Mitigating the Risk of Fraud: Practical Observations and Lessons Learned

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AFC

About the Anti-Fraud Collaboration

The Anti-Fraud Collaboration is dedicated to advancing the discussion of critical anti-fraud efforts through the development of thought leadership, awareness programs, educational opportunities, and other related resources focused on enhancing the effectiveness of financial fraud risk management.

The Anti-Fraud Collaboration was formed in October 2010 by the Center for Audit Quality (CAQ), Financial Executives International (FEI), The Institute of Internal Auditors (The IIA), and the National Association of Corporate Directors (NACD).

The CAQ is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high-quality performance by public company auditors; convenes and collaborates with other stakeholders to advance the discussion of critical issues that require action and intervention; and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs. For more information, visit www.thecaq.org.

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Executive summary

- The Anti-Fraud Collaboration (AFC) published *Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions*, a report on its study that identified common fraud schemes from SEC enforcement actions issued from 2014 through mid-2019, spotlighted areas that present a higher risk of fraud, and offered perspectives on what companies can do to mitigate these fraud risks more effectively. The most prevalent fraud schemes involved improper revenue recognition, reserves manipulation, inventory misstatement, and impairment issues.

- In a roundtable discussion facilitated by the AFC, the Chief Accountant of the SEC Division of Enforcement (the Division) commented that each enforcement action in the AFC's study had some unique aspect to it. The Division has seen cases across all aspects of the financial reporting process—from companies misrepresenting the underlying economic events to matters involving how they disclose what is material to them in certain trends and uncertainties. Many cases illustrate elements of the Fraud Triangle at work, such as pressures and opportunity, usually due to some failure in the internal accounting controls or internal controls over financial reporting.

The Fraud Triangle

- The Chief Accountant stated that SEC enforcement actions can be useful in understanding the efforts taken by the Division. Cases are selected based on a careful review of evidence and fact patterns and an analysis of potential securities laws violations.

The Division brings meaningful cases that provide both the deterrent effect but also the information out there to the preparers of financial statements and gatekeepers involved in the process. The Division aims to signal to those individuals involved in financial reporting that the SEC is paying attention to these issues; that way, they can then go behave accordingly to make sure they do not step across the line into a situation where they, too, have violated securities laws.

+ In the roundtable discussion, participants representing the financial reporting supply chain and other stakeholder groups explored the various fraud schemes, accounting and reporting issues, and contributing fraud factors identified in the AFC's report, and they considered lessons learned from the perspective of their roles. The key themes included fraud risk assessment, internal controls, culture, skepticism, use of technology, new accounting standards, and the impact of the COVID-19 crisis on fraud.

+ Based on the AFC study's findings, although it is often the CEO or CFO who is charged in an enforcement matter, employees down the line often suspect—or perhaps participate in—improper activities but fail to speak up. Compliance programs should not only focus on the tone at the top but also that which permeates the entire organization. Establishing a whistleblower program is also an effective mechanism to uncover fraud or the potential for it; and it is critical for everyone in the financial reporting supply chain to feel comfortable speaking up.

+ The roundtable participants agreed that risk assessment procedures should be thoroughly reevaluated as circumstances change, such as during an economic downturn or when nearing an initial public offering. It is important to build in appropriate risk assessment and fraud prevention procedures when external stressors are present and in a high-pressure environment. Participants described the economic conditions and uncertainties created by the COVID-19 crisis as "ripe for fraud" and it will require more discipline and effort to deter fraud as a result.

+ The AFC's comprehensive analysis of SEC enforcement actions and the cases highlighted in this report are a reminder of the ongoing need for vigilance against financial statement fraud. Some of the problems revealed—insufficient internal controls, poor tone at the top, a weak culture, and lack of skepticism—are widely understood, and yet they continue to plague many organizations. As companies continue to address these perennial concerns, they should also be alert to new risks and disruptions that could potentially further complicate their fraud deterrence and detection efforts.

Introduction

BACKGROUND

The AFC launched an initiative with Latham & Watkins and AlixPartners to conduct a comprehensive study of SEC Accounting and Auditing Enforcement Releases (AAERs) from 2014 through mid-2019. AAERs issued by the SEC may cite the public company, a corporate officer or employee, or an auditor for alleged accounting and/or auditing misconduct. The AFC published *Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions*, a report on its study that identified common fraud schemes from SEC enforcement actions, spotlighted areas that present a higher risk of fraud, and offered perspectives on what companies can do to mitigate these fraud risks more effectively.

The AFC facilitated a follow-up roundtable discussion in which participants representing the financial reporting supply chain (boards of directors, audit committees, financial management, internal auditors, and external auditors) as well as other stakeholders, including forensic specialists and risk officers, explored the various fraud schemes, accounting and reporting issues, and other contributing fraud factors identified in the report. Roundtable participants also worked in breakout groups to discuss select SEC enforcement actions and consider lessons learned from the perspective of their roles. Participants discussed key considerations, including culture, skepticism, internal controls, new accounting standards, and the potential impact of the COVID-19 crisis on fraud.

INTENDED USE AND AUDIENCE

This report summarizes key takeaways from the roundtable discussions of the AFC's study and lessons learned from specific enforcement actions analyzed; it also builds on considerations for the environment during the COVID-19 crisis. This report is intended for all members of the financial reporting supply chain, all of whom have a role in deterring and/or detecting financial statement fraud. The fraud scenarios discussed here are based on real facts and circumstances made publicly available in the enforcement actions released by the SEC. The details of each case included in this report (see ***Appendix A***) are not intended to be complete or definitive, as certain issuer and individual information may have been synopsized for brevity.

Perspectives on financial reporting fraud and SEC investigations

The roundtable participants were given a high-level overview of the AFC study's findings. A panel including Matt Jacques (Chief Accountant of the SEC Division of Enforcement), Vadim Riber (Director of Investigations, Disputes, and Risk Practice at AlixPartners), and Nathan Seltzer (Global Vice Chair of White Collar Defense and Investigations Practice at Latham & Watkins) offered observations on the AFC study as well as insights into regulatory matters.

FINDINGS FROM THE ANALYSIS OF SEC ENFORCEMENT ACTIONS

Financial statement frauds have a significant impact on a variety of stakeholders and have long been a persistent challenge for certain organizations. Those who perpetrate frauds are working with increasing creativity and speed. Enforcement of financial fraud has been a significant activity for the SEC for many years. The Division's efforts can shed light onto the most prevalent kinds of financial statement frauds—and how they are being perpetrated.

The AFC study's five-and-a-half-year period allows for a broad perspective on the accounting issues most often subject to SEC enforcement and the types of financial statement fraud schemes involved; such a period also shows the industries and types of employees most frequently charged. The time frame takes into account the fact that the frauds identified often occurred several years before the enforcement actions were released (it can take months or years to conduct a thorough investigation). The AFC's study provided insights into the following:

- The most common types of fraud and areas most subject to fraud
- The circumstances and fact patterns often associated with fraud
- The employees most likely to be charged with fraud
- The types of frauds that occurred in each industry
- The types of frauds that occurred over an extended period
- How companies can take steps to prevent future fraud

The most identified fraud schemes involved improper revenue recognition, reserves manipulation, inventory misstatement, and impairment issues. The AFC's study also illustrates the importance of determining a company's risks in areas where fraud is most often found. For example, its study found that technology companies often had revenue recognition issues, especially in areas where judgment was involved. Financial institutions frequently faced reserve and valuation problems.

Based on the analysis of these enforcement actions, the panelists noted that many of the schemes involved the reclassification of journal entries at the end of a quarter, such as moving items out of costs of goods sold to improve margins or making other adjustments without support. In a common fraud scenario identified from the analysis, a CFO would direct an adjustment at or near the end of a quarter to meet earnings expectations—without providing adequate supporting documentation or through falsifying documentation, such as enhancing margins with fake timesheets or change orders.

The panelists emphasized the importance of considering the external business environment as well, such as a swing in the price of raw materials impacting the company's expenses, aggressive projections and analyst expectations, or an extraordinary event such as the COVID-19 pandemic. Many cases from the AFC's study involved external stressors on the company that drove people to make bad decisions. When those kinds of external factors are combined with reclassifications or end-of-quarter adjustments, the circumstances can present a prime area for risk—and company executives should be mindful of it.

IMPROPER REVENUE RECOGNITION

A large spectrum of fraud schemes involving revenue recognition issues included misclassification of revenues; improper acceleration of revenues; not meeting performance criteria; not properly accounting for credits; not properly recording lost contracts or adjusting the margins; bill and hold transactions; contingent sales over billings; and generally creating fake customers or falsifying confirmation.

RESERVE MANIPULATIONS

For reserve manipulation issues, the study found improper accruals and classifications; manipulations of reserves related to accounts receivable, warranties, and rebates; "cookie jar" reserves used to hide losses or overstate earnings; and inappropriate recording of accruals and commissions.

INVENTORY ISSUES

A range of inventory issues involved the recording of fake inventory; overcapitalizing costs into inventory and inflating the value; failing to record losses when cost exceeds market value; and other valuation issues related to inventory.

IMPAIRMENT ISSUES

Examples of impairment issues identified include misclassification of loans to avoid impairment charges; timing of recording impairments; and not following protocols or performing appropriate impairment analysis.

INSIGHTS FROM ENFORCEMENT CHIEF ACCOUNTANT

As Jacques noted in his remarks at the AFC roundtable event, the Division is committed to finding and pursuing failures in reporting and financial disclosure matters because of the impact they can have on the financial markets, including individual investors as well as institutions and other stakeholders. The matters that the Division pursues fall into specific categories, but the Division does not start out with set focuses, he said. There is no established formula for a particular settlement or charging decision, nor is there a materiality threshold for books and records or internal accounting control–related violations. Cases are selected based on a careful review of evidence and fact patterns and an analysis of potential securities laws violations.

The Division has seen cases across all aspects of the financial reporting process—from companies misrepresenting the underlying economic events to

matters involving how they disclose what is material to them in certain trends and uncertainties. While revenue recognition is the most frequently identified fraud scheme in the SEC enforcement actions, it would be wrong to conclude that the Division focuses on it—or any other area—because it is a common issue, Jacques said. Instead, this issue comes up often because it is an important driver of perceived value for companies. A company might find that increasing revenue or minimizing expenses are easy ways to manipulate the bottom line.

Jacques noted that many cases illustrate elements of the Fraud Triangle at work, such as pressures and opportunity, usually due to some failure in the internal accounting controls or internal controls over financial reporting. Jacques emphasized that although each case has some unique aspect to it, many investigations begin when the Division learns about possible violations of the securities laws through tips, complaints, referrals, or company self-identification. Further sources include short-seller reports or other information from the public markets and the Division's own proactive look at high-risk areas.

The cases take a significant amount of time and effort to investigate due to the number of entities involved, which can include stakeholders or other parties, such as the auditors, boards of directors, audit committees, noteholders, lenders, and financial institutions that may own assets or liabilities related to the entity under investigation. Investigations involve extensive document reviews and analyses, as well as interviews of relevant individuals. Although the categorization of AAERs—enforcement actions involving accounting and reporting issues—is not all encompassing, as it requires some level of judgment, SEC enforcement actions can be useful in reviewing and understanding the efforts taken by the Division.

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At the outset of an investigation, the Division is not certain that a fraud or violation has occurred and will often close a case without bringing any action, if closing is warranted. When it identifies facts patterns that violate the securities laws, the Division will bring meaningful cases and make sure its message is clear, in order to provide both the deterrent effect but also information out there to the preparers of financial statements and gatekeepers involved in the process. The Division aims to signal to those individuals involved in financial reporting that the SEC is paying attention to these issues; that way, they can then go behave accordingly to make sure they do not step across the line into a situation where they, too, have violated securities laws.

TAKEAWAYS FROM AN ENFORCEMENT PERSPECTIVE

A Concern for Individual Accountability

The Division has long recognized that individual accountability is critical to an effective enforcement program, and holding culpable individuals responsible for their actions is essential. The Division spends a significant amount of time making sure it understands who committed the violation,

who enabled the violation, and what individual actors did in that process. Institutions act through their employees, and holding culpable individuals responsible for wrongdoing is essential to achieving our goals of general and specific deterrence and protecting investors by removing those bad actors from our markets, Jacques said.

Risks Related to New Standards

The panelists discussed the risks related to new standards, including whether they may result in violations. Although he had not made a formal review, Jacques believed that when there is new accounting guidance, the vast majority of the historical enforcement matters in these areas typically violate both the old and new standards, with very few exceptions. The Division is aware of challenges that companies may face in the early stages of implementation; however, at some point there is an expiration date on that as an excuse for failure to properly account for transactions. Jacques cautioned companies against using the adoption of new accounting standards to hide past errors, since the Division does investigate for this possibility.

The Value of Independent Monitoring

An independent monitoring program can be a remedy for companies with fraud issues. The Division takes these programs very seriously as ways to remediate past behavior, Jacques said, as there are potential benefits to having an independent party assess internal accounting controls or other processes in the financial reporting process that may need improvement.

Addressing COVID-19

When the pandemic began, the SEC assembled a cross-divisional working group to prepare for the possible adverse effects of COVID-19 and dedicated significant resources to quickly respond to COVID-19 related matters. The SEC actively monitored the markets for frauds, illicit schemes, and other misconduct affecting US investors related to COVID-19. The SEC suspended trading in issuers where there were issues regarding the adequacy and accuracy of the information in the marketplace in connection with COVID-19 and it also brought a number of enforcement actions against issuers and individuals alleging fraud based on COVID-19 related claims.

Lessons learned from SEC enforcement actions

Roundtable participants were divided into several groups to discuss the lessons that could be learned from in-scope SEC enforcement actions (see ***Appendix A*** for case details). Board members, preparers, internal auditors, external auditors, forensic specialists, risk officers, and academics made up the breakout groups, and the enforcement actions discussed covered three different industries and fraud schemes:

- A loan impairment fraud at a large community bank (Case A)
- An expense accruals fraud case at a manufacturing company (Case B)
- A revenue recognition scheme at a multinational technology company (Case C)

This section highlights participants' observations on key themes identified in the cases and those methods that can be implemented to deter and detect the fraud schemes sooner. In addition to what is covered here, another consideration is the importance of audit planning, including the risk assessment. Part of ongoing risk assessment procedures should be considering what has changed in the wake of the pandemic and the impact of those changes on other functions in the business. Although the three cases described different fraud schemes in a variety of industry sectors, common themes emerged. Key takeaways focused on the following areas:

- Insufficient fraud risk assessment
- Weaknesses in internal controls
- A lack of professional skepticism
- Aggressive tone at the top, resulting in pressure to meet goals
- Lack of appropriate resource allocations, particularly with staffing
- Heightened pressures/risks related to initial public offerings

Fraud Risk Assessment and Internal Controls

Failure to implement or maintain adequate internal controls was a pervasive issue in all cases. Although sufficient controls may appear to be an obvious requirement, the cases demonstrate the need for vigilance in this area; they also reveal the consequences when controls are lax or ignored. One of the banking case breakout groups cited poor design of controls and a lack of independent review of some of the key inputs in the loan impairment with risk rating. As an approach to evaluating internal controls, the first step is to assess the risk, then determine if the existing controls are dynamic enough for that risk, participants noted.

A company's willingness to accept bad news is important. That acceptance can be manifested in several ways. Do employees feel comfortable raising problematic concerns, or do they fear losing their jobs or being penalized in another way? Does the organization have a robust whistleblower program and adequate follow-up to complaints, or does it tend to minimize problems? The answers to these questions can help gatekeepers identify potential fraud risk factors, participants said. A forensic director in the technology case breakout group also noted that, when companies are working with percentage-of-completion principles, it can be difficult for them to accept when to recognize a loss. That can ultimately lead to fraud, a chief risk officer added.

Risk assessment procedures should be thoroughly reevaluated as circumstances change. This is particularly true in the case that involved new circumstances, such as a downturn in the economy and changes in the commercial real estate market, which created external stressors and pressure in the banking case. Separately, in the technology case that centered on a multibillion-dollar contract, a chief risk officer noted that the fact that other contractors had abandoned the contract should have alerted the company's senior management to build in controls or checkpoints on progress to completion and prompted the board or audit committee to ask questions. When it was time for the audit, the abandoned contract should have alerted external auditors to elevated risk immediately, particularly given the size and high-profile nature of the contract. That would raise questions about reaching profitability goals and signal the need for an experienced audit team. A preparer in this breakout group emphasized that neither journal entries nor assumptions should be made based on proposed contract amendments before there is evidence of a contract.

Identify elevated risks in foreign and domestic subsidiaries. When it comes to subsidiaries, "all entities in the organization need to have the same level of oversight supervision," a chief risk officer noted in the technology case breakout discussion. Smaller units should not be ignored, since they may be making material adjustments. In other cases, "sometimes the processes sound good, but they do not actually get implemented in the right way," a forensic director said.

Culture and Tone at the Top

An aggressive tone at the top combined with a weak culture can enable fraud. Proper, proactive oversight and governance are critical, all participants agreed. Senior management either directed, approved, or ignored improper activities in all three cases. Those at the executive level and along the financial reporting supply chain failed to identify or report clear problems. The consequences of a weak culture can be significant and pervasive throughout an organization, leading to errors, corner cutting, and fraud if those in charge do not take proactive steps to promote and maintain an ethical culture. A strong ethical culture can highlight and affirm the organization's standards and promote compliance with those standards.

Boards must understand the culture beyond the C-suite. Although it is often the CEO or CFO who is charged in an enforcement matter, employees down the line often suspect—or perhaps participate in—improper activities but fail to speak up. Compliance programs should not only focus on the tone at the top but also that which permeates the entire organization. Those charged with governance may need to reach out to other parts of the financial reporting supply chain to gather the information and insights necessary to deter or detect fraud.

An audit partner in the technology case breakout group pointed out the importance of gathering information and insights from people carrying out contract negotiations, creating the models, or working on other efforts that might end up being manipulated

at higher levels. A chief risk officer, speaking of this same case, noted that, without reaching out to levels below management, “you might not be given the right piece of audit evidence to identify inappropriate behavior or decisions, or realize the need to ask more questions or for additional documentation.” The lack of involvement by middle management or independent outsiders in decision making was another issue, an audit partner in the banking case breakout group said. Those in workout groups, which deal with troubled commercial loans, and at other levels must have known there were problems, but that knowledge failed to stop the problem. The audit partner concluded that there appeared to be management override as a result.

Everyone in the financial reporting supply chain should feel comfortable speaking up. A whistleblower program is an effective mechanism to uncover fraud or the potential for it, a chief risk officer in the technology case breakout group noted. Questions for board members or other gatekeepers to ask can include how long key executives have been with the organization, whether they are good at giving or receiving feedback, how much input middle management has in decision making, what kinds of compensation metrics are used, and what level of analyst coverage is involved. Gatekeepers should also be aware that the existence of overly powerful executives can lead to potential management override.

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In the banking case, the Chief Accounting Officer (CAO), who is responsible for implementing and maintaining proper accounting policy, was aware of departures from GAAP in the accounting for valuation of certain troubled debt restructurings. However, the CAO accepted the approach and failed to discuss it with the CFO and CEO. The breakout group concluded that having a strong code of conduct does not guarantee that its guidelines are being carried out throughout every level of the organization. The case illustrates the importance of building a culture where individuals feel comfortable challenging senior management when they depart from accepted accounting policies.

The Importance of Skepticism

Exercising skepticism can help spot red flags and warning signs sooner. Roundtable participants agreed that skepticism is valuable throughout the financial reporting supply chain; it enables employees at all levels to step back and spot indicators of fraud. Employees should be encouraged to hone their skepticism and critical thinking, and management at all levels should foster an environment that encourages them to put those skills to work. An aggressive culture, overriding of journal entries, and divergence from written policies should present a major red flag for those exercising skepticism, noted a preparer in the manufacturing case breakout group. That preparer also pointed out the importance of reviewing supporting documentation. A forensic partner discussed the value of internal and external auditors taking the time to ask open-ended questions on culture and the general atmosphere in the organization.

In the manufacturing case, the company’s structure and approach should have been identified as red flags in themselves, according to an accounting professor. There was a powerful CFO who ordered adjustments to journal entries and a philosophy that “earnings is king.” Although the improper journal entries each appeared to be quantitatively immaterial, in the aggregate they contributed to the company’s material misstatements. A board reporting structure that is tuned in to operational risks and includes compliance-minded people is a key factor in mitigating fraud, a forensic partner said. An accounting professor suggested that the real

fraud risk assessment should resemble the client acceptance process, in which the audit firm does not make positive assumptions about the organization.

Staffing and Resource Allocation

Inexperienced or inadequately trained accounting personnel can be a red flag. These employees may not have the experience or competency to recognize or challenge fraudulent entries. They may miss or rationalize red flags because of a lack of knowledge. Even worse, a forensic partner in the manufacturing case breakout group noted, the company may have hired such individuals for those very reasons. Board members also may be chosen because they were not expected to challenge management, an accounting professor said. Another forensic partner suggested checking social media and job sites to get a sense of what employees say about the company culture. Even when an organization has experienced people, it may need to call in specialists to gain additional perspectives. For the auditors, the ultimate answer is "going to those charged with governance and challenging them to fulfill their roles, or arming them with information to help them fulfill their roles," a forensic partner said.

Risks Related to an IPO

Fraud risk may heighten at companies nearing an initial public offering. It is important to build in appropriate risk assessment and fraud prevention procedures in a high-pressure environment. As the manufacturing case showed, that effort includes creating a culture of transparency and ethical behavior. Just post-IPO, a company is immature as an organization in terms of its compliance function, a vice president of internal audit in the breakout group said. The board may also include private equity investors and others who lack independence. In addition, the company may lack a robust internal audit group and may need to use external consultants to boost its expertise, a forensic partner said.

Critical takeaways in the current environment

The AFC's study provided a unique overview of where, how, and why frauds commonly occur, and highlighted typical risks and fraud scenarios. The roundtable participants built on that foundation to apply lessons learned and focused on two matters: issues to consider when implementing new standards and the impact of the COVID-19 crisis. The participants described the economic conditions and uncertainties created by the pandemic as "ripe for fraud" and highlighted several considerations in this section.

IMPLEMENTING NEW STANDARDS

New accounting standards usually lead to new challenges and risks, although it may take a couple of years to detect the impact. As such, it is important to be alert to potential internal control weaknesses or fraud risks when a new standard is introduced. Over the past few years, new accounting standards went into effect in two high-risk areas for fraud: revenue recognition and current expected credit losses (CECL). The impact of the new standards may not be immediately clear because it can take time for investigations to identify new trends or cases.

Revenue Recognition

The new revenue recognition standard, *ASC 606: Revenue from Contracts with Customers*, has been implemented for multiple reporting cycles. That said, changes in the standard can still affect how businesses are adopting its policies and processes in this key accounting area. When the standard was implemented, it was in some ways intended to provide more consistency in application of the standards and alleviate fraud risks, noted a panelist. The new standard is focused on performance obligations and their identification. There was the potential for significant timing issues under the previous standard, and it is likely to continue under the new one. Companies should have developed rigorous processes and documentation on the recognition of revenue when control of a promised good or service is transferred, which is evaluated from the customer's perspective. The risk of improper revenue will continue to persist, such as concerns about falsified revenue and the existence of a properly executed contract.

Current Expected Credit Losses

The CECL standard, *ASC 326: Financial Instruments—Credit Losses*, relies on principles-based judgment to forecast forward-looking information. Add to that the current economic uncertainties and COVID-19's impact on many companies and industries, and the result is a "perfect storm," an audit partner in the banking case breakout group said. Losses must be measured over their expected life, not necessarily at an inflection period or event. Timing, judgment, and modeling may remain vulnerable to manipulation. Allowance percentages can vary significantly, for example, and this situation has been exacerbated by the pandemic. A panelist emphasized that it is important to remember that the CECL standard has applications beyond financial institutions; it can have a significant impact on trade accounts receivable, other debt instruments, and insurance contracts. Present and future risks may be similar to past risks relating to the increased opportunity for manipulation in areas where modeling or judgment is involved, including impairment deferral or untimely loss recognition.

Final Takeaways on New Standards

To address fraud risks in this environment, companies should use robust processes around estimates that can involve significant subjective judgments. Relevant employees outside the accounting team should be given proper training to understand proper implementation and to question procedures that depart from the new rules. Internal auditors will also play a key role. Board members, management, and others in the financial reporting supply chain—while they may not need a deep level of accounting knowledge—must adequately understand new standards to determine not only whether they are being implemented correctly but also whether related new procedures are being manipulated to perpetrate fraud. These stakeholders should likewise be able to challenge excuses that blame surprising or suspicious findings on a new standard.

THE IMPACT OF COVID-19

Maintaining Adequate Controls

The COVID-19 crisis has resulted in a significant increase in employees working remotely, which may impact internal controls. Because of changes to oversight, remote work can raise threats to segregation of duties and the general control environment. Some controls that were performed manually before now may be digital. Staff reductions may have resulted in new control or process owners, or there may be changes to documentation and/or approval procedures. Further, because departments are isolated from each other in a remote work environment, chances to share or uncover critical information may be lost. That is a significant change to risk assessment, a vice president of internal audit in the manufacturing case breakout group said. Among other obstacles, workers are less likely to interact with team members outside the accounting team. For example, the customer services team may have information on warranty claims or other issues that could affect reserves.

In addition, the more interaction that people have in an office environment, the more likely that they will be able to notice and report misconduct.
As a result, controls designed for pre-pandemic circumstances may no longer be appropriate, the roundtable and breakout group participants noted. These changes may not be a sign that controls are being manipulated, but they should be documented and tested. Lack of controls around relief funds distributed during the pandemic is another major concern in this environment. Resource allocation can

IN LIGHT OF THE COVID-19 PANDEMIC, A FORENSIC PARTNER RECOMMENDED ASKING:

For management:

- What is different about how you are executing your controls?
- What do you have the ability to overhear or collaborate about?

For auditors:

- Is the company really doing things the same way?
- What is different for auditors?
- What is different about how you are gathering your evidence?
- Do you still have the ability to collaborate?

also impact risk. Areas where business has closed or reduced operating capacity may not receive the same focus in an internal or external audit. Companies should keep in mind that a decline in revenue or activity in an area does not imply decreased risk. Companies should also evaluate what experiences, learning, and one-to-one coaching their teams may have missed during the pandemic and how to move them forward as needed, the chief risk officer said.

New Approaches Can Bring New Risks

The pandemic has put a great deal of pressure on those companies that have not been hard hit but that are still not performing well. An audit partner has advised audit teams to understand new incentives and pressures and the overall effect on controls. Pressures to limit expenses or meet analysts' expectations, while not unique to COVID-19, may be exacerbated, the audit partner said. As revenues fall or as employees are let go, companies may also be uncovering previously hidden frauds.

It is important to evaluate significant changes in the way businesses operate, such as new sales channels and web stores created during the pandemic, a forensic partner said. Auditors should ask what risks are involved not only in cash collections, treasury, and credit card activity but also in financial statement reporting. There is also "pressure for the new lines of revenue to perform, to attract new customers, and to create revenue" given the costs that went into creating them, the forensic partner said. One solution is to map out potential risks and evaluate the relevant controls.

Auditing in the Remote Environment

Inventory considerations in an audit are an issue because accuracy may be threatened in a remote environment, the roundtable participants agreed. In audits, team members have used FaceTime and Zoom calls, and some have even climbed up to peer in a window to make observations, an audit partner in the banking case breakout group said. Interaction with client personnel is also a challenge, and some auditors have gone to client locations when possible, given restrictions during the pandemic. To ensure that newer staff can learn from more experienced auditors, some firms are creating virtual audit rooms in which employees can work together and junior staff can observe and learn.

Benchmarking and the Value of Technology

Benchmarking can be a valuable tool, an accounting professor in the manufacturing case breakout group said, because it cannot be manipulated. Comparing company revenues to industry data can be a valuable benchmark for predicting fraud, the professor said. Revenue can also be benchmarked against other internal data to find issues, such as a spike in revenue that does not match sales numbers. It is also valuable to examine the outliers in high-risk areas. A forensic partner recommended asking questions such as: Why are we experiencing higher revenue in the last week of each quarter given the nature of our organization, and does that make sense?

Data analytics can help with this benchmarking and with spotting anomalies. Key data may differ for companies, a vice president of internal audit in the same breakout group said, and the external auditors and other outsiders may not scrutinize them as much as internal auditors do. Analytics can play an important role in helping management better understand their businesses and detect fraud. Audit teams can deploy data analytics in preliminary planning to improve sampling so that it is less random; they can apply specific tools for various industries or accounts, a forensic partner said. Data analytics can also make training across international locations less costly and more effective; however, an accounting manager pointed out that asking a simple question can sometimes reveal as much as a sophisticated tool could.

Pressures on Individuals to Commit Fraud

Organizations should be alert to the pandemic's impact on employees, a forensic partner in the manufacturing case breakout group said. Some families may have dropped from two incomes to one, and this financial pressure could lead to misconduct. Without regular in-person interactions, auditors may find it difficult to spot anxieties or changes in behavior associated with fraudulent conduct. Risk assessment from this perspective should be ongoing because incentives and pressures on people all along the financial reporting supply chain may change as the pandemic and its long-term impact continue to unfold. Reductions in headcount may also affect controls or otherwise heighten risk, participants in multiple breakout groups agreed.

Final Takeaways on COVID-19

Overall, the environment resulting from COVID-19 requires more discipline and effort to deter fraud. As part of understanding and adjusting to risks posed by the current environment, risk assessments should consider the effects of the pandemic. Company management and auditors alike need to understand changes in processes and controls, including any policies that were not enforced, changes to controls made in the remote environment, changes that should have been—and have not been—made in the control structure, and which protocols are no longer being followed. They should also consider challenges or limitations when auditors are not able to work on-site. Board members and other gatekeepers should consider what questions they should ask about the steps that management is taking to mitigate or identify fraud risks in light of the COVID-19 pandemic. Together, members of the financial reporting supply chain should evaluate each company's unique situation and its susceptibility to fraud in the current environment.

Conclusion

The AFC's comprehensive analysis of SEC enforcement actions and the cases highlighted in this report are a reminder of the ongoing need for vigilance against financial statement fraud. Some of the problems revealed—insufficient internal controls, poor tone at the top, a weak culture, and lack of skepticism—are widely understood, and yet they continue to plague many organizations. As companies continue to address these perennial concerns, they should also be alert to new risks and disruptions that could potentially further complicate their fraud deterrence and detection efforts. Organizations can use the information in this report and in *Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions* to evaluate their own risk assessment and fraud risk management programs—and consider methods to strengthen them.

Appendix A:

Select SEC enforcement action summaries

A. BANKING & FINANCIAL SERVICES CASE: LOAN IMPAIRMENT FRAUD

AAER No. 3807, Orrstown Financial Services Inc., Thomas R. Quinn, Bradley S. Everly, CPA, Jeffrey W. Embly, and Douglas P. Barton, CPA

Background: Orrstown Financial Services (Orrstown) was a long-established community bank with 31 banks and eight loan production centers in the eastern United States. Approximately 75 percent of the bank's portfolio was in commercial loans. Amid a rapid decline in real estate values in its market, the bank improperly accounted for loan disclosures, particularly loan impairment disclosures, while also committing errors in applying GAAP in troubled debt restructuring impairment loss.

Details: According to the enforcement action, "Orrstown did not timely incorporate material adverse information regarding certain borrowers' financial difficulties into the risk rating component of its loan review process and instead relied largely on stale data." The bank's processes and controls failed to ensure the accuracy of risk ratings set by the Loan Review Officer. The bank failed to disclose that several loans, including those to its largest lending relationships, were impaired, and it did not accurately disclose impaired loans—which resulted in materially misstated filings. Orrstown did not make and keep adequate books and records because it failed to follow GAAP rules on troubled debt restructurings and loan losses, and it failed to create and maintain proper internal accounting controls.

The CEO, CFO, and Chief Credit Officer (CCO) knowingly allowed improper impairment of loans for the bank's three largest customers and later sold the loans at a substantial discount to their carrying values. Orrstown omitted certain loans with impairment losses from its review of the adequacy of its allowance for loan and lease losses schedule of impaired loans, thereby understating impairment disclosures. Executives also allowed the use of an improper cash flow model to calculate impairment losses.

Result: The SEC found that Orrstown underreported its impaired loans—as defined by GAAP—by as much

as $69.5 million in its SEC filings. Orrstown agreed to pay a civil penalty of $1 million. Its CEO, Thomas R. Quinn, former CFO, Bradley S. Everly, and former CCO, Jeffrey W. Embly, each agreed to pay a penalty of $100,000. Its Chief Accounting Officer, Douglas P. Barton, agreed to a penalty of $25,000. Everly was also suspended from appearing and practicing before the SEC as an accountant, which includes not participating in the financial reporting or audits of public companies, although he was allowed to apply for reinstatement after three years.

B. MANUFACTURING CASE: EXPENSE ACCRUALS FRAUD

AAER No. 3949, Advanced Drainage Systems, Inc. and Mark B. Sturgeon, CPA

Background: A US-based manufacturer of water management products, Advanced Drainage Systems, Inc. (ADS) operated a global network of approximately 60 manufacturing plants with more than 30 distribution centers. Prior to and after its initial public offering, ADS materially misstated its financial results and improperly accounted for inventory and related cost accounts, which contributed to its overstating its income before taxes.

Details: At its CFO's direction, ADS improperly capitalized pension and medical costs into inventory, or expensed them into selling, general and administrative expense accounts. ADS capitalized freight without adequate support and improperly accounted for many of its equipment leases. After learning from a member of the company's accounting group that the accrual for rebate liability appeared to be too low, the company recorded only a partial adjustment.

ADS also failed to devise and maintain a sufficient system of internal accounting controls, including those related to journal entries and lease accounting. The company's CFO circumvented existing internal accounting controls by directing or approving unsupported accounting entries. Management overrode accounting policies and calculations and directed or approved entries without adequate documentation. Company personnel failed to follow ADS accounting policies and properly support accounting adjustments.

ADS not only lacked accounting personnel with appropriate experience, it also had insufficient internal accounting controls over segregation of accounting entry and approval duties and documentation requirements for journal entries. When it sold securities, its registration statement contained inaccurate financial statements. Above all, ADS acknowledged in its restatement that poor tone at the top set by senior management and a high-pressure environment contributed to the company's ineffective internal accounting controls.

Result: The SEC found that ADS materially misstated its financial results for fiscal years 2013, 2014, and 2015 and its quarterly financial results for fiscal years 2014 and 2015. The misstatements were due to improper accounting, including unsupported journal entries directed and approved by its CFO, Sturgeon. The company also had insufficient internal accounting controls. In 2016, ADS restated and revised financial results for fiscal years 2013, 2014, and 2015 and its quarterly financial results for fiscal years 2014 and 2015.

ADS violated the antifraud provisions of the Securities Act and the reporting, books and records, and internal accounting control provisions of the Securities Exchange Act. Sturgeon violated sections of those acts and the Sarbanes-Oxley Act. The SEC ordered ADS to pay a $1 million civil penalty. Sturgeon received a $100,000 civil penalty, was ordered to reimburse the company $173,970 in stock sale profits, and was prohibited from appearing or practicing before the SEC as an accountant.

C. TECHNOLOGY SERVICES CASE: REVENUE RECOGNITION FRAUD

AAER No. 3662, Computer Sciences Corp., Michael Laphen, Michael Mancuso, Wayne Banks, Claus Zilmer, and Paul Wakefield

Background: Computer Sciences Corporation (CSC) was a large, mature, US-based, multinational technology services company that operated a global network in North America, South America, Europe, Asia, and Australia. Over the course of three years, CSC engaged in wide-ranging accounting and disclosure fraud related to a $5.4 billion contract, which involved building a software system for the UK's national healthcare provider. Other IT contractors that were also awarded the contract had

abandoned the project due to technical problems and delays from the start.

Details: In response both to early concerns that CSC had with its ability to complete the contract and to its finance team's projections that CSC would fall more than $1 billion short of the original revenue target for the contract, the account's Finance Director led a fraudulent "gap closing" exercise in which his team contrived assumptions about additional revenue CSC would earn on the contract. As an overall result of the company's actions, it materially overstated earnings. The CEO approved use of improper accounting models for this contract, and both the CEO and CFO failed to make required disclosures—and thus made misleading statements to investors about the contract. In a separate fraud, senior executives in Australia manipulated earnings using "cookie jar" reserves and failed to record expenses as required. CSC's Nordic region also engaged in a variety of accounting manipulations to fraudulently inflate its operating results because it was struggling to achieve budgets set by management in the US.

Result: The SEC found that CSC's executives manipulated financial results and concealed significant problems with the company's largest and most high-profile contract. The company and its regional finance executives in Australia and Denmark also manipulated results in those regions. CSC and eight of its executives violated several laws, including the Securities Act, the Securities Exchange Act, and the Sarbanes-Oxley Act. CSC agreed to pay a $190 million penalty. Among the executives who reached settlements, former CEO Michael Laphen agreed to reimburse CSC more than $3.7 million in compensation under the clawback provision of the Sarbanes-Oxley Act; Laphen also paid a $750,000 penalty. CSC's former CFO, Michael Mancuso, returned $369,100 in compensation and paid a $175,000 penalty.

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