

# Financial Reporting Fraud: Prevention & Detection

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# Outline of Presentation

- Definition of Financial Reporting Fraud
- Review of recent fraud cases
- Causes & Indicators
- Susceptible Areas
- Prevention and Detection Techniques
- Fraud Risk Assessment

# Definition of Financial Reporting Fraud

*Financial Reporting Fraud can be defined as:*

- The intentional manipulation of financial reports (data, footnotes and analyses) to present a desired result that is inconsistent with actual results. A desired result could include achievement of a profitability goal, exceeding or meeting predefined targets, minimization of a loss or the description of activities in an incomplete or misleading manner.

# Fraud Statistics

**45 Administrative SEC enforcement actions in 2007 (383 since 2000) (44 in 2006)**

- | <b>2007</b>  | <b>2006</b> |                                |
|--------------|-------------|--------------------------------|
| ● <b>38%</b> | <b>41%</b>  | <b>Revenue recognition</b>     |
| ● <b>11%</b> | <b>12%</b>  | <b>Improper of Disclosures</b> |
| ● <b>11%</b> | <b>11%</b>  | <b>Expense Manipulation</b>    |
| ● <b>8%</b>  | <b>8%</b>   | <b>Asset Manipulation</b>      |
| ● <b>8%</b>  | <b>7%</b>   | <b>Liability Manipulation</b>  |
| ● <b>7%</b>  | <b>7%</b>   | <b>Reserve Manipulation</b>    |
- 
- **Technology, Media Telecommunications responsible for 37% of schemes, Consumer Business 29%**

# Company 1

- \$65 billion Ponzi scheme
- Fraud went undetected for decades
- Knowledge of the way markets work and how regulators thought helped him design a scheme that escaped detection
- Failure to follow normal business practices did not raise red flags (fees, email usage, electronic retention)
- Whistleblower tips not properly investigated
- Examinations were not thorough due to difficulty in conducting

# Company 1 (cont.)

- Examinations not taken far enough when discrepancies arose
- Firm was not registered therefore avoided regulatory scrutiny
- Marketing of services by word of mouth, “a private club”
- Personal touch when questioned or investigated.
- Separate system with limited users and limited audit trails, used to process “fake” trades and produce statements.

# Company 2

- \$7.2 billion loss in trading as a result of the actions of a relatively junior trader
- Unauthorized directional risk, which he concealed by entering into fictitious offsetting trades
- Circumvent internal controls by using passwords and accounts that belonged to other employees
- Control and investigation of canceled or modified transactions appeared to be ineffective or non-existent
- No clear process for escalation of identified control issues
- Inadequate supervision
- Trader expected a large year end bonus
- Trader took only 4 days vacation in 2 years

# Company 3

- 4 years of restatements
- SEC Investigation
- 375 Investigators
- Involvement of Senior Management

**Reason: Pressure to meet Financial targets**

# Company 3 (cont'd)

- Adjustments to reserves
- Entries around the end of the quarter
- Incomplete or incorrect info to auditors
- Lack of proper tone at the top
- Inadequate staff accounting knowledge
- Journal entries lacked supporting documentation
- Journal entries were round dollars of \$3 - \$50 million
- Account reconciliations not performed timely and reconciling items not timely resolved
- Inadequate controls over accrued liabilities

# Why do you need to perform a Fraud Review?

- Companies subject to the Sarbanes-Oxley Act of 2002 are required to maintain a program designed to prevent and detect instances of financial reporting fraud. Additionally, Management is required to assert as part of their Sarbanes-Oxley assertion process (commencing as of September 30, 2004) as to the effectiveness of the controls designed to mitigate the risk of financial reports fraud.
- Financial reporting fraud conviction (willful)
  - \$5MM fine or
  - Up to 20 years imprisonment
  - or both

# Motivation for Financial Reporting Fraud?

- Perception that failure to achieve a desired financial result (e.g. profitability targets; expense reduction targets) can have a negative impact on an individual's compensation or promotion opportunity.
- Desire to please an individual's supervisor resulting in reluctance to communicate "bad news."
- A result that is mutually beneficial to an employee and his/her supervisor creating reluctance to investigate or fully analyze risks or events that may negatively impact results.
- Perception that results matter more in an individual's performance appraisal than compliance with controls or regulations.
- Perception that improper acts, if detected, will not result in significant consequences for the individual.

# Motivation for Financial Reporting Fraud? (continued)

- To present attractive results for investors
- To meet analyst/market expectations.
- To conceal an undesirable condition.
- To avoid the scrutiny of the regulators

# SEC Fraud Cases

- **“the fraudulent conduct described herein was driven by some former managers’ perceived need to meet or exceed the Company’s internal revenue and earnings goals, which were based, in part, on financial analysts expectations” (January 2000)**
- **“....to conceal his theft, he gave the appearance that the subsidiary was operating at a profit when it was not, and to earn performance bonuses, (Name) made false entries to the subsidiary’s books and records over a several year period”**

# SEC Fraud Cases (continued)

- **“Participated in a scheme to improperly convert unclaimed funds in the bank’s custody to its reserve and income accounts in order to meet the bank’s revenue and expense targets” (July 1999)**
- **“....her supervisors told her that (Company) Chief Financial Officer had generated the adjustments to inflate (Company) quarterly results so that the results would meet expectations of Wall Street analysts” (June 2000)**

# Economic Conditions and Fraud Survey

New challenges compliance executives are likely to face in the first recession of the post-Sarbanes-Oxley era.

- 70% say their company experienced reduction in revenues compared to projections for the past year.
- 27% expect “significant” budget cuts in the coming year.
- 46% expect fraud to increase “significantly” of “somewhat”.

# Economic Conditions and Fraud

Many steps companies implement to cope with economic downturn can increase fraud risks.

- Cost-cutting measures such as layoffs and pay cuts can leave employees feeling “disenfranchised”.
- Weaken or eliminate internal controls during restructuring.
- Other cost-cutting actions, such as turning to low-cost foreign suppliers or trying to sell to a global marketplace.

# Opportunities to Commit Financial Reporting Fraud?

- A weak control environment (See Attachment I)
- The absence of a segregation of duties or unclear job descriptions resulting in a lack of clarity of ownership allowing an individual to manipulate data to achieve a desired result.
- The absence of effective supervision allowing an individual (s) to manipulate data to present a desired result or avoid detection of an improper activity (e.g. remote locations; specialized or complex businesses; recently acquired entities or outsourced activities).
- The ability to create transactions to achieve a desired result (e.g. inter-company transactions; fictitious receivables; improper reserves; or manipulation of cut-off procedures).

# Opportunities to Commit Financial Reporting Fraud? (continued)

- Existence of manual processes that are susceptible to manipulation.
- Unfettered systems access that could result in unauthorized approvals or changes to data.
- The absence of sufficient resources allowing one or more individuals to circumvent established processes.
- Failure to perform sufficient background checks resulting in an individual(s) with the propensity or motivation to commit fraud assuming positions within the Company that allow them to manipulate data for their personal benefit.

# Preventing and Detecting Fraud

## ➤ Tone at the Top/Control Environment

**Control Environment** – The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control. It includes integrity, ethical values, competence of the entity's people, management's philosophy, roles and responsibilities and the tone at the top, which sets the basis for how risk is viewed and addressed by an entity's people. The ERM further expands this element to include Objective Setting, which ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entity's mission and are consistent with its risk appetite.

# Preventing and Detecting Fraud (continued)

- **Hiring Practices**
- **Code of Ethics**
- **Ethics Helpline/Whistleblower Program**
- **Education/Awareness**
- **Monitoring Activities**
  - **Conscientious Employees**
  - **Business Unit Risk Assessments**
  - **Fraud Risk Assessments**
- **Audit Committee Oversight (incl. SOX S.301)**

# Preventing and Detecting Fraud (continued)

- **Fix identified control deficiencies**
- **Monitor susceptible areas**
- **Develop issue escalation process**
- **Perform thorough Investigations**
- **Perform Internal Audits**
- **Consider mandatory 2 week vacations**

# Recommendations for mitigating fraud when companies must do more with less

- Continuous auditing and using software to do data mining and data analysis can spot trends.
- Re-emphasize Strong antifraud tone at the top.
- Documented plan of what to do when a fraud allegation arises.
- Update existing or create new fraud risk assessments.

# Fraud Risk Assessment

The following are the main objectives of these assessments:

- The identification of the most significant inherent environment and operational risks of financial reporting fraud in the business (Risks Considered)
- Identification of key drivers, which provide an indication of areas of vulnerability that may need special attention or require further review (Risk Indicators)
- Identification of key control activities and other factors that mitigate the risk of financial reporting fraud (Control Activities)
- Evaluation of the control activities and cross-referencing to the Sarbanes-Oxley Section 404 assessment of such activities (Comments)
- Description of action plans developed to reduce the risk of financial reporting fraud (Planned Actions)
- Overall evaluation of the environment and operating controls (Overall Assessment)

# Fraud Risk Assessment - Environment

Risks Considered	Risk Indicators	Control Activities	Comments	Planned Actions (Date and Responsible Executive)
Ethics	History of ethical complaints.	<ul style="list-style-type: none"> <li>Annual completion by management of conflict of interest survey that includes Code of Ethics acknowledgement.</li> <li>Ethics Office reviews complaints and addresses improvement opportunities with Management if appropriate.</li> </ul>	Independent review ensures 100% response to survey. Reviewer would investigate all complaints and look for trends.	
Hiring Practices	Inappropriate behavior detected in new hires.	New hires are subject to a background check, including Annuity personnel.		
	New hires not familiar with policies related to ethics.	Web based training for new employees will contain more content around ethics.	Business Unit is developing an onboarding program, which will include items such as the ethics program.	
Inappropriate Behavior	High incentives and temptations including pressure to meet unrealistic performance goals such as high performance-dependant rewards.	<p>A business is organized to segregate certain functions that could have a potential conflict of interest. For example,</p> <ul style="list-style-type: none"> <li>Controllers is independent from business</li> <li>Sales reporting is independent from Sales</li> <li>Operational areas separate from Sales</li> </ul>	Compliance, Finance, Law and Internal Audit report outside of the business organization. Corporate Actuarial also has oversight responsibilities for the Actuarial area imbedded within the business.	

# Environmental Aspects to Consider

- Policies & Procedures
  - Process to report unethical matters (whistleblower program)
  - Communication and training on policies; and method to report ethics issues
  - Conflict of interest surveys
  - Security policies
- Personnel
  - Adequate resources
  - Requisite skills
  - Hiring Practices / Background reviews

# Environmental Aspects to Consider (continued)

- Management Supervision
  - Span of control
  - Delegation of authority
  - Adequate monitoring of MIS
  - Proper incentives
  - Proper tone at the top
- Training Adequacy
- Organizational Structure
  - Segregation of Duties
  - Proper flow of monitoring information
- Mission Statement
  - Clarity & Communication
  - Strategic Plans to implement

# Environmental Aspects to Consider (continued)

- Fraud Prevention & Detection
  - Transaction data maintained
  - Special payee/address controls
  - Fraud awareness training
  - Quality review processes
  - Vendor due diligence
  - Loss accounts monitored
  - Non-public data controls
  - Adjusting journal entry review at closings
  - Management incentives to reach business targets

# Fraud Risk Assessment - Accounts

Risks Considered	Risk Indicators	Control Activities	Comments	404 Testing / Planned Actions
<p><b>Income Recognition</b></p> <p>Fraudulent sales may be added to the system.</p> <p>Sales that are not in good order may be recognized as new business.</p> <p>Sales may be reflected in the wrong period.</p> <p>Fees may be booked before they are earned.</p>	<p>Surge in sales revenue for last month of the quarter.</p> <p>Sales do not follow normal cycle.</p> <p>Small number of large sales at the end of the period that help make or exceed production target.</p> <p>Fee income is inconsistent with its drivers.</p>	<p>Sales and revenues are analyzed against plans and forecasts and shared with senior management.</p> <p>An automated interface exists between administrative systems and ledger.</p>	<p>Large-scale effect would need a systematic change or concerted effort in operations.</p>	<p>Sarbanes-Oxley related work in Operations</p>
<p><b>Accounts Payable, Borrowings and Other Liabilities</b></p> <p>Known errors may not be corrected or adjusted and accounted for.</p> <p>Liabilities may not be reflected in the A/P ledger.</p> <p>Improper payments may be made to fictitious or unauthorized payees.</p> <p>Known liabilities may not be booked or may be over-reserved for to allow smoothing.</p> <p>Changes in tax code or states' regulations may be improperly accounted for.</p>	<p>Major system limitation or investigation without a resulting liability.</p> <p>Manual vouchers and payments.</p> <p>Current or prior periods recording of expense that should have been previously reserved for.</p> <p>Significant variances between actual and planned or forecasted expenses.</p>	<p>Disbursement Authorization Guidelines.</p> <p>A/P authorization and authentication controls.</p> <p>Analytical review of A/P and Other Liabilities.</p>	<p>Areas independent of the business group providing oversight at a high level.</p> <p>Changes that result in a net zero change in overall results to plan may not be questioned</p>	<p>Business Unit controllers Sarbanes testing related to analytical review.</p> <p>Accounts Payable Sarbanes-Oxley around authorization controls</p>

# Susceptible Areas

- **Accounting for derivatives** (e.g. hedging; valuation; disclosure)
- **Accounting for acquisitions/dispositions** (e.g. accounting treatment; income/expense recognition; capitalization of expenses)
- **Accounting policy changes or aggressive accounting treatments**
- **Accounts receivables and payables** (including resetting of aging; cut-off procedures)
- **Accrued expenses** (e.g., omission of expenses; establishment of reserves)
- **Capitalization of expenses** (e.g., technology development costs)
- **Re-classifications of financial transactions** (to achieve a target)

# Susceptible Areas (continued)

- **Income or expense recognition** (e.g., acceleration of revenue recognition or deferral of expenses)
- **Valuation of assets** (e.g., valuation methodologies; impairment considerations)
- **Inter-company transactions**
- **Reserves** (various)
- **Special purpose vehicles and/or structured transactions**
- **Miscellaneous accounts: other assets/liabilities including suspense accounts**
- **Un-reconciled account differences** (various)
- **Large transactions at period end** (quarter or year-end)

# Enterprise Risk Assessment

- On an annual basis compile a Confidential “Watch List” of matters that may warrant close attention. Such matters might include businesses with aggressive expense reduction or revenue targets; major restructurings; acquisitions, divestitures and others. During the quarterly process referenced above, the status of “Watch List” items should be considered to determine if any further investigation is warranted.

# Enterprise Risk Assessment (continued)

- Review a listing of transactions identified during the quarterly close process. Upon completion of this review determine if any further investigations are necessary. Document the conclusions reached as a result of this review process.
- Review restatements, adjustments and unusual transactions identified during the quarterly close process and the recording of receivables, payables and reserves related to events that were previously known or should have been known prior to the current period. Determine if any issues warrant further investigation to establish if financial reporting fraud or misconduct has occurred.

# Where to Get More Information

- **PCAOB release #2007-001 “Observations on Auditors implementation of PCAOB Standards relating to Auditors Responsibilities with Respect to Fraud”**

# Attachment I - Indicators of a Weak Control Environment

- Low ethical and moral standards
- High incentives and temptations including pressure to meet unrealistic performance goals such as high performance-dependant rewards
- Inadequate risk awareness and control consciousness
- History of questionable dealings with employees, suppliers, customers, investors and auditors
- History of ethical complaints, particularly financial reporting related
- Failure to respond to known issues
- Failure to escalate concerns

## **Attachment I - Indicators of a Weak Control Environment (continued)**

- **Aggressive or intimidating management style**
- **Poor supervision**
- **Inadequate segregation of duties**
- **History of Internal Audit Reports with unacceptable control consciousness**
- **Wrong attitudes toward financial reporting, including disputes over application of accounting treatments**
- **Inadequate human resources policies and procedures**
- **Inadequate investigation of allegations.**