Fraudulent Financial Reporting and Litigation/Regulatory Action

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CARE Conference

August 5, 2016
Topics for Discussion

• Navigating the litigation and regulatory enforcement landscape

• Proxies for fraudulent financial reporting

• The frequency of fraudulent financial reporting and litigation/regulatory action

• Common fraud schemes

• Issues to consider in connection with research
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Fraudulent Financial Reporting

• A material misrepresentation resulting from an intentional failure to report financial information in accordance with generally accepted accounting principles.

  Center for Audit Quality, Deterring and Detecting Financial Reporting Fraud A Platform for Action, October 2010

• Intentional deception through a material misrepresentation or omission in connection with the purchase or sale of a security.

  SEC Rule 10b-5

• Intentional acts, misstatements or omissions, that result in a material misstatement in financial statements, designed to deceive users and where the effect causes financial statements not to be presented in conformity with GAAP.

  AU 316.05 and .06

• Fraud is a crime of extraordinary variety, limited only by human imagination, that is as old as falsehood and as versable as human ingenuity.

  Courts throughout the United States
Shared Responsibility to the Investing Public for Mitigating the Risk of Financial Reporting Fraud

Principal Anti-Fraud Role
- Oversight of tone at the top, financial reporting, internal & external auditor
- Solid knowledge of industry/business
- Understanding of fraud risks

- Independence and objectivity
- Ability to challenge management, the board, and the audit committee
- Assess fraud risks and monitor controls

- Independence and objectivity
- Ability to challenge management, the board, and the audit committee
- Assess fraud risks as part of audit planning and execution

- Strong tone at the top
- Maintenance of effective internal controls
- Robust fraud risk management program

## Navigating the Landscape

<table>
<thead>
<tr>
<th></th>
<th>Company</th>
<th>Board Audit Committee Management</th>
<th>Auditor (Firm &amp; Individuals)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC</td>
<td>✔️</td>
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</tr>
<tr>
<td>PCAOB</td>
<td>✔️</td>
<td></td>
<td>✔️</td>
</tr>
<tr>
<td>AICPA / State Board of Accountancy</td>
<td>✔️</td>
<td>*</td>
<td>✔️</td>
</tr>
<tr>
<td>State Regulators</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>DOJ</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Shareholders</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
</tbody>
</table>

* Only subject to enforcement if a CPA and/or AICPA member
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Proxies for Fraudulent Financial Reporting?

Allegation
- “Academic” Models
  - Earnings Management/Manipulation
  - Fraud Prediction
- Restatement
- Private securities litigation
- Regulatory
  - Investigation
  - Filing of an action

Settlement
- Private securities litigation
- Regulatory enforcement

Finding
- Investigative conclusion
- Judge / jury

Admission
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SEC Allegations of Auditor Deficiencies in Connection with Alleged Fraud Have Been Rare

• During 1998–2010, approximately 9,500 entities filed financial statements with the SEC on an annual basis

• There were 87 instances where the SEC leveled sanctions against an auditor in connection with alleged fraud during that period, 35 of which involved national firms

• The most common deficiencies noted were:
  – Failure to exercise due professional care
  – Insufficient levels of professional skepticism
  – Inadequate identification and assessment of risks
  – Failure to respond to identified risks with appropriate audit responses to gather sufficient competent evidence

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# Fraud Taxonomy

## TOP FRAUD CATEGORIES

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Premature Revenue Recognition</strong></td>
<td><strong>Omitted or Improper Disclosures</strong></td>
</tr>
<tr>
<td><strong>Fictitious Revenues</strong></td>
<td><strong>Related Party Transactions</strong></td>
</tr>
<tr>
<td><strong>Overvalued Assets and Undervalued Expenses/Liabilities</strong></td>
<td></td>
</tr>
</tbody>
</table>

## OTHER CATEGORIES

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fictitious Assets and/or Reductions of Expenses/Liabilities</strong></td>
<td><strong>“Wrong Way” Frauds</strong></td>
</tr>
<tr>
<td><strong>Omitted or Undervalued Liabilities</strong></td>
<td><strong>Equity Frauds</strong></td>
</tr>
<tr>
<td><strong>Misclassifications</strong></td>
<td><strong>Illegal Acts</strong></td>
</tr>
</tbody>
</table>


Illustrative Fraud Schemes

- Fictitious Revenues
  - Not Based on Firm Orders
  - Percentage: 19%

- Overvalued Assets and Undervalued Expenses/Liabilities
  - Undervalued Allowance for Bad Debts or Loan Losses
  - Percentage: 18%

- Omitted or Improper Disclosures
  - On Accounting Policy
  - Percentage: 17%

- Related Party Transactions
  - Disclosure Problems
  - Percentage: 16%


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Appendix
SEC Enforcement Actions
Increased in the Past Two Years

Financial Fraud/Issuer Disclosure  Other Enforcement Actions

<table>
<thead>
<tr>
<th>Year</th>
<th>Financial Fraud/Issuer Disclosure</th>
<th>Other Enforcement Actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>185</td>
<td>630</td>
</tr>
<tr>
<td>2006</td>
<td>138</td>
<td>574</td>
</tr>
<tr>
<td>2007</td>
<td>219</td>
<td>656</td>
</tr>
<tr>
<td>2008</td>
<td>157</td>
<td>671</td>
</tr>
<tr>
<td>2009</td>
<td>143</td>
<td>664</td>
</tr>
<tr>
<td>2010</td>
<td>126</td>
<td>681</td>
</tr>
<tr>
<td>2011</td>
<td>109</td>
<td>735</td>
</tr>
<tr>
<td>2012</td>
<td>94</td>
<td>734</td>
</tr>
<tr>
<td>2013</td>
<td>73</td>
<td>676</td>
</tr>
<tr>
<td>2014</td>
<td>106</td>
<td>755</td>
</tr>
<tr>
<td>2015</td>
<td>148</td>
<td>807</td>
</tr>
</tbody>
</table>

Source: SEC

Note: The Division of Enforcement adjusted its definition of Enforcement Actions starting in 2013 so as to exclude 21(a) Reports and certain civil contempt matters. Under the prior definition, the total for Fiscal Year 2013 is 686.
Accounting Class Action Filings Increased in Recent Years

Few Accounting Class Action Filings Involve Restatements

<table>
<thead>
<tr>
<th>Year</th>
<th>N</th>
<th>Non-Restatement Cases</th>
<th>Restatement Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>28</td>
<td>(41%)</td>
<td>41 (59%)</td>
</tr>
<tr>
<td>2007</td>
<td>48</td>
<td>(62%)</td>
<td>29 (38%)</td>
</tr>
<tr>
<td>2008</td>
<td>75</td>
<td>(77%)</td>
<td>22 (23%)</td>
</tr>
<tr>
<td>2009</td>
<td>45</td>
<td>(74%)</td>
<td>16 (26%)</td>
</tr>
<tr>
<td>2010</td>
<td>43</td>
<td>(73%)</td>
<td>16 (27%)</td>
</tr>
<tr>
<td>2011</td>
<td>53</td>
<td>(66%)</td>
<td>27 (34%)</td>
</tr>
<tr>
<td>2012</td>
<td>28</td>
<td>(62%)</td>
<td>17 (38%)</td>
</tr>
<tr>
<td>2013</td>
<td>28</td>
<td>(60%)</td>
<td>19 (40%)</td>
</tr>
<tr>
<td>2014</td>
<td>40</td>
<td>(58%)</td>
<td>29 (42%)</td>
</tr>
<tr>
<td>2015</td>
<td>50</td>
<td>(70%)</td>
<td>21 (30%)</td>
</tr>
</tbody>
</table>

Accounting Class Actions Comprise the Majority of Settlements

Accounting Class Actions Represent a Significant Portion of Settlement Dollars

Note: Dollars in Billions. Settlement dollars are adjusted for inflation; 2015 dollar equivalent figures are used.