

APPENDIX F – ANALYSIS OF SEC ACCOUNTING AND AUDITING ENFORCEMENT RELEASES

SCOPE AND METHODOLOGY

1 The Panel studied recent SEC Accounting and Auditing Enforcement Releases (AAERs) to supplement the Quasi Peer Reviews and held discussions with the SEC staff regarding the apparent causes of actual or alleged instances of fraudulent financial reporting and audit failures. The Panel’s objective was to obtain additional insights regarding the characteristics that frequently were present in these matters, as well as insights regarding the auditors’ work that either resulted in detecting or not detecting material misstatements. The Panel used those insights to identify lessons that might be useful in improving audit effectiveness and in helping to develop some of the recommendations in this report, especially in Chapters 2 through 4.

Scope

2 The study, which was conducted by Professor Thomas Weirich of Central Michigan University, covered the AAERs issued from approximately July 1, 1997, through December 31, 1999, involving the Big 5 firms or their clients. The Panel limited the study to the Big 5 firms and their clients because the Big 5 firms audit the most SEC registrants and because most of the Panel’s efforts have focused on the effectiveness of their audits. The study included 96 AAERs involving 38 different matters.

Methodology

3 After reading the AAERs, Professor Weirich met with members of the staff of the Office of the Chief Accountant of the SEC to discuss each case. The discussions focused on:

- The root causes of or contributing factors to an effective or ineffective audit
- The auditors’ actions, including what they did right and what they did wrong
- Any implications for the audit risk model
- The steps that could or should have been taken to prevent or detect the alleged financial reporting or audit failure
- The systemic and quality control implications
- The penalties (if any) the SEC assessed against the auditors
- The client personnel involved
- The client personnel’s apparent motivations for materially misstating the financial statements
- The methods the client personnel apparently used to misstate the financial statements

4 The SEC staff answered questions using the information contained in the SEC's non-public enforcement files. Professor Weirich did not have access to those files. To help structure his discussions with the SEC staff, Professor Weirich developed a questionnaire that members of the Panel and its staff reviewed. After his meetings with the SEC staff, Professor Weirich prepared a written summary of the key elements of each case, including the auditors' actions during the audit, if those actions were known.

5 Subsequently, the Panel's staff director met for a total of five full days with Professor Weirich and members of the SEC staff to review and discuss each of the cases, spending more than an hour on average on each case.

6 Two significant limitations of this study were:

- While the SEC staff routinely examines the auditors' involvement in each case, the SEC's files generally did not contain much or any information about the auditors' work unless the auditors were named in the AAER, which happened in seven of the 38 cases.
- Professor Weirich did not have direct personal access to the SEC's files because they contain non-public information. Instead, he had to rely on the SEC staff's responses to his questions.

FINDINGS

Overview

7 The SEC named the auditors in seven of the 38 cases, and may name the auditors in others where the SEC has not completed its investigations. In those cases where no actions were brought against the auditors, the reasons included: there was insufficient evidence to support an action against the auditors, only unaudited interim financial statements were misstated, and the auditors discovered the misstatements. For instance, in 12 of the 38 situations, the auditors discovered the fraudulent activities, reported them to the audit committee and resigned or required restatements, or both.

8 There appeared to be substantial variations in the quality of the audits. At one extreme, the auditors appeared to have performed extremely thorough audits under the leadership of heavily involved, highly skeptical partners and managers who were able to ferret out well-concealed, massive, collusive frauds. At the other extreme, inexperienced auditors appeared to have been virtually unsupervised, overlooked seemingly obvious "red flags" and failed to follow up adequately on exceptions noted during their audit tests.

Accounts Frequently Misstated

9 Most of the misstatements involved relatively routine transactions and accounts rather than complex judgmental areas and more esoteric transactions and accounts, such as derivatives or other complex financial instruments, restructuring reserves, business combinations or in-process research and development charges.

10 The most frequently misstated transactions and accounts were:

Revenue and accounts receivable	26 cases (out of 38)
Expenses	13
Cost of sales and inventory	9
Sales discounts/returns and allowances	8
Property, plant and equipment	7
Accounts payable and accrued liabilities	5
Securities valuations	3

11 These findings are consistent with those of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in its research study, *Fraudulent Financial Reporting: 1987–1997, An Analysis of U.S. Public Companies*.

Common Techniques for Overstating Revenue

12 As indicated above, approximately 70% of the cases in the study involved the overstatement of revenue—either premature revenue recognition or fictitious revenue. The most frequent techniques for overstating revenue were:

- Recognizing revenue contrary to agreements with customers, including:
 - Recognizing revenue on consignment sales
 - Recognizing revenue despite having entered into side agreements
 - Recognizing revenue on conditional sales to related parties
 - Recognizing revenue on bill and hold transactions
 - Inflating invoices in kickback schemes
 - Recognizing revenue when the risks and rewards of ownership had not passed to the customer
 - Recognizing revenue on shipments not ordered by customers
 - Recognizing revenue on non-qualifying barter transactions
- Manipulating cut-off, including:

- Recording revenue on shipments after year end by backdating shipping documents
- Delaying the recognition of returns
- Generating fictitious transactions, including:
 - Recognizing fictitious revenue with false journal entries
 - Recognizing fictitious revenue on shipments of mock products or obsolete inventory
 - Recognizing fictitious revenue on shipments to public or company warehouses

13 In many instances the entity used more than one of the preceding techniques to overstate revenue. Many of these techniques are similar to those identified in the COSO report.

Other Factors Associated with Materially Misstated Financial Statements

14 During the study, Professor Weirich noted:

- Numerous instances where entities used information technology to facilitate material frauds, such as by making inappropriate modifications to computer programs, recording hundreds of small non-standard entries rather than a few large ones, or “freezing the date” in the computer system
- Numerous instances where non-standard entries were used to conceal misstatements
- A few instances of materially misstated financial statements resulting from the misappropriation of assets
- Several instances where the entity’s inherent risk apparently increased as a result of significant changes in the entity’s business (e.g., the loss of one or more major customers or the existence of a new competitor with a better, cheaper product), and the auditors apparently were not aware of these changes or did not accurately assess how they increased inherent risk
- Numerous instances where management had overridden controls, including controls over aging accounts receivable, recording shipments, changing computer programs and classifying disbursements. Because the auditors seem to have been unaware that management was overriding controls, they apparently assessed control risk and fraud risk as considerably lower than they actually were.
- Several instances of material fraud, either fraudulent financial reporting or misappropriation of assets, at relatively small divisions or subsidiaries. In some of these instances, the auditors apparently had not visited the locations in several years even though the entities did not have any internal auditors, controls at the locations were weak, or competition for the locations’ products had increased substantially, thereby increasing the risk at the locations.

- Numerous instances where the auditors’ substantive procedures apparently were not adequate to detect material misstatements. Examples included:
 - Inadequate (small) sample sizes¹
 - Not adequately following up on exceptions noted on, or fax responses to, confirmations
 - Not adequately testing the following: the approval process for sales, sales or inventory cut-offs,² charges to asset accounts, or the valuation of securities or property, plant and equipment
 - Not controlling the confirmation process or not confirming the terms of large or unusual sales transactions, especially those that occurred at year end
 - Not ascertaining whether the financial statements agreed or reconciled with the accounting records
 - Over-relying on management’s representations (i.e., not obtaining sufficient evidence to corroborate or refute management’s representations, such as management’s explanations for unusual fluctuations noted when performing analytical procedures)
 - Not testing the accuracy of computer-prepared schedules
- Various instances where the auditors apparently were not aware of, or did not pay sufficient attention to, such factors as negative cash flows, extended sales terms, customers taking longer than usual to pay, increased product returns, or very large percentages of sales being recorded at the end of periods
- A very limited number of situations where the external auditors may not have tested, supervised and reviewed the internal auditors’ work as thoroughly as would have been desirable
- Some instances where the personnel assigned to audit certain areas, such as receivables and inventories, did not appear to have sufficient training and experience or to be adequately supervised

In many of these situations, the auditors appeared to have demonstrated a lack of sufficient professional skepticism.

15 Professor Weirich also noted that the entities with the most sophisticated frauds often were very concerned about concealing them from the auditors and ensuring that “the numbers and the relationships among them would ‘look right’ to the auditors when they performed their analytical procedures.” A favorite technique for accomplishing this was to “play around” with the numbers, often through the use of non-standard entries, until they “looked right.” In these circumstances, key ratios such as the accounts receivable and inventory turnover ratios and the

¹ In several situations, cut-off tests were limited to examining the documentation for a very small number of transactions.

² See note 1.

gross margin percentages presumably met the auditors' expectations rather than raising questions that might have revealed the fraud.

16 In a limited number of instances, succumbing to time pressures may have contributed to the auditors' failure to detect material misstatements, while in others, the auditors' resistance to time pressures may have facilitated their detection of the misstatements.

Fraud Participants and Incentives for Committing Fraud

17 In most of the 38 cases, one or more members of top management were involved in or aware of the activities that resulted in the materially misstated financial statements. For example, the CFO apparently was involved in almost two-thirds of the cases, the CEO in almost one-half, and the controller in almost one-half. In some situations, numerous lower-level personnel (such as accounting clerks, district sales managers, or personnel in the IT department who reprogrammed the computer to conceal the fraud) also were involved in or at least aware of the activities.

18 In still other situations, top management apparently was unaware that the overall financial statements were materially misstated, since the fraud was perpetrated at a subsidiary or division where the personnel apparently were trying to either "make the numbers" or cover up their misappropriations of assets. Finally, in a few situations, third parties were involved in attempting to conceal the fraud, such as by sending false confirmation responses to the auditors.

19 In five situations, one or more of the members of management involved in the misstatements had been with the audit firm, in three situations as partners, prior to joining the company.

20 The personnel involved in making the misstatements are reported to have cited various incentives for participating, including:

- Meeting analysts' expectations
- Meeting corporate earnings targets
- Raising additional capital
- Complying with financial covenants for loans or lines of credit
- Reporting favorable results for an IPO
- Earning bonus awards or stock options
- Satisfying NASDAQ listing requirements
- Funding personal expenses