

# Fraudulent Financial Reporting and Litigation/Regulatory Action

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CARE Conference

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# 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

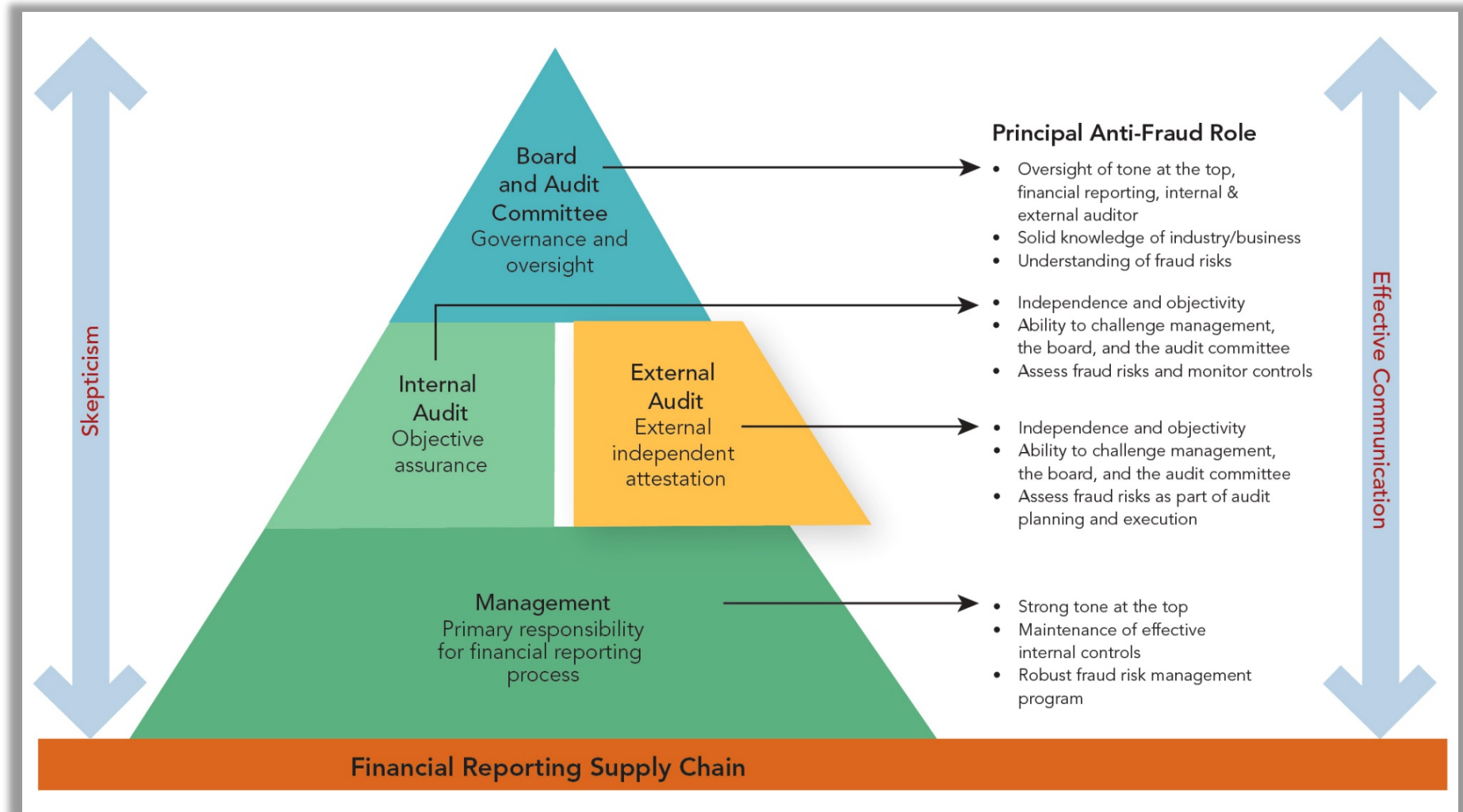
- Intentional acts, misstatements or omissions, that result in a material misstatement in financial statements, designed to deceive users and where the effect causes financial statements not to be presented in conformity with GAAP.

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



Source: *Detering and Detecting Financial Reporting Fraud: A Platform for Action*, Center for Audit Quality, 2010.

# Navigating the Landscape

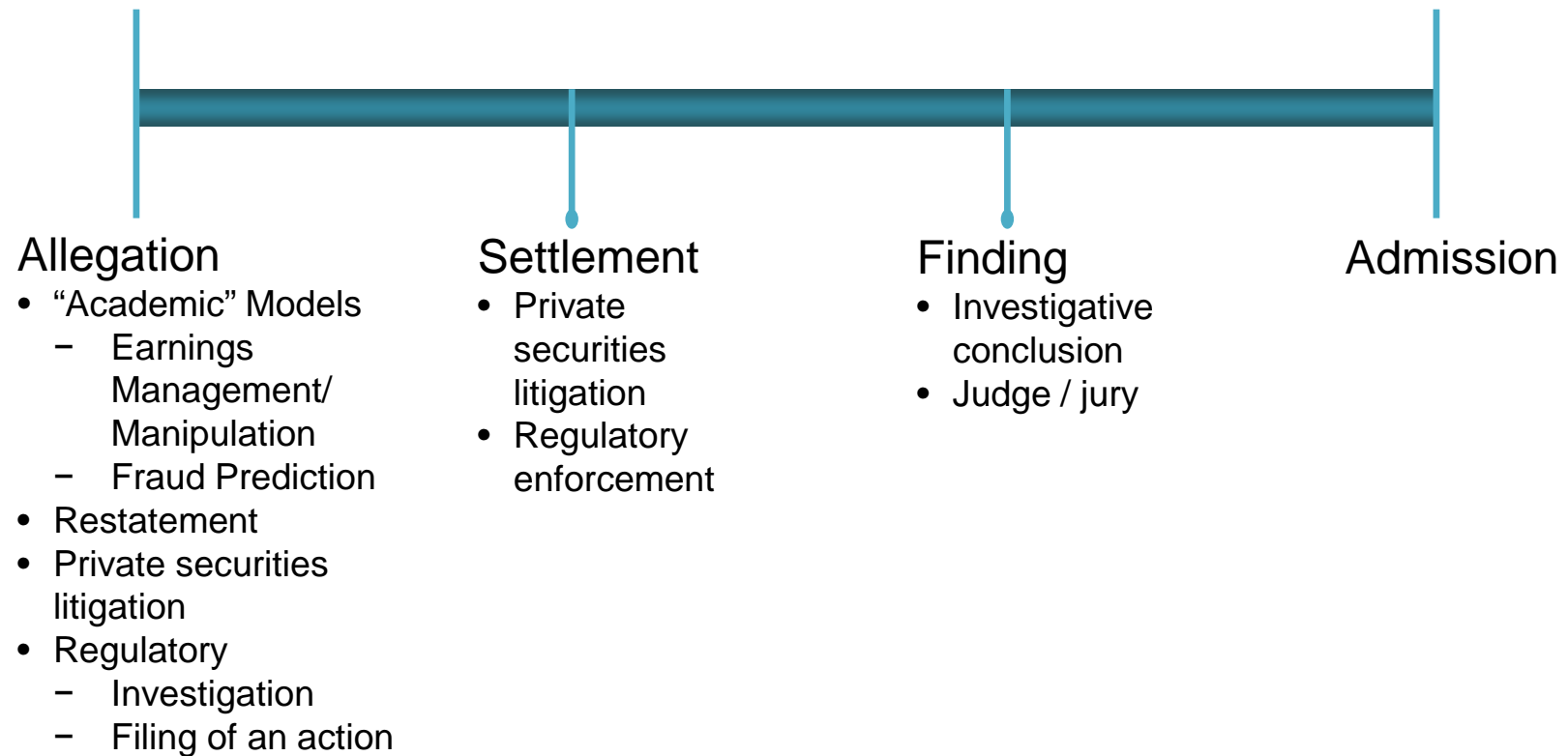
	Company	Board Audit Committee Management	Auditor (Firm & Individuals)
SEC	✓	✓	✓
PCAOB			✓
AICPA / State Board of Accountancy		✓ *	✓
State Regulators	✓	✓	✓
DOJ	✓	✓	✓
Shareholders	✓	✓	✓

\* Only subject to enforcement if a CPA and/or AICPA member

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# Proxies for Fraudulent Financial Reporting?





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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

Source: Beasley, Carcello, Hermanson, and Neal, *An Analysis of Alleged Auditor Deficiencies in SEC Fraud Investigations: 1998- 2010*, May 2013.

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# Fraud Taxonomy

## TOP FRAUD CATEGORIES

- |  |   |
|--|---|
| <ul style="list-style-type: none"> <li>• Premature Revenue Recognition</li> <li>• Fictitious Revenues</li> <li>• Overvalued Assets and Undervalued Expenses/Liabilities</li> </ul> | <ul style="list-style-type: none"> <li>• Omitted or Improper Disclosures</li> <li>• Related Party Transactions</li> </ul> |
|--|---|

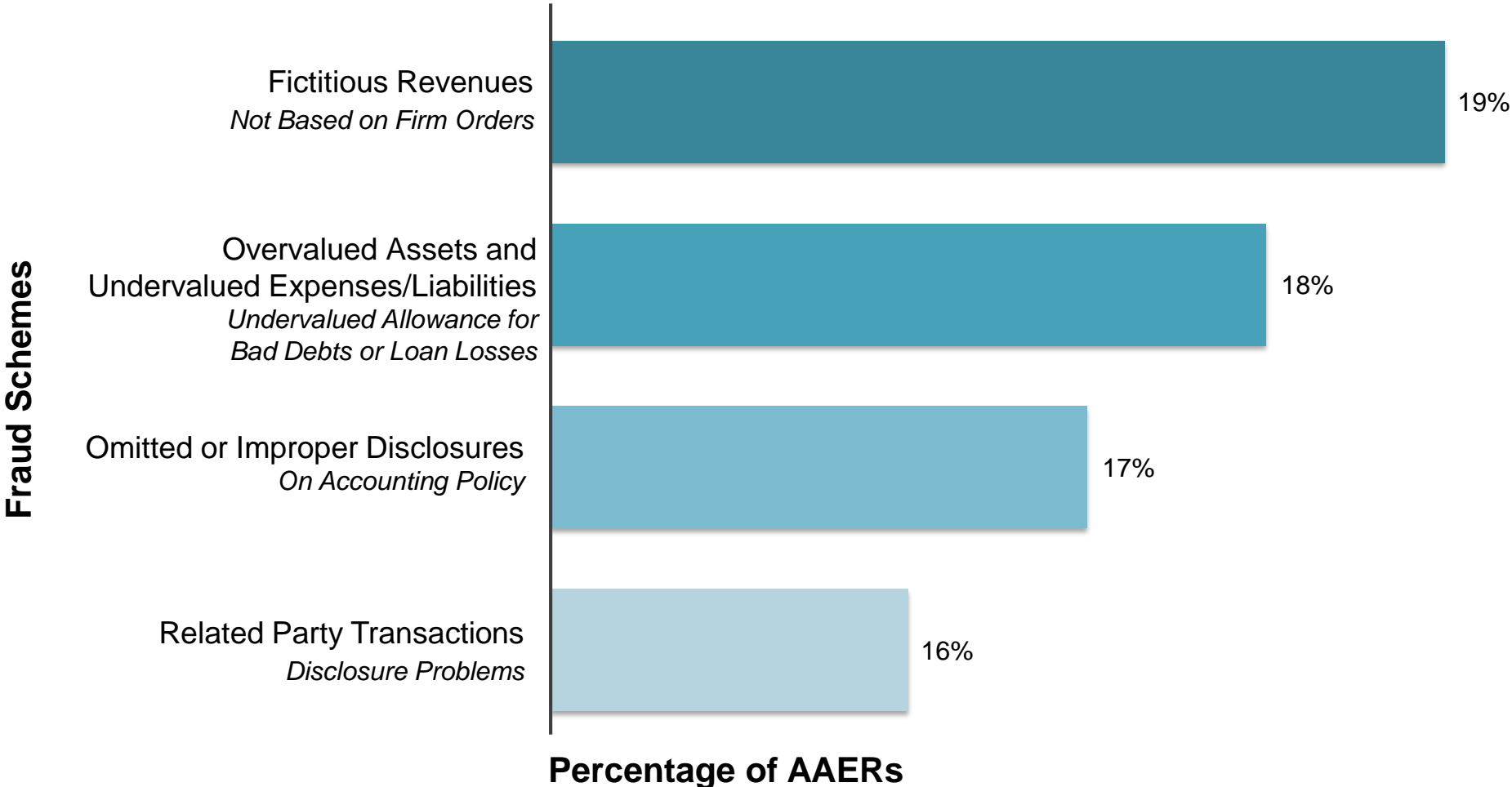
## OTHER CATEGORIES

- |   |   |
|---|---|
| <ul style="list-style-type: none"> <li>• Fictitious Assets and/or Reductions of Expenses/Liabilities</li> <li>• Omitted or Undervalued Liabilities</li> <li>• Misclassifications</li> </ul> | <ul style="list-style-type: none"> <li>• “Wrong Way” Frauds</li> <li>• Equity Frauds</li> <li>• Illegal Acts</li> </ul> |
|---|---|

Source: Bonner, Sarah E., Zoe-Vonna Palmrose, and Susan M. Young, *Fraud Type and Auditor Litigation: An Analysis of SEC Accounting and Auditing Enforcement Releases*, *The Accounting Review* Vol. 73, No. 4, October 1998, pp. 503–532.

Note: Full taxonomy reprinted as Appendix C in “Education and Training in Fraud and Forensic Accounting: A Guide for Educational Institutions, Stakeholder Organizations, Faculty and Students” (DOJ Program, National Institute of Justice, March 2007), pp. 53–59.

# Illustrative Fraud Schemes



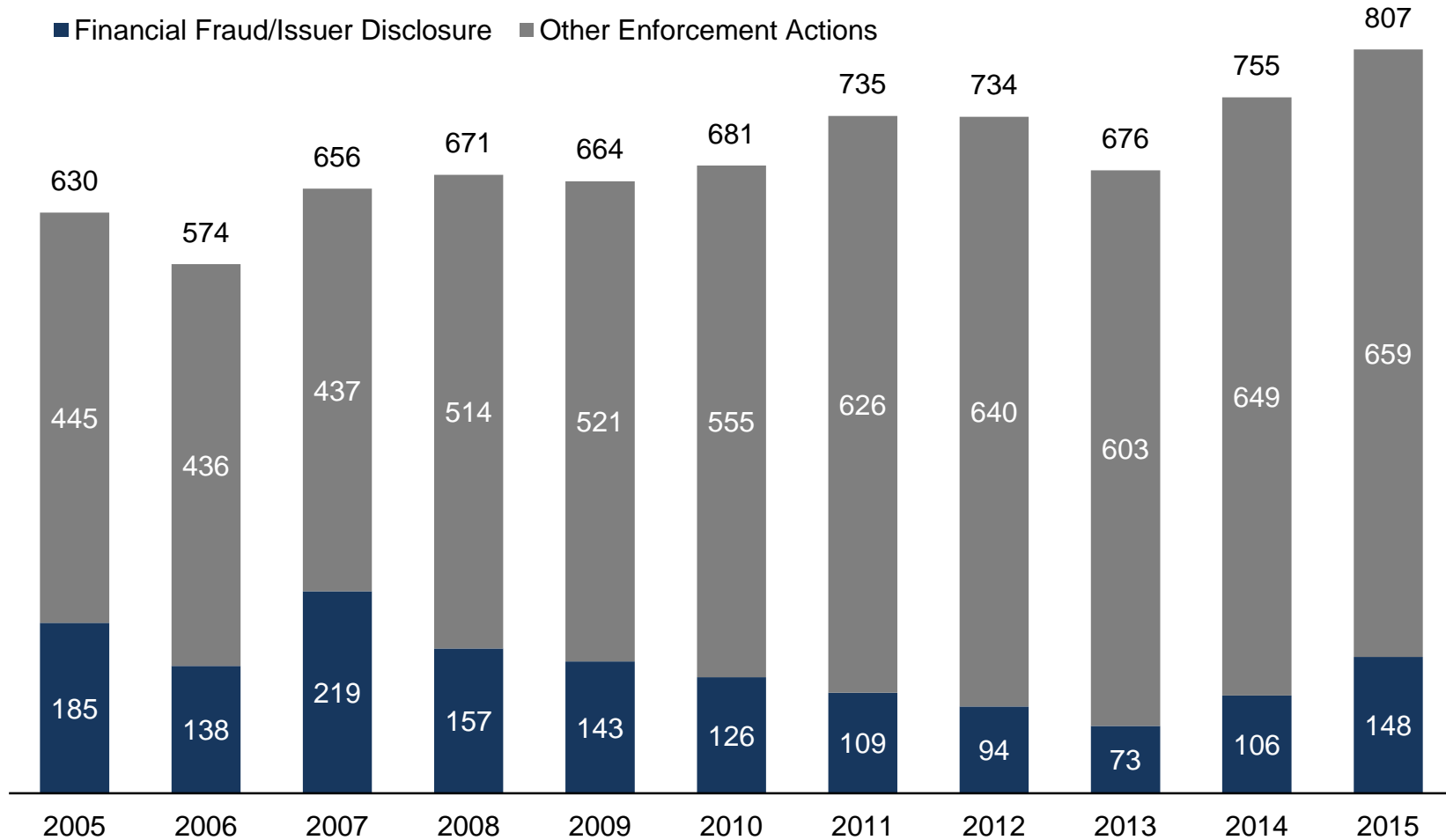
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# Appendix

# SEC Enforcement Actions Increased in the Past Two Years



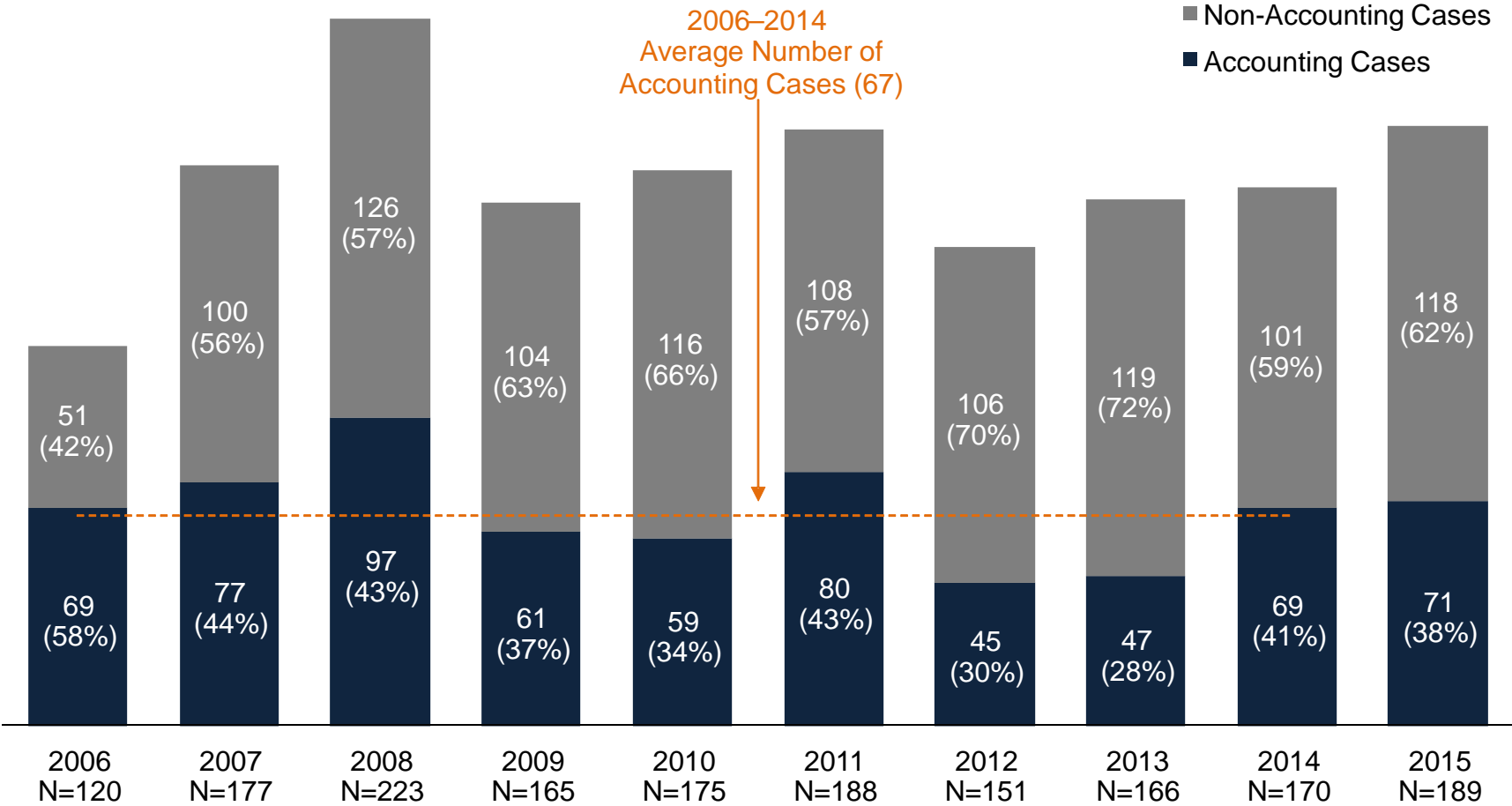
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Source: SEC

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.



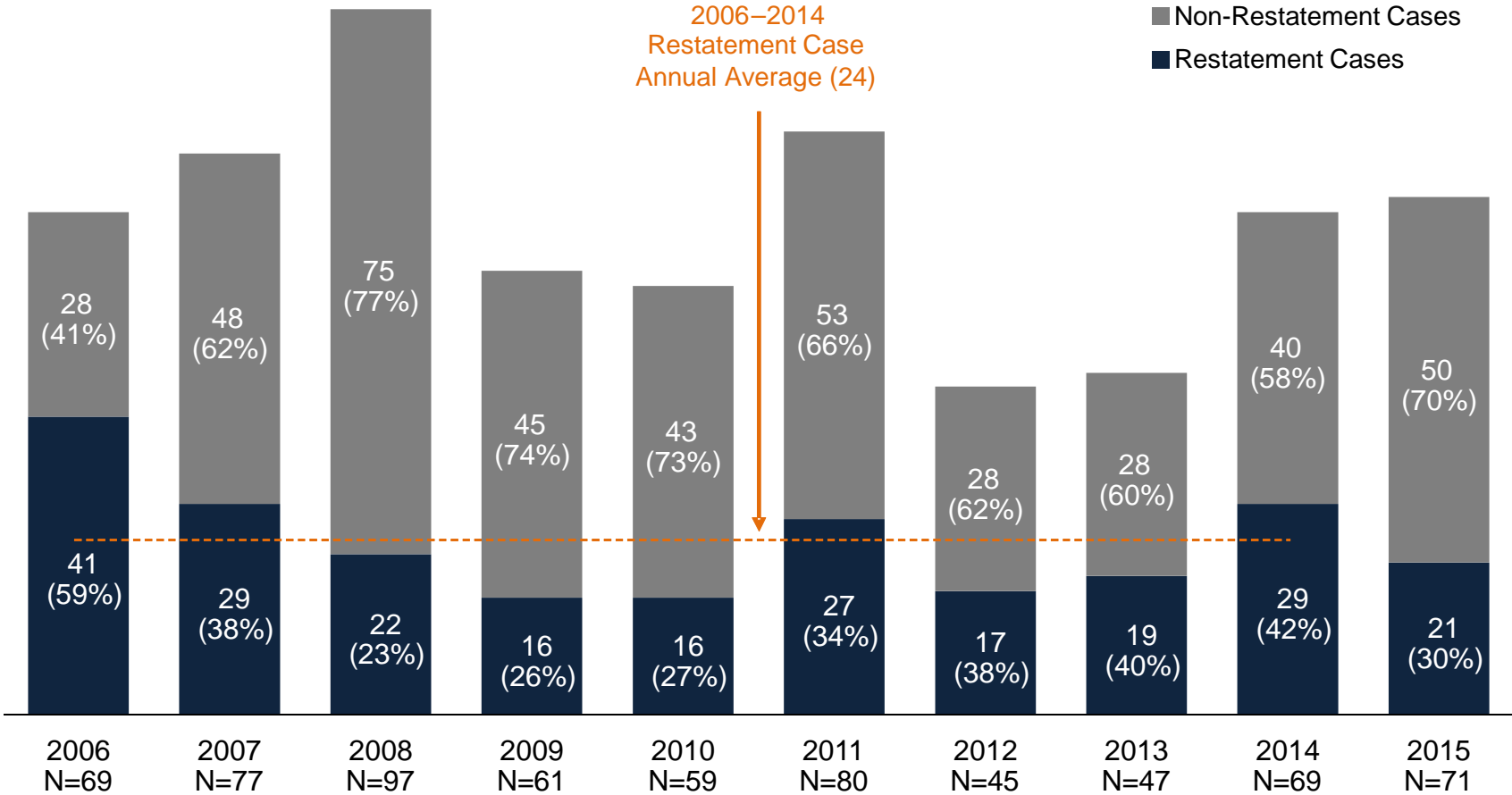
# Accounting Class Action Filings Increased in Recent Years



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Source: Accounting Class Action Filings and Settlements –2015 Review and Analysis, Cornerstone Research, 2016.

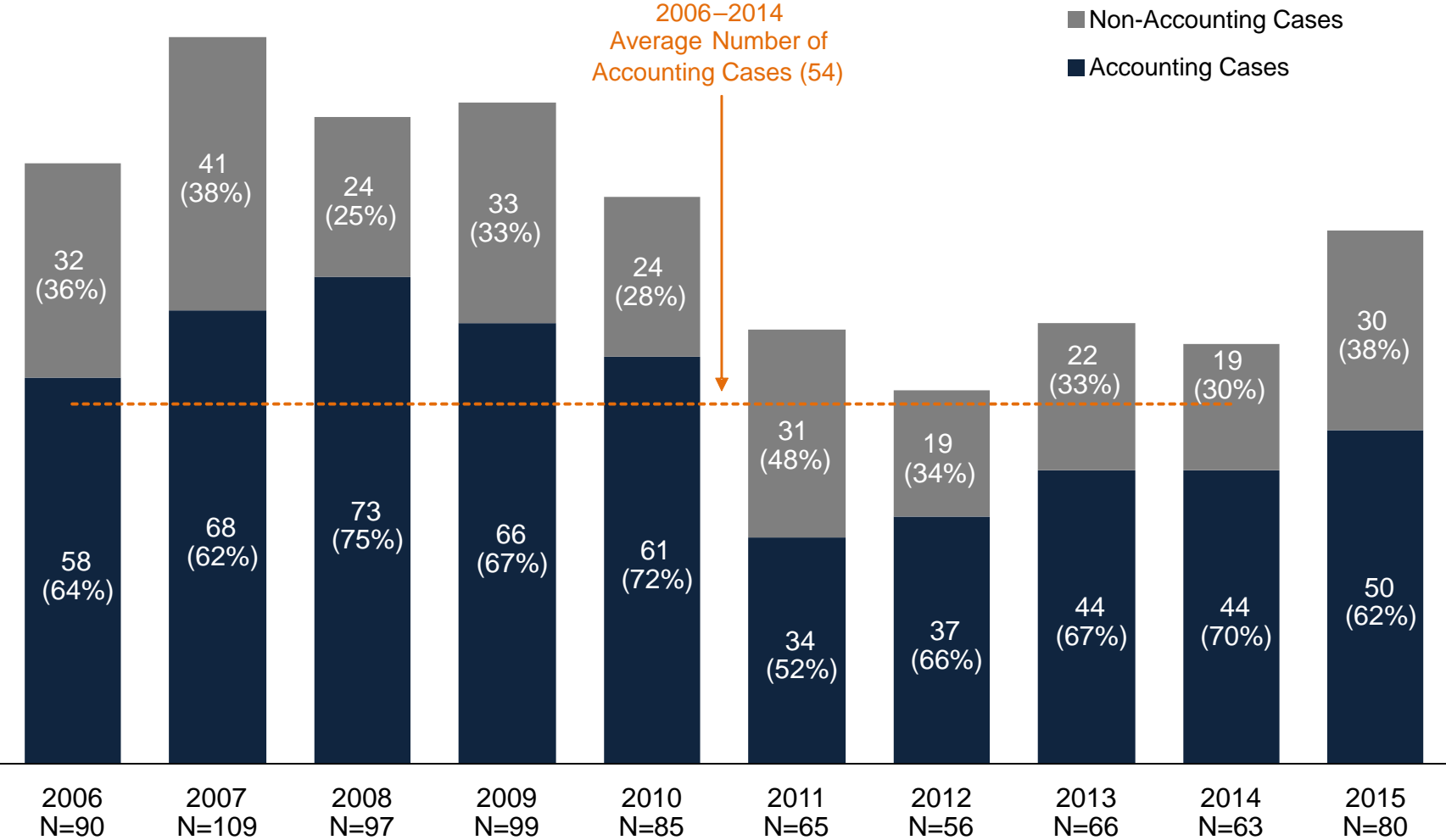
# Few Accounting Class Action Filings Involve Restatements



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Source: Accounting Class Action Filings and Settlements –2015 Review and Analysis, Cornerstone Research, 2016.

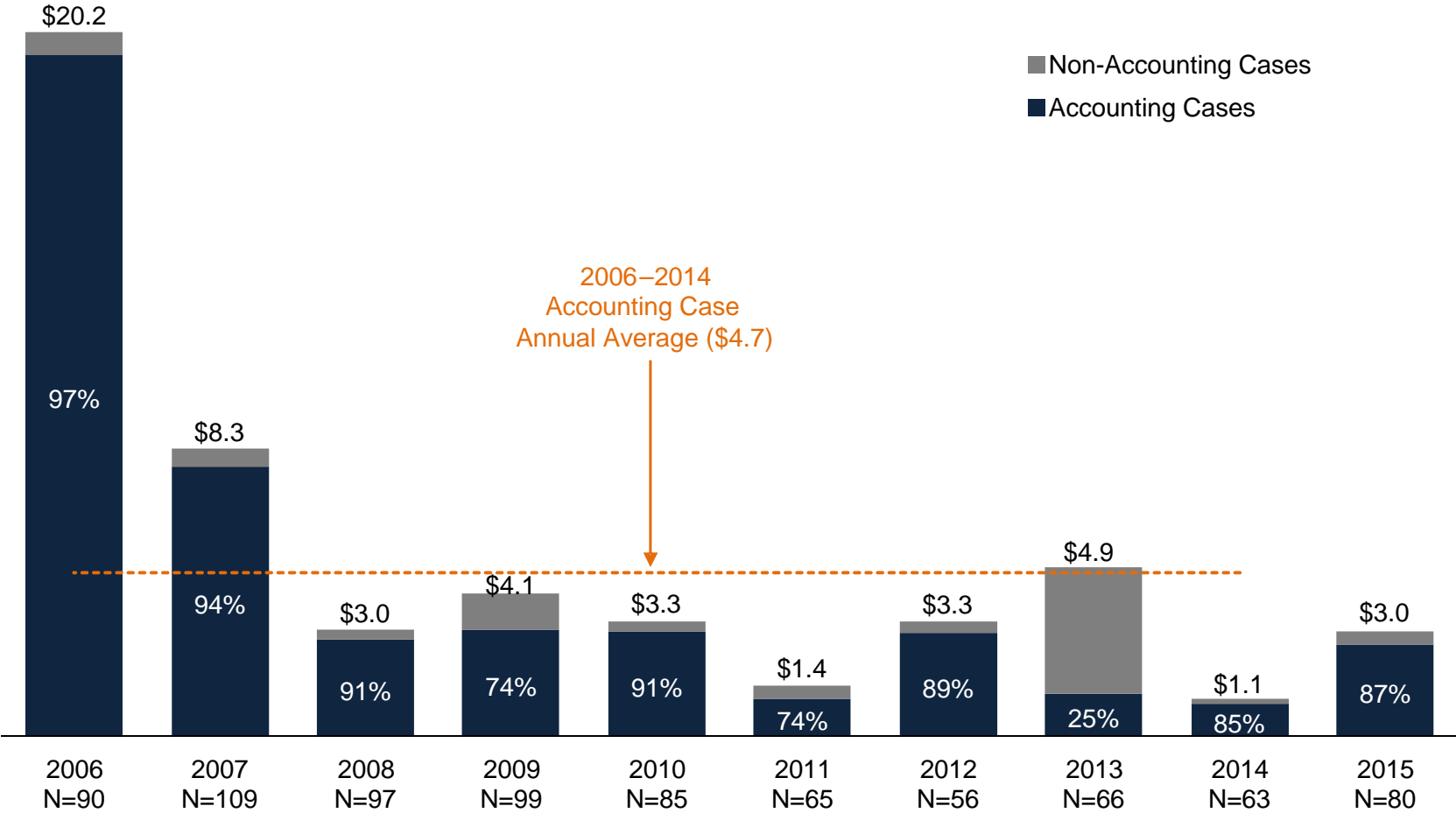
# Accounting Class Actions Comprise the Majority of Settlements



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Source: Accounting Class Action Filings and Settlements –2015 Review and Analysis, Cornerstone Research, 2016.

# 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.

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Source: *Accounting Class Action Filings and Settlements – 2015 Review and Analysis*, Cornerstone Research, 2016.