How to Prevent and Recognize Financial Statement Fraud

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Definition of Financial Statement Fraud

SAS 99 defines fraud as “an intentional act that results in a material misstatement in financial statements that are subject to audit.”
Key Ingredients for Financial Statement Fraud

Financial statement fraud will not take place without some combination of these ingredients:

- Someone, usually an executive, who will benefit
- Subordinates, accountants and others willing to assist (“enablers”)
- Unalert gatekeepers (e.g., auditors; board of directors)
A Key Question

Are you an Enabler? (i.e., one who assists another in destructive behavior.)
ETHICS AND THE ART OF ACCOUNTING
What is “Ethics”? 

Webster’s definitions:

- Ethics “the principles of conduct governing an individual or a group <professional ethics>”
- Profession: “a calling requiring specialized knowledge and often long and intensive academic preparation”
- Are CPAs in industry members of a “profession”?

[Image of an open book]
AICPA – Guidance Professional Conduct

Principles

- Responsibilities
- Public Interest
- Integrity
- Objectivity and Independence
- Due Care
- Scope and Nature of Services
AICPA – Guidance for CPAs in Industry

- Duty to external accountants
  - Candid
  - Full disclosure
- Subordination of judgment
  - Failure to record transactions
  - Misleading financial statements
- Ultimate solution to conflict: resign from the company!
IFAC Code of Ethics

- International Federation of Accountants (IFAC)
- Code of Ethics for Professional Accountants
- Effective 6/1/06
- Separate section for “Professional Accountants in Business”
IFAC Code of Ethics
(cont’d)

Fundamental Principles
• Integrity
• Objectivity
• Professional Competence and Due Care
• Confidentiality
• Professional Behavior
IFAC Code of Ethics
(cont’d)

Threats to Principles
• Self-interest
• Self-review
• Advocacy
• Familiarity
• Intimidation
Mark Twain on Ethics

“Always do right. This will gratify some people and astonish the rest.”
Nightmare Scenario – Assistant Controller

- **First Quarter** – you discover potential revenue recognition problem; consult with Controller; it appears immaterial; decide to investigate further

- **Second Quarter** – there is definitely a problem; more material than was thought; Controller says let’s not tell the CFO, he will only get upset – let’s fix it next quarter
Nightmare Scenario – Assistant Controller

(cont’d)

• Third Quarter – to correct the problem would wipe out half of quarter’s EPS; CFO says we have to make our numbers; we will spread the write-off over next four quarters; don’t tell the auditors

• Fourth Quarter – receive a call from Investor Relations; rumor that there is a problem with revenue; what should we tell the shareholders?
“Looking for Earnings in All the Wrong Places”

Our numbers look a little low this quarter – is it ok to adjust:

- Loan loss reserves
- Expense accruals
- Inventory valuation accounts
- Warranty reserves
Other Common Corporate Ethics Issues

- Padding expense accounts
- Hiding negative information
- Deliberately ignoring company policies
- Misrepresentations to customers, vendors, creditors
- Misleading statements about your qualifications
- Accepting gifts from suppliers
- Manipulating department reports or budgets
- Improper payments to customers, etc.

[Topics for another day …]
LRN Ethics Study

- 834 full-time employees from various industries
- 80% had disagreement with the ethics of supervisor, fellow employee or management
- 21% felt pressure to engage in illegal activity
- 25% witnessed illegal or unethical activity in the last 6 months

Source: Strategic Finance – November 2006
2007 National Business Ethics Survey

- 2000 employees at US private and public companies
- 56% personally observed violations of company ethics standards, policy or law
- 42% who witnessed misconduct did not report it; of those:
  - 54% did not expect company would take corrective action
  - 36% feared retaliation

Source: Strategic Finance January 2008
Corporate “Bullying”

As a result of bullying, I have:

- Fudged some numbers 15.0%
- Omitted information 20.0%
- Lost objectivity 17.5%
- Disclosed confidential information 20.0%
- Been afraid to disclose personal limitations that could compromise my work 28.0%
- Looked for a new position 62.5%

Source: Survey of 168 Management Accountants, Strategic Finance, September 2009
Common Rationalizations

• Everybody else does it
• They’ll never miss it
• Nobody will care
• The boss does it
• No one will know
• I don’t have time to do it right
• That’s close enough
• Some rules meant to be broken
• It’s not my job

Source: Strategic Finance – November 2006
Rationalization and Pressure

According to SAS 99:

• Some individuals possess an *attitude*, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.

• However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

• The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud.
What do These People Have in Common?

Paul Venesky
Michael Resnick
Lisa Zappala
Weston Smith
Judith Kudla
Alvin Dahl
Joseph Rougara
William DeLoach
Suzanne Brown
Randy Casstevens
William Shovers
Kevin Morano
Berdi Rassam
Howard Smith
Larry Crawford
Jerry Wells
What do These People Have in Common? (cont’d)

Scott Veech
John Jacobsen
Diane Bjorkstrom
Theodore Noncek
John Dwyer
Deanna Seruyga
Eric Sieracki
James Schneider
Todd Chisholm

Mark Bloom
J. Michael Broullire
Joseph Weller
Kevin Krakora
Sandra Miller
Harry Nicodemus
S. Blair Abernathy
Leslie Jackson
Wayne Pratt
What do These People Have in Common?
(cont’d)

Don Cole
Robert Putnam
Elaine Decker
David Decker

Theodore Fricke
Eric Tyra
Bryan Treadway
William Wiseman
FINANCIAL RESTATEMENT TRENDS
Top 10 Restatement Sources

1. Debt, warrants and equity security issues
2. Cash flow statement classification errors
3. Expense reporting issues
4. Deferred and stock-based compensation issues
5. Tax-related issues
6. Acquisitions, mergers, disposals
7. Liabilities, payables, reserves, accruals issues
8. Revenue recognition issues
9. Accounts/loans receivable, investments, cash issues
10. Consolidation issues, including VIE and off-B/S issues

Source: PCAOB 11/17/08

<table>
<thead>
<tr>
<th></th>
<th>Restatements</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>1,314</td>
<td>20%</td>
</tr>
<tr>
<td>Core Expenses</td>
<td>2,639</td>
<td>40%</td>
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<tr>
<td>Non-Core Expenses</td>
<td>2,202</td>
<td>33%</td>
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<tr>
<td>Debt and Interest</td>
<td>732</td>
<td>11%</td>
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<tr>
<td>Reclass/Disclosure</td>
<td>478</td>
<td>2%</td>
</tr>
<tr>
<td>Asset Valuation</td>
<td>356</td>
<td>5%</td>
</tr>
<tr>
<td>Taxes</td>
<td>350</td>
<td>5%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>6,633</strong></td>
<td><strong>100%</strong></td>
</tr>
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</table>

* Sums to more than 100% because some companies have more than one restatement issue

<table>
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<tr>
<th>Restatement Characteristic</th>
<th>Total Count</th>
<th>Total Percent</th>
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</thead>
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<tr>
<td>All restatements</td>
<td>6,633</td>
<td></td>
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<tr>
<td>Income-decreasing</td>
<td>5,806</td>
<td>88%</td>
</tr>
<tr>
<td>Core earnings</td>
<td>3,953</td>
<td>60%</td>
</tr>
<tr>
<td>Fraud</td>
<td>350</td>
<td>5%</td>
</tr>
<tr>
<td>Any severe characteristic</td>
<td>6,212</td>
<td>94%</td>
</tr>
<tr>
<td>Core earnings or fraud</td>
<td>3,998</td>
<td>60%</td>
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</tbody>
</table>
(May 2010)

• Fraud found in 347 cases
• CFO named in 65% of cases; CEO in 72%
• Motivation:
  – Meet earnings expectation
  – Increased stock price
  – Pending financing
  – Increase management compensation
• Primary industries: computer hardware/software, other manufacturing and healthcare
Time for a Quiz
Quiz - Fraud

According to the COSO study the average cumulative size of the fraudulent misstatement was:

- $12.1 million
- $25.0 million
- $397.7 million
- $532.2 million
What Are The Most Common Types of Revenue Recognition Fraud?

1. Recording of fictitious revenue
2. Recognizing inappropriate amount of revenue from swaps, round-tripping or barter arrangements
3. Recognition of revenue from sales transactions billed, but not shipped (“bill and hold”)
4. Recognition of revenue where there are contingencies associated with the transaction that have not yet been resolved.
5. Improper accounting for or failure to establish appropriate reserves for rights to refunds or exchange, liberal cancellation or refusal rights or liberal or unconditional rights of return granted through undisclosed oral or written side agreements
6. Recognition of revenue when products or services are not delivered, delivery is incomplete, or delivered without customer acceptance.

Source: Deloitte Forensic Center June 2007
What Are The Most Common Types of Revenue Recognition Fraud? (cont’d)

Top 6 Fraud Schemes:

- The ‘top’ 6 fraud schemes listed above account for 70% of all revenue recognition schemes identified.
- Recording fictional revenue is the most common type of revenue-recognition fraud.
- Next was recognizing inappropriate revenue from swaps, “round-tripping,” or barter arrangements.
- The remaining four subtypes were fairly evenly distributed.

Source: Deloitte Forensic Center June 2007
SOME MEASURES TO PREVENT FRAUD
“Tone at the Top”

What if the Corporate Code says “Do the Right Thing” but the Corporate Culture says “Do Whatever it takes to Close the Deal”? 
Types of Management Behavior Underlying Restatements

- Normal human error
- Understaffing/under-resourcing
- Willful blindness
- “Aggressive” favorable accounting treatment
  - Somewhat justified?
  - Totally bogus?
- Aggressive sales pitch to auditors
- Intentional deception
- Intentional deception plus deliberate cover-up
Quiz – Fraud Triangle

The concept of the fraud triangle states that, for a fraud to occur, three factors generally are present. Which of the following is NOT one of the three sides of the fraud triangle?

a. Criminal predisposition
b. Incentive or pressure
c. Perceived opportunity
d. Rationalization

Source: Journal of Accountancy May 2009
Risk Factors Contributing to Fraud

- Earning pressure from investors/stakeholders
- Tight loan covenants or credit renewals
- Aggressive compensation arrangements
- Management under scrutiny for poor performance
- Aggressive growth strategies
- Industry marked by aggressive players
Some Leading Indicators for Financial Statement Fraud

- Sudden change in financial management positions
- Change in auditors
- Poor audit committee communication
- Excessive related party transactions
- Financial statement trends that don’t make sense
- Frequent significant top-side accounting adjustments
Quiz – Ways to Prevent Fraud

In general, the best way to prevent fraud is to:

a. Implement harsh penalties for perpetrators
b. Outsource all possible functions
c. Increase the perception of detection
d. Conduct covert audits

Source: Journal of Accountancy May 2009
Establishing the Right Tone for Ethical Culture

- Talk about the importance of ethics
- Model ethical conduct
- Keep promises and commitments
- Keep employees informed
- Hold employees accountable

Source: P. Harned, Compliance Week, 9/6/06
Creating a Culture to Prevent Financial Fraud

- Fraudulent financial reporting by upper-level management typically involves override of internal controls within the financial reporting process. Because management has the ability to override controls, or to influence others to perpetrate or conceal fraud, the need for a strong value system and a culture of ethical financial reporting becomes increasingly important. This helps create an environment in which other employees will decline to participate in committing a fraud and will use established communication procedures to report any requests to commit wrongdoing. The potential for management override also increases the need for appropriate oversight measures by the board of directors or audit committee...
• Fraudulent financial reporting by lower levels of management and employees may be deterred or detected by appropriate monitoring controls, such as having higher-level managers review and evaluate the financial results reported by individual operating units or subsidiaries. Unusual fluctuations in results of particular reporting units, or the lack of expected fluctuations, may indicate potential manipulation by departmental or operating unit managers or staff.

Source: Statement on Auditing Standards No. 99, Considerations of Fraud in a Financial Statement Audit by American Institute of Certified Public Accountants, Inc.
COMMUNICATION IS KEY

Proposed SAS on Consideration of Fraud emphasizes communication

- Management representations and communications
- Discussion among audit team
- Communication with those charged with governance
- Communication with regulatory and enforcement authorities
- Document communications
Quiz-Audit Requirements re: Fraud

Which of the following is NOT a required element of an audit conducted in accordance with AU section 316, *Consideration of Fraud in a Financial Statement Audit*:

a. Professional skepticism
b. Knowledge of the company’s business
c. Use of fraud risk factor checklist
d. Brainstorming session

*Source: Journal of Accountancy May 2009*
AU sec. 380 requires the auditor to discuss with the audit committee the auditor’s judgments about the quality, not just the acceptability, of the company’s accounting principles.

What does “Quality” mean in this context?
[T]he auditor should evaluate whether the company’s controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include:

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.
Suggested Measures to Prevent Financial Statement Fraud

- Adopt a culture of high ethical values
- Adopt a culture of accountability
- Build trust with employees; open-door policy
- Talk about the possibility of fraud
- Give permission to blow the whistle
- Analytic review of financial statements
  - Why did the ratio *not* change
  - Inconsistencies
  - Healthy skepticism
- Emphasize sustainable growth over short-term gains
SEC Enforcement

Mary Schapiro
Heavy SEC Caseload

Number of settled enforcement actions, by year:

<table>
<thead>
<tr>
<th></th>
<th>All Types</th>
<th>Misstatements</th>
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<tr>
<td>2006</td>
<td>678</td>
<td>104</td>
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<tr>
<td>2007</td>
<td>716</td>
<td>170</td>
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<td>2008</td>
<td>659</td>
<td>135</td>
</tr>
<tr>
<td>2009</td>
<td>609</td>
<td>122</td>
</tr>
<tr>
<td>2010</td>
<td>681</td>
<td>108</td>
</tr>
</tbody>
</table>

From 2002 to 2008, the SEC settled with a total of 197 companies and 700 individuals on charges related to misstatement cases.

SEC Aggressively Pursues Enforcement Against Accountants

- CPA Firms
- Individual CPAs in public accounting
- CPAs in industry
  - CFOs
  - Controllers
  - Lower-level accountants
  - Other financial executives
- Also – Audit Committee members
Are You “Practicing Before the Commission”? 

Some accountants who may be:

- CFOs, controllers, other financial professionals
- Internal and external auditors
- Consultants who provide data for SEC reports or assist auditors

If so, subject to regulation by the SEC under Rule 102(e)
Recent SEC Case – Carole D. Argo, CPA (9/08) CFO of SafeNet, Inc.

- Allegations include:
  - fraudulent option backdating scheme
  - falsified documents for auditors
- Six months imprisonment, $1 million fine, barred from SEC practice
Recent SEC Case – Scott Veech, CPA (1/10) CFO of Merge Healthcare, Inc.

- Allegations include improper revenue recognition
- $280,000 in penalties or disgorgement, three year suspension
Will You Be Prosecuted?

Antonia Chion, Associate Director, identified factors that the Division of Enforcement will consider in evaluating option backdating cases:

• How egregious was the conduct?
• What is the quality of the evidence?
  – e.g., is there evidence of alteration or falsification?
• The duration of the conduct (number of instances of backdating)?
• What is the quantitative materiality of unrecorded compensation expense?
• Is there a restatement and, if so, how large?
Will You Be Prosecuted?

(cont’d)

• Scienter – What is the knowledge of the individuals?
• Is there evidence of concealment, obstruction or lying?
• Does anyone have money in pocket?
• Did other non-options misconduct occur?
• What about cooperation and remedial acts?
RESTATEMENT CASE STUDY
Restatement Case Study – Fraud – Gemstar-TV Guide

Gemstar restated its financials for the 3 years ending 2002 after alleged fraud in its revenue recognition

- Restated revenue by $357M
- CEO fired, pled guilty, fined
- Company settled with SEC for $10M
Restatement Case Study – Fraud – Gemstar-TV Guide

(cont’d)

• Gemstar manipulated revenue in three ways:
  – Record revenue of expired, disputed or non-existent agreements
  – Revenues from round-tripping or non-monetary transactions
  – Shifted revenues from other divisions to its IPG sector
Restatement Case Study – Fraud – Gemstar-TV Guide
(cont’d)

- Charged KPMG, a partner, two former partners and a manager on the Gemstar audit
- Sanctions:
  - $10 million to firm
  - Individuals barred from SEC practice
  - Additional training on revenue recognition issues and materiality
  - Adopt new policies re: consultation with national office
Restatement Case Study – Fraud – Gemstar-TV Guide
(cont’d)

• SEC says KPMG
  – Knew or should have known:
    ➢ The revenue recognition was improper
    ➢ Footnote disclosure was wrong
  – Over-relied on management representations
  – Failed to exercise professional skepticism
  – Failed to adequately assess qualitative materiality
Compare financial statements before and after restatement:

Before:
http://www.sec.gov/Archives/edgar/data/923282/000101706202000604/d10k405.htm

After:
http://www.sec.gov/Archives/edgar/data/923282/000095016803001148/d10ka.htm
Restated 10-K has a Restatement FN with 27 bullet points, including the following:

During the year ended December 31, 2001, the nine months ended December 31, 2000 and the year ended March 31, 2000, the Company recognized licensing revenues under expired license agreements with certain consumer electronic manufacturing licensees. The Company has determined that there is insufficient contemporaneous evidence of such licensees’ intent to pay to satisfy the collectibility criteria of SAB No. 101. Therefore, the revenues should be recorded in the periods that the related cash was received by the Company. As a result of this restatement, revenues and pre-tax income in the Technology and Licensing sector have decreased by $9.5 million, $1.2 million and $4.7 million for the year ended December 31, 2001, the nine months ended December 31, 2000 and the year ended March 31, 2000, respectively.
Restatement Case Study – Fraud – Gemstar-TV Guide

(cont’d)

- Audit Risks:
  - Revenue recognition – always a sensitive area
  - Rapid growth and acquisitions
  - Compensation arrangements gave executives substantial incentives to inflate results
  - Were there indications of weak control environment and tone at the top?
DODD-FRANK WHISTLEBLOWER RULES
Whistleblower Rules

Adopted by SEC to implement the Dodd-Frank Whistleblower provisions, the Dodd-Frank whistleblower provisions are among the most far-reaching changes enacted by the Act, and could have unpredictable effects.

The new rules provide for bounties to be paid and for greatly enhanced protections for whistleblowers.

SEC Chairman Mary Schapiro commented, “Too many people remain silent in the face of fraud,” and the new rules “are intended to break the silence of those who see a wrong.”
The Whistleblower Bounty

• A bounty paid to a whistleblower who voluntarily provides “original information” about a possible federal securities law violation that has occurred, is ongoing, or is about to occur

• 10 to 30 percent of any monetary sanctions collected if they exceed $1 million
The Whistleblower Bounty
(cont’d)

• A whistleblower will become eligible for an award by:
  – voluntarily providing information not previously known to the SEC
  – that leads to a successful enforcement action
  – in which the SEC or authorities obtain monetary sanctions totaling more than $1 million
The auditor's inquiries regarding fraud risks should include the following:

(a) Inquiries of management regarding: … (5) Whether and how management communicates to employees its views on business practices and ethical behavior; (6) Whether management has received tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, management's responses to such tips and complaints; and (7) Whether management has reported to the audit committee on how the company's internal control serves to prevent and detect material misstatements due to fraud
(b) Inquiries of the audit committee, or equivalent, or its chair regarding: … (3) Whether the audit committee is aware of tips or complaints regarding the company's financial reporting (including those received through the audit committee's internal whistleblower program, if such program exists) and, if so, the audit committee's responses to such tips and complaints; and
AGG’s Securities and Corporate Governance Practice

Arnall Golden Gregory LLP counsels public and private companies, as well as officers, directors, investors, and underwriters, in matters regarding transactions, compliance, and corporate governance. Our clients include entrepreneurial private companies, as well as companies listed on NYSE, NASDAQ, AMEX, and OTC Bulletin Board. We work together with those clients to provide solutions that make sense given their goals and resources.

We regularly counsel companies and underwriters in a variety of complex securities transactions, including initial and follow-on public offerings, “going private” and “roll-up” transactions, mergers, PIPES offerings, and private offerings.