and Accounting Policies	
<b>2 Perspectives from Regulators</b>	<b>7</b>
Overview of Regulator Activities	
The Work of the SEC's FRAud Group	
Issues and Themes from the Regulators' Presentations	
<b>3 The Important Role of Company Accounting Policies</b>	<b>13</b>
Accounting Policies	
Revenue Recognition	
<b>4 ICFR Considerations</b>	<b>16</b>
General Themes	
Potential Warning Signs	
Management Review Controls	
Documentation	
Management Override	
<b>5 Staffing Challenges in a Complex Accounting Environment</b>	<b>22</b>
Desired Competencies and Qualities	
Staffing for Dealing with Complex Accounting Issues	
The Internal Audit Function and Staff	
Staffing Issues and the External Auditor	
Human Resource Challenges Specific to Smaller Organizations	
Compensation Issues	
<b>6 Conclusion</b>	<b>26</b>
<b>Appendix: Workshop Participants</b>	<b>27</b>

# Foreword

When the Anti-Fraud Collaboration was formed in October 2010, the CAQ, FEI, NACD, and The IIA committed to work together on advancing the discussion of critical issues that impact the integrity of financial reporting. The results of these efforts would be transparent, inclusive, and shared broadly with key stakeholder groups.

In 2014, the CAQ and the Financial Reporting and Audit (FRAud) Group within the Division of Enforcement at the Securities and Exchange Commission (SEC or Commission), entered into a dialogue to explore areas where the Collaboration could work together with the SEC to advance our common objective of deterring and detecting financial reporting fraud.

The Collaboration undertook an analysis of the SEC's Accounting and Audit Enforcement Releases (AAERs)—releases announcing financial reporting-related enforcement actions brought by the Commission—that identified a failure in internal control over financial reporting (ICFR). The Collaboration held a [webcast](#) in July 2015 to present the key findings of that analysis and to begin a dialogue about the challenges that were identified. In an effort to delve more deeply into those challenges, in 2016 the Collaboration held two workshops that brought together the primary members in the financial reporting supply chain—audit committee members, external and internal auditors, and senior management.

The objectives of the workshops were to:

1. Provide an opportunity for members of the financial reporting supply chain to learn more about the work of the SEC's FRAud Group and how it coordinates with other government agencies and the Public Company Accounting Oversight Board (PCAOB);
2. Facilitate a robust discussion about accounting policy, centering on highly subjective and complex accounting areas, and the design and operating effectiveness of ICFR; and
3. Discuss steps that the various members of the financial reporting supply chain could take in their organizations to mitigate the risk of repeating the errors uncovered in the SEC enforcement actions.

This report summarizes the main themes and discussion points of the workshops. It describes leading practices that successful organizations have adopted to mitigate

the risk of committing securities violations with a focus on improving accounting policy, ICFR, and staffing, particularly in relation to highly subjective and complex accounting areas. Our intent is that this report will inform a dialogue that recognizes the key role leading practices play in deterring securities violations, including financial reporting misstatements that may be due to error or fraud.

Our thanks to all of the attendees who were generous with their time and insights, which made the workshops a success. (The Appendix contains a list of the participants at each event.) Their insights, captured in this report, provide value not only to publicly held companies, but also to private companies, nonprofit organizations, and government agencies. We look forward to their support as we continue to work on the vital issue of fraud deterrence.



**Cindy Fornelli**  
*Executive Director*  
Center for Audit Quality  
Co-Chair, Anti-Fraud Collaboration



**Mary Schapiro**  
*Vice Chairman, Advisory Board*  
Promontory Financial Group, LLC  
CAQ Governing Board Member  
Co-Chair, Anti-Fraud Collaboration

# Executive Summary

## Workshop Overview

In March and June of 2016, the Collaboration held workshops in New York and San Francisco, respectively, that brought together members of the financial reporting supply chain, including audit committee members, financial executives, internal auditors, and external auditors. The purpose of the workshops was to explore issues that were identified in an analysis of enforcement actions in which the SEC (1) took an action against an issuer or individual because of a securities violation and (2) asserted that there were issues with the company's ICFR. Each workshop featured breakout sessions that used case studies as a catalyst for the discussions.

The main objectives were to facilitate robust discussions on the appropriateness and effectiveness of accounting policies centering on highly subjective, complex accounting areas, as well as on ICFR design and operating effectiveness. The workshops generated numerous recommendations on methods and techniques to help deter fraud and enhance financial reporting.

Each of the two workshops provided participants an opportunity to learn more about the enforcement activities of the SEC and the PCAOB, and how the two agencies coordinate on investigations.

This Executive Summary highlights the salient points and primary recommendations from the workshop proceedings.

## Perspectives from Regulators

Representatives from the SEC's FRAud Group and Office of the Chief Accountant (OCA), as well as the Division of Enforcement and Investigations (DEI) at the PCAOB discussed the purpose and work of their organizations. The regulators emphasized their close cooperation in pursuing mutual anti-fraud objectives. Divisions of the SEC and the PCAOB are in regular communication to coordinate investigations.

The accounting areas that tend to be the focus of SEC enforcement actions are revenue recognition, expense recognition, valuation issues, asset impairments, and earnings management. Revenue recognition and valuation issues were common among enforcement actions that identified ICFR problems.

The panelists spoke of a revived interest among regulators in strengthening companies' ICFR. Regulators see



In every investigation that we embark on related to financial reporting, and issuer disclosure and audit failures, we're always looking at the gatekeepers—board of directors, audit committee, external auditors, even external consultants—what they did, what they knew, how did they document it.

— Margaret McGuire  
Chief, SEC FRAud Group

improved ICFR regimes as key for stemming fraud and reducing the number of restatements. As new risks arise, there is not always sufficient evidence that controls are updated to address those risks. Regulators also discussed recent enforcement cases.

There was discussion about the self-reporting of possible securities law violations to regulators. Participants from the private sector expressed skepticism about the benefits of cooperation programs. Regulators strongly maintained that they give substantial credit to companies that self-report and that provide extraordinary cooperation in SEC investigations. A PCAOB representative confirmed that the Board had a similar philosophy and approach with respect to external auditors.

Regulators affirmed that the reporting of non-GAAP financial measures has been getting much attention inside the SEC. Therefore, companies should be aware of the exposure they have from reporting non-GAAP financial measures that do not comply with SEC regulations.<sup>1</sup>

## The Important Role of Company Accounting Policies

The panel discussions and breakout sessions were significantly devoted to issues of accounting policy around highly subjective and complex areas and the related internal controls.

<sup>1</sup> SEC Release No. 33-8176, *Conditions for Use of Non-GAAP Financial Measures*, also referred to as Regulation G, has been effective since March 28, 2003. For the most recent interpretations of this rule, see the *Compliance & Disclosure Interpretations* updated May 17, 2016.



Financial reporting is a team sport. We all have different roles to play. But unless everybody is bringing their best athletes forward in these different roles, it can have a significant effect on whether the outcome is positive or negative.

- Leslie Seidman  
Executive Director, Center for  
Excellence in Financial Reporting,  
Lubin School of Business

The following is a summary of key recommendations concerning accounting policies:

- ▶ Accounting policies must adhere to technical accounting guidance. Supervisors and managers are responsible for implementation. It is critical that these policies be understandable to non-accountants who may not be conversant in the nuances of technical accounting.
- ▶ Process must be married to policies. Accounting policies must be reviewed at regular intervals and companies should have a process to identify and monitor changes in activities that have a potential impact on accounting.
- ▶ Policies must be tested in the field prior to implementation, and then monitored for compliance post-implementation.

In particular, there was a focus on revenue recognition accounting policies and procedures. Recommendations included the following:

- ▶ The revenue recognition policy should be granular, because even slight differences in interpretation can have a major impact on revenue recognition.
- ▶ Where possible, contract terms should be standardized and reflect how transactions at a contract level relate to the requirements of GAAP. Deviations from typical contract terms that have implications for revenue recognition should be well documented and elevated for approval by senior management.
- ▶ Clear responsibility and communication lines among legal, business, and finance should be created

so that all key players understand and approve of transactions. This is especially important for implementing the new revenue recognition standard that is effective January 1, 2018 for calendar year-end public companies.

## ICFR Considerations

Over the course of the workshops, several broad themes emerged regarding ICFR and its importance to fraud deterrence:

- ▶ Tone at the top is an essential component of an ICFR regime.
- ▶ A risk-based evaluation is the best approach for achieving effectiveness and efficiency in ICFR.
- ▶ Internal controls over unusual and nonroutine transactions are sometimes overlooked or given less attention than core processes when developing an effective ICFR regime.

Other topics of discussion, which are detailed later in this report, included potential warning signs, the role of the audit committee, testing of management review controls, and required documentation. Lastly, the risks of management override and strategies to minimize such risks were discussed.

## Staffing Challenges in a Complex Accounting Environment

The workshops addressed the competencies required for individuals participating in the financial reporting supply chain, including corporate accounting staff, internal auditors, and external auditors, as well as considerations for smaller organizations.

The discussion focused on critical thinking skills that are needed in addition to technical accounting expertise. During breakout sessions, participants agreed that communication and listening skills are also vitally important.

Complex accounting issues where expertise is highly specialized and limited—such as derivatives, taxation, and securitization—present difficult staffing and auditing challenges. Regardless of management's confidence in the expertise of in-house staff, auditors must obtain sufficient evidence when testing controls for the accounting area to support their opinion on ICFR. Some participants suggested that the accounting department (or in some cases the audit committee) be given the resources to confer with an outside expert in such instances.



# 1 Introduction



## A Joint Effort to Improve ICFR

The SEC's FRAud Group (previously a Task Force) identifies potential securities law violations in the preparation of financial statements and the disclosure of financial information to investors. It performs this objective by identifying and exploring areas susceptible to fraudulent financial reporting. These efforts include an ongoing review of financial statement restatements and revisions, an analysis of performance trends by industry, and the use of technology-based tools. A primary goal of the FRAud Group is to identify financial reporting frauds earlier than they might otherwise have been detected to mitigate their impact on shareholders and the capital markets.

The Collaboration sought to find ways to work together with the FRAud Group that would further our common objective of improving the integrity of financial reporting. Insights from the FRAud Group could provide opportunities to educate members of the financial reporting supply chain about issues that the SEC was uncovering in its enforcement investigations and to spur discussions about steps that preparers, their internal auditors, audit committees, and external auditors might take to strengthen their ability to lessen the risk of financial reporting fraud.

The Collaboration explored lessons learned from SEC enforcement actions that cited problems with ineffective ICFR. The CAQ commissioned a study of [Accounting and Audit Enforcement Releases](#) (AAERs) issued during 2013, 2014, and the first quarter of 2015 that identified deficiencies in a company's ICFR.<sup>2</sup> Because the disposition of an investigation typically takes a few years, in two-thirds of the AAERs studied the securities violations uncovered began in 2007, 2008, and 2009—a period that coincided with the recent financial crisis.

Nearly 40 unique filers met the criteria of having an enforcement action that included some discussion about ICFR. There were no obvious trends in the characteristics of the companies analyzed. Company size, measured by revenue, ranged from under \$75 million to over \$10 billion. National and state commercial banks accounted for nearly one-quarter of the cases reviewed. Other than the banks that faced an enforcement action, there was no clear pattern with respect to the industry sector. In fact, the AAERs studied covered 26 different industry sectors based on the primary line of business of the issuer, according to the Standard Industrial Classification codes.

<sup>2</sup> Accounting and Auditing Enforcement Releases can be found on the SEC's website: <https://www.sec.gov/divisions/enforce/friactions.shtml>.

## Difficult Accounting Issues

Three accounting issues were problematic for companies under investigation: revenue recognition, loan impairment, and valuation. Both highly subjective and complex, these three areas were under stress during the financial crisis and therefore more prone to manipulation or error. The analysis of the AAERs also highlighted issues with the accounting policies pertaining to these areas. In the enforcement actions studied, the SEC cited that the companies either did not have an adequate accounting policy or procedure for the issue being investigated; the company was non-compliant with their existing policy or procedure; or that management acted to override the company's accounting policy.

The Collaboration held a [webcast](#) with a panel of experts in July 2015 to begin a dialogue about the challenges that were identified in the analysis of the enforcement actions. The goals of the webcast were to (1) explore lessons that can be learned from SEC enforcement actions; (2) focus on problems that have a nexus to ineffective ICFR; and (3) provide concrete steps that organizations can take to improve their financial reporting process. The webcast suggested several areas where members of the financial reporting supply chain could focus and improve their oversight by asking the following questions:

- ▶ What accounting areas are under stress?
- ▶ What is the company's accounting policy and is it documented?
- ▶ Is discipline exercised in applying the accounting policy?
- ▶ Has the company hired competent staff for the accounting or ICFR jobs they are asked to perform?
- ▶ Is the staff competently supervised?

In an effort to delve more deeply into topics discussed during the webcast, the Collaboration brought together in a workshop setting the primary members in the financial reporting supply chain—audit committee members, external and internal auditors, and senior management.

## Workshops on ICFR and Accounting Policies

Under the leadership of the CAQ, the Collaboration conducted workshops in New York and San Francisco in March and June 2016, respectively. The objectives of the workshop were to:

- ▶ Facilitate a robust discussion about accounting policy, centering on highly subjective and complex accounting areas, and the design and operating effectiveness of ICFR; and
- ▶ Discuss steps that the various members of the financial reporting supply chain could take in their organizations to mitigate the risk of repeating the issues uncovered in the SEC enforcement actions.

The workshops also provided an opportunity for members of the financial reporting supply chain to learn more about the work of the SEC's FRAud Group and how it coordinates with other government agencies and the PCAOB.

The all-day events began with panel discussions moderated by CAQ Executive Director Cindy Fornelli, with representatives of U.S. regulators, including members of the SEC's FRAud Group and OCA, and the PCAOB. These sessions provided attendees a unique opportunity to learn how regulators identify and pursue potential violations.

Following the regulator conversations, there were multidisciplinary panel discussions, which included audit committee members, preparers, internal and external auditors, and counsel. Leslie Seidman, former chairman of the Financial Accounting Standards Board (FASB) and chair of the audit committee at Moody's Corporation, served as moderator. The discussions centered on three main themes: (1) highly subjective and complex accounting areas, with a focus on accounting policies; (2) ICFR and management override; and (3) staffing considerations.

The workshops concluded with breakout sessions to facilitate frank discussions about the accounting and internal control issues faced among members of the financial reporting supply chain. Attendees broke into small groups to discuss abbreviated case studies based on actions brought by regulators. The cases offered a platform for a wide-ranging dialogue about ICFR issues faced by both small and large companies, and how to manage them.

This report on the workshop proceedings is organized as follows:

- ▶ Perspectives from Regulators
- ▶ The Important Role of Company Accounting Policies
- ▶ ICFR Considerations
- ▶ Staffing Challenges in a Complex Accounting Environment





# 2 Perspectives from Regulators

## Overview of Regulator Activities

The workshops in New York and San Francisco featured representatives from the SEC's FRAud Group as well as the PCAOB's DEI. A representative from the SEC's OCA also participated in the New York workshop. The views expressed by these regulators were their own and not necessarily those of their agencies or any individual in these agencies.

The panel discussions were designed to inform the workshop attendees about the activities that the regulators undertake with respect to enforcement investigations and to provide insight into how the different agencies coordinate during the investigation process.

## The Work of the SEC's FRAud Group

The proceedings in New York began with a discussion between the CAQ's Fornelli and Margaret McGuire, Chief of the FRAud Group. In San Francisco, Jason Lee, Senior Special Counsel in the FRAud Group (based in the SEC's Los Angeles regional office), performed a similar role in introducing the FRAud Group to attendees.

The FRAud Group was established in 2013 as a Task Force and is now a permanent group within the Division of Enforcement. Its mission is to identify potential federal

securities law violations related to financial reporting, issuer reporting, and auditing. The FRAud Group aims for early detection of matters that, if left unchecked, could have a substantially negative impact on securities markets.

Among its projects is the issuer review initiative, which has identified almost 300 issuers as being of interest. These are companies that appeared on the FRAud Group's radar for meeting certain criteria—e.g., earnings restatement, auditor resignation—that distinguished them from other public companies. The initiative has led to the opening of a number of new matters by the Division of Enforcement.

McGuire emphasized that analytics are key to the work of the FRAud Group, which makes use of a massive collection of information on issuers. Analytics were originally provided by the Division of Economic and Risk Analysis (DERA) Accounting Quality Model, which evolved into the Corporate Issuer Risk Assessment (CIRA). McGuire noted that CIRA can be tailored to reflect the interest and needs of the FRAud Group.

## THE IMPACT OF THE OFFICE OF THE WHISTLEBLOWER

Whistleblower submissions are often a great source of information to advance existing, or to initiate new,

SEC investigations related to financial fraud.<sup>3</sup> Due to their high quality, whistleblower submissions don't often impact the work of the FRAud Group, as the group is focused on identifying previously undetectable misconduct. "We are like miners, digging out [potential fraud] from the ground," said McGuire. "You don't need a miner's hat to unearth misconduct where a whistleblower has brought it to the surface." The SEC's Office of the Whistleblower is an important ally of the FRAud Group in fraud detection, and its work helps identify trends in submissions involving financial reporting and audit matters. As of January 2017, SEC enforcement actions from whistleblower tips have resulted in more than \$935 million in financial remedies. Since the SEC's whistleblower program began, approximately \$149 million has been awarded to 41 whistleblowers who voluntarily provided the SEC with original and useful information that led to a successful enforcement action.<sup>4</sup>

## THE "INCUBATION" OF FRAUD GROUP MATTERS

Financial fraud investigations have no typical lifecycle; they are "more like a snowflake than a widget," said McGuire. But because they are document intensive, and can entail calling dozens of witnesses from every level of a company, the average financial fraud investigation is measured in years, not months.

McGuire commented that "[T]he unique thing about the FRAud Group and the work we do is that—unlike investigative staff who are charged with advancing investigations and measuring the investigative progress all the time—we have both the luxury and the obligation to incubate these matters and see what they grow into. It is a daunting but very rewarding task."

Certain matters identified by the FRAud Group may be of immediate interest and referred out to investigative staff across the country. For other matters identified, the FRAud Group may determine that no allocation of staff resources is necessary at the outset.

In the middle of this spectrum are matters where, in McGuire's words, "we think there is something there, but we're not quite certain." The FRAud Group will decide whether or not to incubate the matter—that is, decide whether there is an investigative theory worth pursuing. The FRAud Group may reach out and invite the issuer, its business partners, or its auditors to meet with the staff or to provide documents, seeking to determine

why a company adopted one accounting treatment and not another. According to McGuire, pre-investigation is a prime opportunity for an issuer to talk to the staff and educate it on what the company is doing, what its business model demands, and the best way to report on the financial health of the company.

In many FRAud Group matters where the staff's initial questions are answered, no further action may be taken. Other FRAud Group matters may evolve into an enforcement investigation, including certain investigations that result in filed enforcement actions.<sup>5</sup>

McGuire discussed her view of the role of "gatekeepers" in the financial reporting supply chain:

In every investigation we embark on related to financial reporting, issuer disclosure, and audit failure, we always look at the gatekeepers—board of directors, audit committee, external auditors, even external consultants—and what they did, what they knew, and how they documented it... The role of the gatekeeper should be in all capital letters because it's a hugely important role. Ideally, that gatekeeper is coming out on the side of assisting the SEC staff in its investigation, as opposed to being a focus of it.

## SEC'S OCA

In the New York session, Brian Croteau, former Deputy Chief Accountant in OCA, gave an introduction to the work of that office.

OCA is responsible for establishing and enforcing accounting and auditing policy to enhance the transparency and relevancy of financial reporting, and for improving the professional performance of public company auditors in order to ensure that financial statements used for investment decisions are presented fairly and have credibility.<sup>6</sup>

OCA also sees itself as a service organization to other SEC staff by providing advice on accounting, auditing, and internal control matters. In these capacities, OCA responds to requests for support from the FRAud Group and other parts of the Division of Enforcement. Croteau stated: "We are there as a resource to the FRAud Group, to all of Enforcement broadly... To some extent we rely on them to involve us at the right time when they feel they do need technical expertise or support."

<sup>3</sup> See SEC website Office of the Whistleblower page at <https://www.sec.gov/whistleblower>.

<sup>4</sup> See SEC press release at <https://www.sec.gov/news/pressrelease/2017-27.html>.

<sup>5</sup> See the SEC FRAud Group Spotlight page for examples of filed enforcement actions.

<sup>6</sup> See SEC website Office of the Chief Accountant page at <https://www.sec.gov/oca>.

At the same time, Croteau added, OCA may also suggest matters for the FRAud Group, or ask it to get involved in areas OCA sees as new or evolving risks. Anytime OCA becomes aware of what appears to be or is a violation of securities law, the matter is entered into the [Tips, Complaints, and Referrals \(TCR\) System](#) of the SEC, which can be accessed by its various internal divisions and offices.

## PCAOB

In New York and San Francisco, respectively, Liban Jama, Senior Advisor in the PCAOB's DEI, and Michael Plotnick, Deputy Chief Trial Counsel in DEI, discussed the PCAOB's activities.

The PCAOB's mission is to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB pursues its mission through various channels, including the work of its inspectors; the Office of Research and Analysis (ORA), the analytics branch that looks at the marketplace as a whole; and the Public Source Analysis (PSA) process, a team within DEI which is part of the overall case identification process. PSA monitors and accesses public disclosures in SEC filings, news articles, and other sources to identify potential new matters.

"We look at macro indicators to have a better sense of where the pressure points are in our overall economy," said Jama. "There may not be particular trends you can overarch across the economy, but there are particular industries where, based on economic pressures, there may be issues."

## CLOSE COOPERATION AMONG THE REGULATORS

The representatives of the FRAud Group, OCA, and the PCAOB repeatedly stressed that their organizations work closely together, coordinating efforts where investigations are pursued. The three groups are in constant contact with each other across offices nationwide. To the greatest extent possible, duplicative efforts that waste resources and sow confusion are eliminated.

Croteau stated that OCA is a "joint moving party" with the Division of Enforcement on matters that could result in a Rule 102(e) action against an accountant.<sup>7</sup> "Collaboration between OCA and Enforcement," said McGuire, "is one of the things that makes our

<sup>7</sup> Rule 102(e) allows the SEC to censure, suspend, or disbar any person for engaging in improper professional misconduct in practicing before the Commission.



enforcement actions much more informed, much more on point, much more targeted." Touching on OCA's role as an intersecting point between the SEC and the PCAOB, Croteau stated:

What we do is attempt to help the Commission in discharging its oversight responsibilities over the PCAOB, which are comprehensive. It is important that we think early and often about collaborating, sharing information, and making sure nothing is falling through the cracks and we're not duplicating efforts... The SEC may be working on the management side of an enforcement case where the PCAOB may be working on the auditor piece, or the SEC may take both, depending on the facts and circumstances. That requires very close coordination and communication.

The PCAOB's Plotnick discussed its cooperation with the SEC, including the decision of whether the PCAOB or the SEC will pursue a matter against auditors:

We coordinate with the SEC continuously and constantly throughout our cases. When we start looking at a particular audit firm, we will report that to the SEC to see if they are already doing it. Are we going to get out ahead of what they are doing? Are they looking at the issuer? Should we be looking at the auditor? And so it really is on a case by case basis, and it develops very differently over very different cases with different offices. Some SEC offices are more likely to say to us, 'We've got the issuer covered, but why don't you look at the auditors?' Other times the





SEC team will decide, ‘We are going to pursue that case,’ so we will typically defer to the SEC.

## Issues and Themes from the Regulators’ Presentations

### PATTERNS IN ENFORCEMENT ACTIONS

The FRAud Group’s areas of focus are those that have long garnered regulator interest—revenue recognition, expense allocations, valuation, and asset impairment. Underlying the importance of these specific issues is regulator concern that senior officers of a company will engage in earnings management. Indeed, the pressure to meet internal projections (partly for compensation purposes) and external expectations (to satisfy investors) was often cited at the workshops. Said Lee: “Having done this for close to 20 years, I would say the driving force behind almost every type of public company misconduct is the need to meet earnings expectations.”

One trigger that draws the attention of the FRAud Group is multiple revisions to financial statements.<sup>8</sup> McGuire indicated that, while there is nothing fraudulent about a revision per se, multiple revisions over a short period of time—for example, five or six revisions in three years—is a red flag to regulators. If the revisions are continually for the same metric or business unit, it will only heighten regulator interest, especially from an ICFR perspective.

#### ICFR

In its effort to combat fraud, regulators have placed renewed emphasis on ICFR. The regulators expressed

<sup>8</sup> Revisions are corrections of errors to the financial statements that are not considered material, and are not required to be corrected in an amended filing. Companies are not required to disclose revisions on Form 8-K Item 4.02. According to an SEC final rule, issued in August 2004, if a company or its auditors conclude that the “company’s previously issued financial statements...no longer should be relied upon because of an error in such financial statements...” this must be disclosed on Form 8-K, Item 4.02, and the company must file corrected reports on Form 10-K/A and/or Form 10-Q/A.

a sense that, after a strong push on ICFR because of passage of the Sarbanes-Oxley Act, there may now be some “deferred maintenance” building up in the system. In other words, evaluations of ICFR have become routine, with some companies becoming complacent and new risks are not always adequately considered. Stated Croteau:

One thing I’ve always wondered is why very few companies make the required quarterly disclosures [related to changes in] controls.<sup>9</sup> I presume companies make material changes to their controls: they have acquisitions, their businesses are changing all the time. Yet very few disclose material changes.

The importance that the SEC places on ICFR is reflected in, among other matters, the [Magnum Hunter Resources \(MHR\) case](#), in which the SEC alleged that the company and two senior officers improperly concluded the company had no material weaknesses. The SEC also charged a former MHR consultant and former audit engagement partner with “improperly evaluating the severity of MHR’s internal control deficiencies and misapplying relevant standards for assessing deficiencies and material weaknesses.”<sup>10</sup> The MHR case illustrates that there doesn’t need to be a restatement of financial statements for such a case to be levied.

“I think [MHR] is an important case because it sends the message that a company needs to take its ICFR obligation seriously,” said Croteau. He added that hopefully there will be more disclosure of material weaknesses by companies when such deficiencies exist.

<sup>9</sup> In accordance with SEC rules, paragraph (c) of Item 308 requires the company to disclose in each quarterly and annual report whether or not there were changes in the company’s internal controls in the last quarter that have materially affected, or are reasonably likely to materially affect, the company’s internal control over financial reporting.

<sup>10</sup> See “SEC Charges Company and Executives for Faulty Evaluations of Internal Controls,” <https://www.sec.gov/news/pressrelease/2016-48.html>.

The interest in ICFR is in part driven by the number of revisions the FRAud Group was seeing for which there were no prior indications of a material weakness in controls. “It’s much more rewarding to be able to prevent a fraud that might actually harm investors,” said McGuire. She believes such cases are worth pursuing, because it is preferable if fraud and potential misstatements are deterred, detected, and corrected through better ICFR before, rather than after, the fact.

### PCAOB Concerns

Representatives from the PCAOB cited several areas of traditional and continuing concern in their mission of external auditor oversight:

- ▶ Insufficient professional skepticism, which encompasses accepting management’s representations without sufficient audit evidence to support those conclusions. Professional skepticism requires that auditors have an attitude that includes a questioning mind and a critical assessment of audit evidence.<sup>11</sup>
- ▶ Lack of independence, i.e., situations where the auditor’s independence was compromised.
- ▶ Inadequate supervision by senior auditors of junior staff, which includes the lack of timely review or upfront coaching.

Turning to emerging issues, PCAOB staff said a current focus is the quality of cross-border audits, especially those involving non-U.S. affiliates of the global accounting networks. The PCAOB is concerned that auditing standards are not necessarily followed by affiliates in certain countries. Plotnick remarked, “Quality control procedures at the U.S. firm level don’t necessarily translate to certain foreign affiliates of their own firms; even at the biggest affiliates of some of the biggest firms, the quality controls aren’t nearly as good.”

Improper document alteration is another issue receiving PCAOB attention. In April 2016, after observing related issues in inspections of group networks and other firms, the PCAOB issued [Staff Audit Practice Alert No. 14](#). PCAOB staff emphasized that any attempt to improperly alter audit documentation in connection with a PCAOB inspection or investigation is a mistaken effort. “The sanction involved may well be a lot worse than failure to document something or missing something in the audit,” said Plotnick.

<sup>11</sup> See PCAOB, Maintaining and Applying Professional Skepticism In Audits, Staff Audit Practice Alert No. 10, [https://pcaobus.org/Standards/QandA/12-04-2012\\_SAPA\\_10.pdf](https://pcaobus.org/Standards/QandA/12-04-2012_SAPA_10.pdf).

Providing an SEC Enforcement perspective, Lee added that, while SEC investigations are civil in nature, “Once you start getting into document destruction and alteration, that could result in a criminal referral [to the U.S. Department of Justice].”

## SELF-REPORTING AND COOPERATION

### Cooperation with Agencies

The workshops generated a discussion concerning self-reporting (i.e., the reporting of possible securities law violations to the SEC by public companies on their own volition) and cooperating with the SEC on the investigation.<sup>12</sup>

Lee introduced the discussion in San Francisco by stating:

Cooperation is the hallmark of any sort of modern day enforcement regime... Self-reporting [and] remediation goes to the heart of the Commission’s ability to protect the public... In my mind it is what every good corporate citizen should do should that company uncover misconduct.

Croteau said all self-reports to OCA are entered into the TCR database, noting that “depending on the severity of an individual matter, or a collection of multiple matters, over time that could [result in an enforcement action].”

### Timing

Asked about the “when” of self-reporting, McGuire responded:

From our perspective, ‘early and often’ is the refrain. I can totally appreciate why an issuer, the board [of directors], and the audit committee would want an opportunity to get their hands around something, even to determine if this is something they need to self-report... If you’re coming to the agency for the first time and you [already] have a bound 500-page report of your internal investigation, you are probably self-reporting too late.

### Cooperation Credit Given by the SEC

The heart of the discourse centered on the amount of cooperation credit that would be given by the SEC to a company for self-reporting.<sup>13</sup>

McGuire said “the early phone call, self-report, cooperation throughout the SEC staff’s investigation, and

<sup>12</sup> The SEC’s Enforcement Cooperation Program is described at <https://www.sec.gov/spotlight/enfcooperationinitiative.shtml>.

<sup>13</sup> For a discussion on the topic, see the Anti-Fraud Collaboration’s webcast held December 13, 2016, titled *SEC Investigations: Are There Benefits to Cooperation and Self-Reporting?* <http://thecaq.org/sec-investigations-are-there-benefits-cooperation-and-self-reporting>.

all of the self-remediation steps that an issuer can take... it is always going to be better [to self-report than have the SEC discover it].”

She added that, while the SEC always tries to be transparent, “there are limits about how much we can say about those cooperative efforts... Nonetheless, any issuer that has received that type of credit, they feel the credit.”

One participant said that, among audit committee chairs, there was wide diversity of opinion on self-reporting—and significant skepticism. “There do not appear to a lot of audit committee chairs who believe the [end-result of self-reporting] to be much different than what [the SEC] would do to us if we didn’t self-report.”

In response, McGuire stated:

I don’t know how to dissuade that notion. I can assure you that the issuers that have self-reported early, had good communications with the staff, have cooperated with the staff’s investigation, and have taken those steps that a reasonable person would think are

appropriate in terms of remediating the circumstances that led to the self-reportable instance... Those issuers get full credit, and sometimes amazing credit, meaning not even an action against them, or certainly a potential fraud action can be something less severe.

Speaking from a PCAOB viewpoint with respect to enforcement investigations involving the public company auditor, Jama added that the “PCAOB’s program and policies relative to cooperation are modeled on the SEC’s; we make every effort to ensure consistency of approach where appropriate based on the facts and circumstances of the matter.”<sup>14</sup>

## NON-GAAP FINANCIAL MEASURES

The regulators noted that non-GAAP financial measures have been getting “a lot of attention,” although that may not be reflected in an increase in related investigations. “Any issuer who is using non-GAAP measures inappropriately opens themselves up to a myriad of vulnerability in the enforcement space,” said McGuire.

Regarding the responsibility of the external auditor, Croteau stated, “The auditor may not have a very direct role... [but] if they believe there’s something that would be worthy of communication to an audit committee or to management relative to this space, I think it would be very appropriate to engage in that dialogue.”<sup>15</sup>

The external auditor is responsible to read other information in documents containing audited financial statements and consider whether such information, or the manner of its presentation, is materially inconsistent with the audited financial statements.<sup>16</sup> The external auditor has no responsibility over a company’s earnings release, which often includes non-GAAP financial measures. In response to regulatory speeches and comment letters, the disclosure of non-GAAP financial measures has received renewed attention by all members of the financial reporting supply chain.<sup>17</sup>

14 See PCAOB, *Policy Statement Regarding Credit For Extraordinary Cooperation In Connection With Board Investigations*, PCAOB Release No. 2013-003, April 24, 2013 at [https://pcaobus.org/Enforcement/Documents/Release\\_2013\\_003.pdf](https://pcaobus.org/Enforcement/Documents/Release_2013_003.pdf).

15 For a discussion of the role of auditors and non-GAAP financial measures, see Standing Advisory Group Meeting, *Company Performance Measures And The Role Of Auditors*, May 18-19, 2016, <https://pcaobus.org/News/Events/Documents/051816-SAG-meeting/Company-Performance-Measures-5-18-16.pdf>.

16 AS 2710 (previously AU sec. 550), *Other Information in Documents Containing Audited Financial Statements* at <https://pcaobus.org/Standards/Auditing/Pages/AS2710.aspx>.

17 The CAQ published *Questions on Non-GAAP Measures: A Tool for Audit Committees and Non-GAAP Financial Measures: Continuing the Conversation*, in June and December, respectively, to promote discussion regarding stakeholder responsibilities regarding use of non-GAAP financial measures.







# 3

## The Important Role of Company Accounting Policies

The workshops were heavily focused on discussing the results of the AAERs analyzed in the Anti-Fraud Collaboration study (described in the Introduction), which can be classified into three types of accounting issues: (1) revenue recognition, (2) loan impairment, and (3) valuation.

“These areas share two characteristics,” according to Michael R. Young, a securities lawyer and Partner at Willkie Farr & Gallagher LLP, who conducted the analysis of the AAERs. “First, they involve accounting that was highly judgmental and often difficult to estimate. Second, they involve areas that were under stress during the period of the financial crisis. And central to these issues is accounting policy.”

### Accounting Policies

#### CREATION AND IMPLEMENTATION

The creation of accounting policies was the source of extensive discussions at both the New York and San Francisco workshops.

One oft-repeated admonition was that companies must strive to adopt policies that are understandable and clear, even (perhaps especially) in areas of accounting



You’re never going to remove subjectivity and complexity [from accounting policies]. But if you can make the process objective and consistent, you can design effective controls even in complicated areas...When you don’t have a rigorous process to go through, that’s when you miss things.

- Workshop Participant,  
San Francisco

complexity. Although policy is often written by technical accountants, it is primarily non-accountants, such as the sales force, whose actions impact the accounting results. “You have to take the FASB determinations and rules and create policy that everyone in your company can follow,” said one participant.

Moreover, process must be married to policy: strong communication and coordination between the owners of accounting policies and the employees in the field are

**A participant in New York discussed how their company developed a policy advisory group to attain its goal of having accounting policies that are clear and understandable. This group comprises:**

"...individuals who know nothing about accounting. They are people from the front line, from different parts of the organization, and different parts of the globe. And so the accounting policy is put in plain language—all the words from the FASB, EITF [Emerging Issues Task Force], etc. are taken out—so people can fully understand it. The group gives its feedback, and that's how policy gets changed and implemented. There is no policy that gets issued from an accounting point of view without that group signing off on it."

### **Recommendations for Implementing Accounting Policies**

1. Create policies that are in lock-step with authoritative guidance, and, if possible, in plain language.
2. Develop examples to help those in the different business lines understand how to apply the guidance/policy.
3. Communicate the policies and examples developed by corporate accounting with operations and perform field tests.
4. Embed or involve accounting/finance professionals in or with operations.
5. Tie compliance and behavior to compensation.

required. Accounting policies should be reviewed at regular intervals and address how to identify and monitor changes; they must specify what happens when new, unforeseen issues arise, and how to communicate them. And policies should enable additions and changes to controls.

Accounting policies and procedures are, therefore, living documents undergoing change through an iterative process. Policies and procedures must be tested in the field prior to implementation and then monitored post-implementation to ensure they are being applied consistently with accounting guidance as written. The risk to the organization from an accounting policy that is either not implemented or not implementable as written is substantial.

Several participants noted that international operations are especially vulnerable to a breakdown in understanding and application of accounting policies and inconsistencies in financial reporting. The suggestion was made of placing home office accounting staff in key overseas markets to determine policy adherence.

## **Revenue Recognition**

In addition to accounting policies generally, the workshops emphasized revenue recognition, due to its

significance and because of the new revenue recognition standard, effective January 1, 2018, for calendar year-end public companies.<sup>18</sup>

### **IMPORTANT CHARACTERISTICS**

Participants identified essential traits of revenue recognition that make it particularly vulnerable to fraud. Because of these traits, a strong accounting policy for revenue recognition is important.

1. Revenue recognition is closely tied to key metrics—earnings, margins, and revenue itself—that are reported both externally and internally. Externally, these metrics are crucial to Wall Street's valuation of the company's stock. Internally, they have a major impact on employees—in the area of compensation, and in the C-suite. Therefore, many employees in the organization are under pressure, in one form or another, to meet expectations for these metrics.
2. The timing of revenue recognition is crucial to company results. Revenue recognition can often be manipulated and is susceptible to earnings management.

<sup>18</sup> Accounting Standard Update (ASU) No. 2014-09—*Revenue from Contracts with Customers* (Topic 606).



3. Revenue recognition is a complex accounting area where application guidance varies by revenue stream. Policy and training are not “one-size-fits-all” in large, highly diverse, and geographically dispersed organizations.
4. In some companies, a large percentage of revenue comes from overseas activities, which can lead to extensive communication, training, and coordination challenges.

#### REVENUE RECOGNITION ACCOUNTING POLICY LEADING PRACTICES

During the workshops, participants made a number of observations and recommendations regarding leading practices for accounting policies related to revenue recognition:

1. Accounting policies in this area should be granular, because even slight differences in interpretation can have a major impact on revenue recognition. Where possible, the policy should include examples understandable to non-accountants to assist in implementation. This is especially important as companies implement the new revenue recognition standard.
2. An effort should be made to standardize contract terms, and deviations from typical contract terms should be well documented and approved by senior management. The accounting function should be made aware of such deviations. One participant strongly recommended that an accounting expert be involved in contract negotiations. Review of final sales contracts and completion of a revenue recognition checklist are common internal controls.
3. Because accounting policy is affected by the actions of the sales force and other parts of the organization, internal audit or a business control function should test whether executed contracts have been accounted for in accordance with the accounting policy.

The new revenue recognition standard affects all entities—public, private, and not-for-profit—that have contracts with customers. It is broad reaching across an organization and impacts many functional areas: accounting, tax, financial reporting, ICFR, financial planning and analysis, investor relations, treasury (e.g., debt covenants), sales, legal, information technology, and human resources (e.g., employee compensation plans). It involves significant judgments and estimates, thoughtful revision of accounting policy, and new required disclosures. The CAQ has published *Preparing for the New Revenue Recognition Standard – A Tool for Audit Committees* to assist audit committees in their oversight role of the implementation of the new standard.

4. Clear responsibility and clear lines of communication among legal, business, and finance must be created so that all key players understand sales transactions.
5. Internal controls need to be dynamic and updated as business activities evolve and GAAP requirements change. This includes controls to adopt and implement the new revenue recognition standard.

# 4

## ICFR Considerations



### General Themes

As noted, the workshops involved a range of panelists and participants from the financial reporting supply chain who engaged in moderated panel discussions and smaller breakout sessions. From these wide-ranging discussions, several broad themes regarding ICFR emerged:

1. For all members of the financial reporting supply chain, the importance of tone at the top cannot be overstated. In most cases of alleged financial fraud, the SEC names the CEO and/or the CFO in the complaint. Commission staff noted that the driver of earnings management—the catalyst for most fraud cases—is often top management, such that the focus on the CEO and CFO is not surprising. In cases the PCAOB has brought against individual auditors, it is usually the lead audit engagement partner or other senior members of an audit engagement team who are disciplined.
2. A risk-based approach is essential for an efficient and effective execution of management’s assessment and the external auditor’s evaluation of ICFR. Not only does the risk of material misstatement need to be well thought out, the risk of key controls is an important assessment. This assessment drives the nature, timing, and extent of testing that is performed and the amount of audit evidence that is considered sufficient.
3. Core processes—such as those for everyday sales transactions—are only one component of ICFR. Equally important are internal controls over unusual and nonroutine transactions. These controls require special attention when they relate to unique transactions that are significant to the organization.<sup>19</sup>
4. There is a tendency for controls to become static. Controls are designed and implemented under circumstances that exist at a specific time. The company must track changes in its business processes and risks; as these change, the company’s controls must change accordingly.
5. The culture of subsidiaries, both foreign and domestic, must be monitored closely by the head office, taking into account tone at the top as well as local customs. When the cultures both within the organization and externally are significantly different, the risk of miscommunication may be higher, which can increase the risk of fraud.

<sup>19</sup> See the PCAOB June 10, 2014 Fact Sheet that includes amendments adopted to strengthen auditor performance requirements for significant unusual transactions at [https://pcaobus.org/News/Releases/Pages/06102014\\_Fact\\_Sheet.aspx](https://pcaobus.org/News/Releases/Pages/06102014_Fact_Sheet.aspx).





6. Both *preventive controls* and *detective controls* are essential. Preventive controls are particularly useful because they can stop inappropriate behavior before it happens.
7. A single control occurring at the end of a business process cannot, in most circumstances, be relied upon to deter fraud. Internal controls are typically necessary through the length and breadth of a process—in the case of a loan, for example, from origination to reporting the loan loss reserve. Throughout the process, the internal controls should be responsive to all relevant risk points: i.e., “what could go wrong?”
8. Smaller organizations may find segregation of duties particularly difficult to achieve owing to fewer resources. Moreover, ICFR may have low priority in start-up organizations: management has to balance the resources devoted to governance with those required for growth. Generally, small companies may be at greater risk for ICFR deficiencies. Solutions may include greater involvement of senior management in ICFR processes and tapping external resources.

## Potential Warning Signs

During the workshops, participants discussed a number of potential warning signs that may indicate increased risk related to fraudulent financial reporting:

- ▶ A very strong-willed CEO who creates a “don’t ask questions” culture. CEOs tend to have commanding

**In an atmosphere of fear of the CEO, each side of the fraud triangle comes into sharper relief:**

*Perceived pressures* are heightened by a culture that is only interested in keeping the CEO happy.

*Perceived opportunities* are expanded to where any safeguard can be superseded in the all-important quest of doing the CEO’s bidding.

*Rationalization* is easier when employees grow increasingly cynical from the dysfunctional tone at the top, which can lead them to perform activities that result in a fraud or to ignore potentially fraudulent behavior by others.

personalities, but a CEO who is so intimidating that opposing views are not welcomed or are not considered is a problem.

- ▶ A culture of perfection that inhibits open and transparent communication. “Perfection might sound

## Role of the Audit Committee

The important role of the audit committee in deterring fraud was a consistent thread interwoven throughout the panel discussions and workshops. To optimize audit committee effectiveness, participants made the following recommendations:

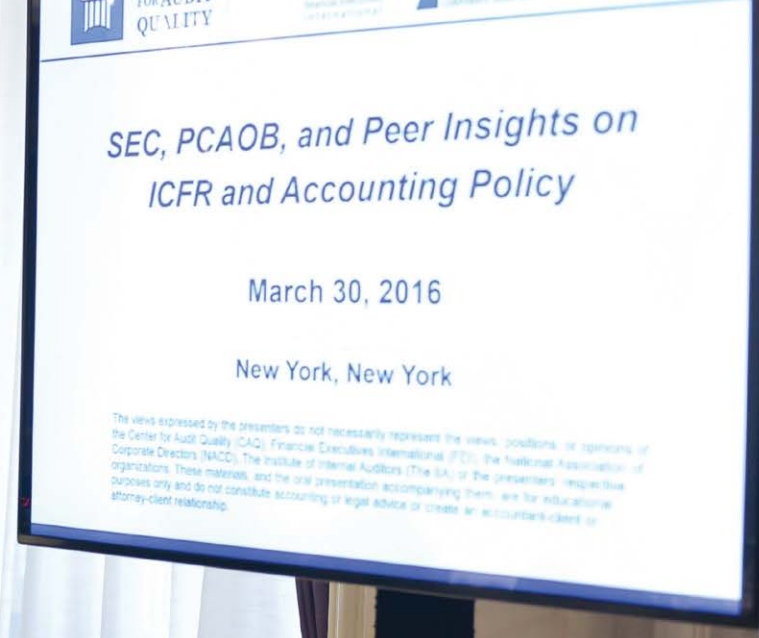
1. The audit committee's lines of communication should be widely open to senior management, not just to the CFO. Employees should feel comfortable reporting to the audit committee, either directly or through the company's ethics hotline, in situations where they believe they have been pressured by management to perform illegal or unethical acts.
2. The audit committee should look beyond the packets of materials they are routinely given before a meeting and ask, "What else should we be talking about?" Similarly, audit committee meetings with management are often arranged for a specific purpose with agendas decided well in advance of meetings. Audit committees should be proactive in broaching other topics when necessary.
3. The audit committee needs to take greater ownership of accounting issues and ask more open-ended questions about them. One participant recommended that a member of the audit committee listen to the company's earnings call with analysts to consider if the messaging is consistent with the financial filings.
4. For audit committees in industries with highly specialized accounting, the audit committee may benefit from external industry specialists. The role of

the audit committee should include challenging senior management on the accounting for complex transactions.

5. When audit committee members and management have both served long terms, there can be a tendency for problems to go unnoticed and questions left unasked. Turnover on boards can provide fresh eyes and a new spirit for engaging in accounting issues.
6. As part of the assessment of ICFR by both the company and the external auditor, concerns related to inadequate or ineffective staffing should be considered when evaluating the design and operation of a company's controls. Some participants said the external auditor and audit committees should address the topic of company staffing both formally and informally.
7. More broadly, participants emphasized that both formal and informal interaction is necessary among external auditors, the financial reporting team, internal auditors, and the audit committee. Through these interactions, relationships are strengthened and more candid communication can occur.

Finally, while enforcement actions against audit committees are uncommon, they are not unprecedented. Lee cited [MusclePharm](#) as the "rare case" brought against a member of the audit committee. The audit committee chair had reason to know that the company had not disclosed certain perquisite compensation paid to its executive officers. The audit committee chair's lack of action resulted in an enforcement action. For more information, see <https://www.sec.gov/news/pressrelease/2015-179.html>.





good—everyone is striving to do their best,” said one participant. “But will anybody raise their hand when there’s bad news to deliver?” In such an atmosphere, problems can be ignored and allowed to mushroom.

- Pressure to meet key metrics. How much pressure is there to find that extra revenue or income to meet an analyst’s forecast, or comply with a debt covenant? Significant compensation plans that are tied only to revenue and earnings is another warning sign. “Compensation needs to be a combination of short- and long-term incentives,” said one participant. “Compliance must be part of the compensation determination as well.”<sup>20</sup>

## Management Review Controls

Management review controls are the activities conducted by management to assess the reasonableness of estimates and other financial information. The adequacy and testing of management review controls were topics of discussion at the workshops.

An important type of management review control often involves review of projections, including challenging cash flow forecasts, understanding the rationale behind the projections, reviewing the projections in comparison to historical trends for reasonableness, and so forth. Auditors gain an understanding and obtain evidence of how management reviews such projections, and they understand the industry and business to corroborate and challenge the analysis.

Moreover, management review controls must be robust and precise. Said one participant “It can’t just be, for

<sup>20</sup> Please see the July 2016 Collaboration webcast *Coming to Terms with Short-Termism: Implications for Fraud* at <http://www.thecaq.org/coming-terms-short-termism-implications-fraud>.

One participant in New York said documentation is the best, and sometimes the only, way to know what happened in the past, since people’s memories can be inadequate or mistaken. Documentation is therefore the “friend” of all those who have financial reporting responsibilities.

example, ‘the economy grew, so sales went up.’” That kind of simplistic analysis can mask change that includes specific positive and negative elements.

Finally, several participants spoke to the importance of documentation in management review controls—especially from an audit perspective of trying to understand the steps management took in performing the review. The level of precision is significant, as well as linking the management review controls with the relevant financial statement assertions.<sup>21</sup> Management review controls generally address higher risks to the financial statements and, therefore, management should have adequate evidence surrounding the design and operating effectiveness of these controls.

## Documentation

Besides its importance in management review controls, documentation received broad attention

<sup>21</sup> See the discussion of evaluating the precision of management review controls in PCAOB, Staff Audit Practice Alert No. 11, p.20, [https://pcaobus.org/Standards/QandA/10-24-2013\\_SAPA\\_11.pdf](https://pcaobus.org/Standards/QandA/10-24-2013_SAPA_11.pdf).

## Leading Practices for Evaluating and Documenting ICFR

The workshops provided a number of suggestions about leading practices for evaluating and documenting ICFR:

1. Controls documentation and testing should be embedded into the day-to-day operations such that it is not strictly a compliance exercise that only satisfies auditors.
2. Communication is key. There may be a perceived gap between the nature and extent of evidence that management considers necessary to support their evaluation and assessment of ICFR and what their external auditors require. Management and their auditors should discuss what level of documentation will evidence key controls for both management and auditor responsibilities.
3. New personnel should understand why the internal controls are important and the role they play in the process. They should be trained in documentation requirements by the accounting or business unit staff, as appropriate. It is helpful if accounting policies and procedures include the company's documentation requirements.
4. The mapping, documentation, and testing of controls is an opportunity to discover and make operational improvements.
5. Where extensive internal control documentation issues are identified by the external auditor, audit committees should be involved to determine that appropriate remedial action is taken.

in the workshops as a significant element in the fraud deterrence effort, as well as a key component to effective ICFR. One participant noted that documentation is often thought of as something done to satisfy auditors. As required by the SEC, management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its assessment. Beyond this compliance requirement, it is also a leading practice. One participant said documentation is the best, and sometimes the only, way to know what happened in the past, since people's memories can be inadequate or mistaken. It is therefore the "friend" of all those who have financial reporting responsibilities.

Unfortunately, while the importance of documentation is appreciated within the upper levels of accounting departments, that is not necessarily true throughout the organization. Documentation therefore needs to be linked with the risk assessment. Specifically, the nature and extent of documentation must be aligned with the risk of material misstatement and the risk of the control.

As indicated, management's documentation is also important as audit evidence. In talking about the adequacy of documentation around internal controls, one participant said that a company must generate evidence that a control was executed in a manner consistent with its design. "There has to be more than just a sign-off: there needs to be evidence that there was indeed a meeting, particular topics were talked about, and what the follow-ups were."

Another participant saw the need for more robust documentation used in management review controls about alternatives *not* selected. "Why was D chosen instead of A, B, or C?" Such enhancements may be particularly useful in the case of complex accounting estimates or subjective judgments like those regarding intent. It is also important to include, as policy, the factors a company considers in making certain judgments, such as changing loan classification, long-lived asset impairment, or discontinuance of a business.

## Management Override

Management override may be defined as the overruling of established control procedures that could allow direct or indirect manipulation of the accounting records and preparation of fraudulent financial statements. It tends to occur in accounts, like reserves, whose determination is subjective and where judgment plays a key role. In these areas, changes made to estimates may be subject to management bias. "Some people call management

## Potential Warning Signs

Both management and auditors should consider the following, which are frequently associated with fraudulent journal entries:

1. The characteristics of entries or adjustments. Such characteristics may include entries:
  - a. made to unrelated, unusual, or seldom-used accounts,
  - b. made by individuals who typically do not make journal entries,
  - c. recorded at the end of the period or as post-closing entries that have little or no explanation or description, or
  - d. containing round numbers or a consistent ending number.
2. The nature and complexity of the accounts. Inappropriate journal entries and adjustments may be applied to accounts that:
  - a. contain transactions that are complex or unusual in nature,
  - b. contain significant estimates and period-end adjustments,
  - c. have been prone to errors in the past,
  - d. have not been reconciled on a timely basis or contain unreconciled differences,
  - e. contain intercompany transactions, or
  - f. are otherwise associated with an identified risk of material misstatement due to fraud.
3. Journal entries or other adjustments processed outside the normal course of business. Numerous computer software tools are now available to help identify journal entries with certain identifying characteristics associated with fraud.

Note: Auditing standards require the auditor to use professional judgment in determining the nature, timing, and extent of the testing of journal entries and other adjustments. For purposes of identifying and selecting specific entries and other adjustments for testing, and determining the appropriate method of examining the underlying support for the items selected, the auditor should consider guidance at AS 2401.61 (previously AU 316.61).

override the Achilles' heel of fraud prevention," said one workshop participant. Management override may affect interim financial information in addition to annual financial statements.

## STRATEGIES TO MINIMIZE RISK OF MANAGEMENT OVERRIDE

During the workshops, participants suggested several strategies that could reduce the threat of management override:

1. A member of senior management should review any journal entries or other adjustments made by individuals who typically do not make journal entries, such as the CEO or CFO.
2. The company's board and audit committee should be ready to challenge the CEO and CFO on significant accounting changes and estimates.
3. Senior management should be evaluated not only on traditional metrics like earnings or revenue but also on the quality of the company's regulatory/compliance/control environment.
4. Sales activity, especially for the company's largest customers, should be monitored for unusual transactions.
5. A quality of earnings analysis that shows where earnings came from (i.e., how much from normal recurring operations, from one-time amounts such as sale of land, or from changes in accounting estimates) should be prepared every quarter for the audit committee.



# 5 Staffing Challenges in a Complex Accounting Environment

In addition to strong accounting policies and ICFR, another key topic discussed at the workshops was the need for high quality staffing. The challenges related to hiring, retaining, training, and motivating staff are paramount to navigating a complex accounting environment.

## Desired Competencies and Qualities

The workshops addressed the qualities and competencies that are desirable in several members of the financial reporting supply chain, including internal auditors, external auditors, and corporate accounting staff.

### THOUGHT PROCESSES

Some participants said that, rather than focusing only on technical accounting knowledge when hiring staff, they place importance on the thought processes of potential employees, as they try to determine:

- ▶ Do they possess sufficient critical thinking skills?
- ▶ How do they go about reaching a decision?
- ▶ How do they work with staff at different levels of the organization to obtain information?

- ▶ Are they comfortable developing and expressing their own views in a team setting, or do they just follow the herd?
- ▶ What examples can they show to demonstrate their thinking had an impact on their organization?
- ▶ Do they have natural curiosity? (One participant said, “I want my staff to be asking ‘why, why, why.’”)

Some attendees placed more emphasis on technical knowledge, especially when the candidate’s expertise was needed to complement that of the rest of the team. The candidate might bring knowledge and qualities that would otherwise be lacking in a group that requires a range of competencies and skills.

Another participant noted that accounting staff must often deliver news that isn’t welcome, as well as information that may not be considered the highest priority, to both senior and junior members of the organization. Can the employees communicate with staff in different functions at different levels in a way that will affect their behavior?

Thus, communication skills are also important; employees must *listen* when they interview someone and adjust their





prepared list of questions accordingly. Staff must be willing and able to ask meaningful questions to increase their level of understanding and knowledge around an issue.

Part of the hiring process involves attempting to identify applicants who might be susceptible to committing fraud. However, this is not an easy task. Placed under unusual pressure, even people of integrity and good background may commit wrongful acts that in normal circumstances they would not consider.

### **Staffing for Dealing with Complex Accounting Issues**

Complex accounting issues—such as derivatives, taxation, and securitization—present a special staffing challenge. These are areas where knowledge is highly specialized and expertise is limited. The company employee responsible for such an area may be considered

an expert. But auditors must obtain sufficient evidence when testing controls for the accounting area to support their audit procedures, regardless of management's assessment of the expertise of such in-house staff. Some participants suggested that the accounting department (or in some cases the audit committee) be given the resources to confer with an outside expert in such instances.

Complex accounting issues may also create segregation of duties challenges. The potential for fraud is heightened by the “expert” in an accounting area who—using the excuse that no one else can do the job—avoids taking mandatory vacations. Control failures are often exposed during periods when a replacement takes over the responsibilities of a vacationing employee. Further, even if there are no problems with the employee's work, the company needs to have sufficient resources and documentation should the staff member be absent for an extended period or leave the organization.



What controls can be implemented to assess significant assumptions and judgments made by such in-house experts? One solution may be for the audit committee to encourage management to engage someone from outside the company to review the in-house expert's processes and conclusions. An outsourced or co-sourced internal audit function offers another solution, especially for smaller companies. There may be objections raised that only the in-house expert has the necessary knowledge, but in most accounting areas, there are numerous qualified people who can be enlisted to independently assess an accounting estimate for reasonableness or test a related control. The important thing is that in-house experts cannot be considered "untouchable." Companies need to have people who can question and challenge their findings and conclusions.

At the same time, one participant noted:

You can't staff an expert for every transaction, so it's natural to lean on external third parties. That said,

it's not as if someone internally can't read the same guidance, ask questions, be inquisitive, challenge positions, identify the judgment areas, and make sure the accounting makes sense from a business perspective.

## The Internal Audit Function and Staff

Internal audit typically has a wide scope of work, including complex accounting areas. One participant noted that it is important for internal audit to have the necessary skill sets within the function to cover this wide scope. At times there is a need to address extremely technical topics.

A few participants described how their internal audit staff use data analytics to identify instances of manipulation of accounting entries. One participant mentioned they recruit individuals for internal audit that have up-to-date computer and data analysis skills to support this activity.





Not only do you need good tone at the top, but in critical areas you should have multiple people, as many as possible, involved in the decision-making process. Even if they bring different perspectives, if everyone has equal accountability of signing off on those complex judgments, at least they know enough and can ask questions.

-Workshop Participant,  
San Francisco

To be effective, internal auditors must have knowledge of the business and have the confidence of management that is being audited. One participant commented on staffing the internal audit function: “I have seen a lot of different ways of staffing internal audit. One that I liked was rotating executives (financial and nonfinancial) through internal audit. It gave them the ability to learn about the business, plus the mix of expertise helped blend skills.” It is important for internal audit to build and nurture these relationships so the business units being audited can understand the value added by internal audit in helping address higher risk areas.

Because internal audit has exposure to a wide variety of company operations, it is often a feeder of personnel to other parts of the organization. This practice does raise potential conflict-of-interest issues when an internal auditor is seeking a new position and auditing the hiring division at the same time. The career aspirations of internal auditors must be considered to ensure they maintain their independence and objective mindset. One solution offered to address the potential conflict was adopting a “cooling off” period where internal auditors cannot interview for positions in departments they have audited within the last six months.

## Staffing Issues and the External Auditor

External auditors are concerned with assessing the adequacy and competency of their clients’ financial reporting staff, as well as finding the right people for their own firms.

In performing the audit, external auditors have an opportunity to assess the technical expertise and professional demeanor of the issuer’s financial reporting staff. External auditors may discuss deficiencies in these areas with senior management and, where necessary, the audit committee.

In hiring for their own firms, the external auditors need to determine whether a candidate will, as an engagement team member, possess those character

traits that are likely to manifest sufficient professional skepticism. External audit firms seek to hire people who won’t shrink from asking challenging questions of company staff and who won’t hesitate to have the sensitive conversations with senior management that are sometimes necessary.

## Human Resource Challenges Specific to Smaller Organizations

Participants discussed how smaller organizations face a continuing challenge in finding and retaining competent staff. Larger companies often have the resources to hire more employees at better pay, both in and outside the accounting department, which can provide a stronger infrastructure for ICFR.

Moreover, in smaller companies, there is rarely a duplication of expertise—indeed, employees often have to perform several job functions that in a larger company would each be performed by a single person. Segregation of duties thus becomes more difficult to achieve.

The strains on segregation of duties may necessitate the closer supervision and stronger involvement of senior management. Many CEOs and CFOs, however, may be reluctant to increase the time they spend on accounting tasks, believing their strengths and skills should be devoted to growing the company. As a result, smaller organizations may need to outsource functions they cannot perform on their own.

## Compensation Issues

As noted earlier, management and employees might align their performance and choose priorities based on how they are compensated. A compensation program that considers only financial metrics such as earnings, stock price, and revenue fosters a culture where issues of corporate governance and fraud deterrence may be given low priority. Operational goals and rewards for employee performance need to be in balance and adhere to ethical conduct. Qualitative and quantitative performance measures, both long- and short-term, are necessary.

# 6

## Conclusion

U.S. capital markets thrive when investors can rely on the financial statements of listed companies. Financial reporting fraud undermines this crucial component of investor confidence, and poses a grave threat to the functioning of those markets.

The workshops conducted in New York and San Francisco by the Collaboration sought to inform attendees of the SEC's efforts in uncovering financial fraud and disseminate leading practices for its deterrence and detection.

The focus of these workshops was on highly complex, subjective accounting areas—most notably revenue recognition—which present special challenges in internal control, including management override. Beyond this emphasis, the participants gained wide exposure to the problems attendant to the development of accounting policies and the controls necessary to determine their compliance with the standards, as well as the importance of complete and accurate documentation.

These efforts are achieved through the recruitment and retention of staff, trained and managed appropriately, who create a control environment conducive to financial statement integrity.

The underlying theme of the workshops is the importance of communication, cooperation, and coordination among the various links in the financial reporting supply chain. The soundness of the control environment and the integrity of the financial statements issued by public companies depend on regulators, senior management, auditors, and audit committees working together.

The Collaboration will seek to identify opportunities to promote a dialogue between financial reporting supply chain members around ICFR in general, and controls around highly subjective and complex accounting areas in particular. This report can serve as a catalyst for discussion around leading practices that deal with the important issues raised in these workshops with an eye toward improving the rigor of ICFR and financial reporting.



# Appendix: Workshop Participants

**MARCH 30, 2016**  
**New York City**

**Douglas J. Anderson**  
Managing Director - CAE  
Solutions  
The IIA, Inc.

**Brett Bernstein**  
Partner  
KPMG LLP

**Erik Bradbury**  
Professional Accounting  
Fellow  
Financial Executives  
International

**Jay Brodish**  
Partner  
PwC

**Michael Campana**  
Partner  
Honkamp Krueger & Co.,  
P.C.

**Brian Cassidy**  
Professional Accounting  
Fellow  
Center for Audit Quality

**Margot Cella**  
Senior Director of  
Research  
Center for Audit Quality

**Brian Croteau**  
Former Deputy Chief  
Accountant, Office of the  
Chief Accountant  
Securities and Exchange  
Commission

**Lili DeVita**  
Vice President and COO  
Financial Executives  
International

**Sam Eldessouky**  
Senior Vice President,  
Controller and Chief  
Accounting Officer  
Valeant Pharmaceuticals  
International, Inc.

**Ryan Evans**  
Partner  
KPMG LLP

**Sarah Fitch**  
Managing Director  
PwC

**Cindy Fornelli**  
Executive Director  
Center for Audit Quality

**Frank Gatti**  
Board of Directors  
National Association of  
Corporate Directors (NJ)

**Bob Hagemann**  
Audit Committee Chair,  
Zimmer Biomet, Ryder  
System, Inc.  
Audit Committee Member,  
Graphic Packaging  
International, Inc.

**Brian Hecker**  
Partner  
Crowe Horwath LLP

**Michele Hooper**  
Audit Committee Chair  
PPG Industries, Inc.

**Suzanne Hopgood**  
CEO  
The Hopgood Group

**Liban Jama**  
Senior Advisor – Legal,  
Policy & Strategy  
Public Company  
Accounting Oversight  
Board

**Chris Johnson**  
Partner  
Crowe Horwath LLP

**Peter Kind**  
Audit Committee Chair  
Enable Midstream  
Partners, LP

**William Kraut**  
Partner  
Newport Board Group  
LLC

**Anthony M. Lendez**  
Consulting Partner  
BDO USA LLP

**Mike Lundberg**  
National Director of  
Financial Institutions  
Services  
RSM US LLP

**Margaret McGuire**  
Chief, Financial Reporting  
and Audit Group  
Securities and Exchange  
Commission

**Dave Middendorf**  
National Managing Partner  
KPMG LLP

**Catherine Nance**  
Senior Director of  
Professional Practice  
Center for Audit Quality

**Pamela Packard**  
President and Board  
Director  
National Association of  
Corporate Directors (NY)

**Marc Panucci**  
Former Partner  
PwC

**Thomas Payne**  
Research Manager  
Center for Audit Quality

**Jessica Roos**  
Managing Director  
Citigroup Inc.

**Maria Rueda**  
CFO  
Abacus Federal Savings  
Bank

**Leslie Seidman**  
Executive Director  
Center for Excellence in  
Financial Reporting  
Lubin School of Business

**Thomas Sullivan, Jr.**  
Partner  
PwC

**Andrej Suskavcevic**  
President and CEO  
Financial Executives  
International

**Tom Terranova**  
Managing Director  
BDO Consulting

**Mike Young**  
Partner  
Willkie Farr & Gallagher  
LLP

**JUNE 21, 2016**  
**San Francisco**

**Eric Allegakoen**

Vice President - Global  
Audit, Assurance & Risk  
Advisory Services & CAE  
Adobe Systems Incorporated

**Douglas J. Anderson**

Managing Director - CAE  
Solutions  
The IIA, Inc.

**Kathy Anderson**

Managing Director, North  
American Advocacy  
The IIA, Inc.

**Cheemin Bo-Linn**

Board Member  
Evena Medical

**Joseph Bronson**

CEO  
The Bronson Group, LLC

**Lisa Campisano**

Controller  
Core-Mark International

**Margot Cella**

Senior Director of Research  
Center for Audit Quality

**Richard Chambers**

President and CEO  
The IIA, Inc.

**William Chiasson**

Audit Committee Chair  
Fossil Group, Inc.

**Robert Dance**

Managing Director  
Deloitte & Touche LLP

**J. Scott Fargason**

Louisiana State University  
Founder, BoardofDirectors.  
com

**Cindy Fornelli**

Executive Director  
Center for Audit Quality

**Robert B. Hirth, Jr**

Chairman of the Board  
Committee of Sponsoring  
Organizations of the  
Treadway Commission

**Howard Hoover**

Board Member  
American Honda Financial

**Richard Jackson**

Partner, Assurance  
EY

**Mike Jenkins**

Vice President Internal Audit  
Facebook

**Josh Jones**

Partner  
EY

**Jared Lauber**

Senior Director-Internal  
Audit  
McKesson Corporation

**Jason Lee**

Senior Special Counsel,  
Financial Reporting and  
Audit Group  
Securities and Exchange  
Commission

**Cecil Mak**

Partner  
KPMG LLP

**Raffi Margossian**

Partner  
RSM US LLP

**Steve Marsden**

Senior Manager  
RSM US LLP

**Steve Meisel**

Partner (retired)  
PwC

**Laura Merkl**

VP and Corporate Controller  
MuleSoft, Inc.

**Brian Miller, CPA, CFE**

National Assurance Partner  
BDO USA LLP

**Christina Minasi**

Partner  
BDO USA LLP

**Josh Paul**

Technical Accounting &  
SEC Reporting  
Google

**Marc Panucci**

Former Partner  
PwC

**Thomas Payne**

Research Manager  
Center for Audit Quality

**Michael Plotnick**

Deputy Chief Trial Counsel,  
Division of Enforcement and  
Investigations  
Public Company Accounting  
Oversight Board

**Allen Plyler**

Senior Technical Accounting  
Manager  
Silicon Valley Bank

**Julie Ruehl**

CAO  
Big Heart Pet Brands

**Barbara Scherer**

Board Member  
NETGEAR, Ansys, and  
UCT

**Theo Schwabacher**

Senior Institutional  
Consultant  
Morgan Stanley

**Hagi Schwartz**

Audit Committee Chair  
Mimecast Limited

**Brent A. Simer**

Professional Practice –  
Quality & Regulatory  
Matters Senior Manager  
EY

**Constance Skidmore**

Audit Committee Chair  
ShoreTel Inc.

**Vanessa Teitelbaum**

Technical Director -  
Professional Practice  
Center for Audit Quality

**Julie Vichot**

Partner  
Deloitte & Touche LLP

**Yi Wong**

Senior Director, Internal  
Audit  
Visa Inc.

# Anti-Fraud Collaboration



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