Mitigating the Risk of Common Fraud Schemes:

Supplemental Analysis of SEC Enforcement Actions

May 2022

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).

CAQ CENTER FOR AUDIT QUALITY

The Center for Audit Quality (CAQ) is a nonpartisan public policy organization serving as the voice of U.S. public company auditors and matters related to the audits of public companies. The CAQ promotes high-quality performance by U.S. public company auditors; convenes capital market stakeholders to advance the discussion of critical issues affecting audit quality, U.S. public company reporting, and investor trust in the capital markets; and using independent research and analyses, champions policies and standards that bolster and support the effectiveness and responsiveness of U.S. public company auditors and audits to dynamic market conditions.

fei financial executives international

FEI is the leading advocate for the views of corporate financial management. Its more than 10,000 members hold policymaking positions as Chief Financial Officers, Treasurers and Controllers at companies from every major industry. FEI enhances member professional development through peer networking, career management services, conferences, research and publications. Members participate in the activities of 65 chapters in the US. FEI is headquartered in Morristown, NJ, with an office in Washington, DC. For more information, visit www.financialexecutives.org.

The Institute of Internal Auditors

The IIA is the internal audit profession's most widely recognized advocate, educator, and provider of standards, guidance, and certifications. Established in 1941, The IIA today has more than 200,000 members from more than 170 countries and territories. The IIA's global headquarters are located in Lake Mary, Fla. U.S.A. For more information, visit www.theiia.org or www.globaliia.org.

NACD

NACD empowers more than 20,000 directors to lead with confidence in the boardroom. As the recognized authority on leading boardroom practices, NACD helps boards strengthen investor trust and public confidence by ensuring that today's directors are well-prepared for tomorrow's challenges. World-class boards join NACD to elevate performance, gain foresight, and instill confidence. Fostering collaboration among directors, investors, and corporate governance stakeholders, NACD has been setting the standard for responsible board leadership for 40 years. To learn more about NACD, visit www.NACDonline.org.

As a follow up to its recent report, *Mitigating the Risk of Common Fraud Schemes: An analysis of SEC Enforcement Actions*, the Anti-Fraud Collaboration (AFC) analyzed data collected during its comprehensive review of 204 SEC enforcement actions to provide additional insights into various data attributes related to the 140 in-scope fraud schemes (AFC report).

The scope and review period of this supplemental analysis remained the same as that noted in the original report, which covered publicly available data released by the Securities and Exchange Commission (SEC) from January 1, 2014 through June 30, 2019. The 531 enforcement actions released by the SEC during the review period included cases involving a wide range of alleged misconduct, related but not limited to, intentional and non-scienter frauds, issuer reporting and disclosures, auditor shortcomings, absent or insufficient internal controls, deficient disclosure controls, non-GAAP measures, the Foreign Corrupt Practices Act, securities offerings, insider trading, broker dealer, and cyber-related misconduct.

Our analyses focused on those SEC enforcement actions involving accounting and reporting issues, specifically financial statement frauds and books and records violations. For the purposes of our analyses, we refer to these as “in-scope fraud schemes.” See Appendix A: Scope and Methodology in the AFC report (page 29) for more details.

I. TOP IN-SCOPE FRAUD SCHEMES BY INDUSTRY

+ The AFC report classified the most common fraud schemes into four major categories based on highest number of cases: improper revenue recognition (40 percent), reserves manipulation (28 percent), inventory misstatement (12 percent), and loan impairment deferral (8 percent). See section *Fraud Schemes and Related Issues* in the AFC report (page 9) for additional information.

+ Of the industry sectors that were most commonly charged by the SEC, technology services companies had the most instances of **revenue related issues** with 11 enforcement actions, followed by the manufacturing (8), healthcare (8), and energy (7) industry sectors.

+ For **reserves related issues,** banking and finance (8), technology services (5), and manufacturing (4) companies were charged most frequently.

+ Healthcare (3), technology services (3), and manufacturing (2) companies had enforcement actions involving **inventory related issues**.

+ Banking and finance (12) companies were charged in 86 percent of the cases involving **impairment related issues.**

KEY ELEMENTS OF FRAUD SCHEMES

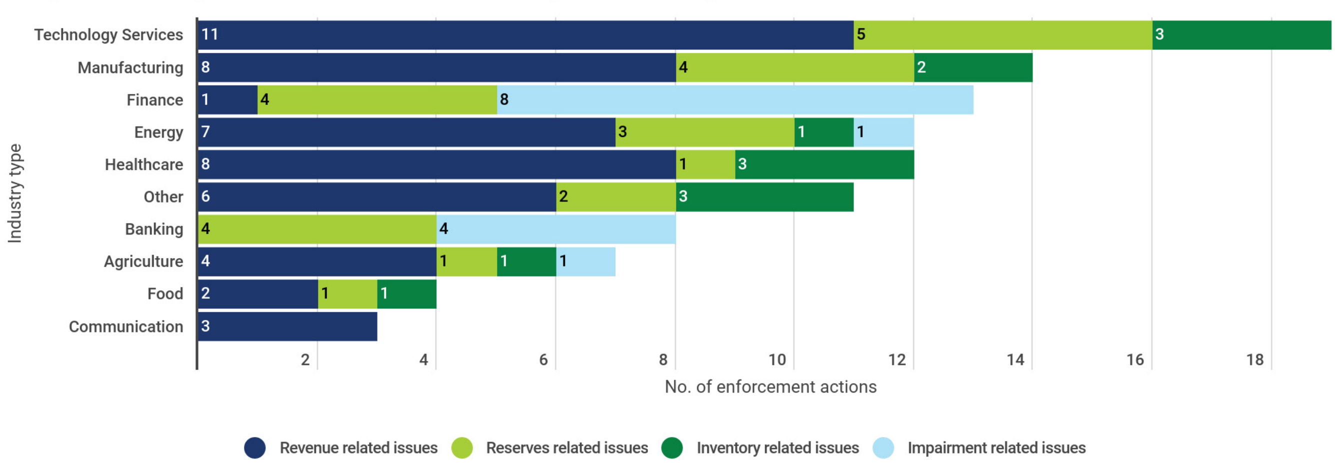
Revenue related issues
Improper revenue recognition attributable to timing, valuation, fictitious revenues, and percentage of completion.

Reserves related issues
Manipulation or improper reduction of reserves, timing of reserves and of recording of expenses, manipulation or misclassification of expenses, improperly calculated rebate/expense accruals, and failure to recognize liabilities.

Inventory related issues
Inventory misstatement including misstating cost of sales and misstating or overstating inventory.

Impairment related issues
Timing of impairments, including loan impairment deferral, failure to record asset impairment, faulty valuations, and improper reserves manipulation.

Top In-Scope Fraud Schemes by Industry



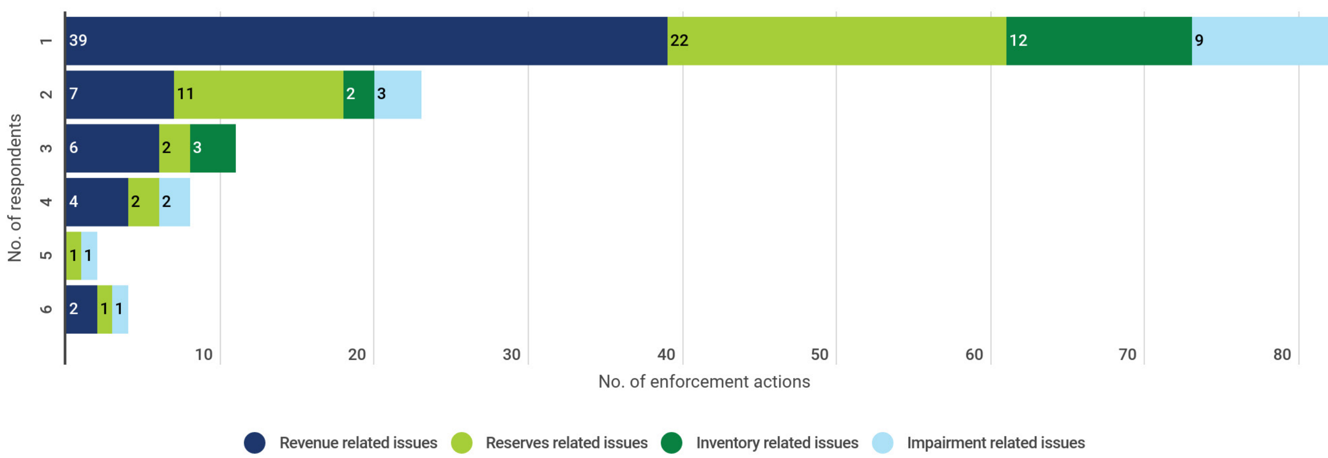
II. RESPONDENT TYPES BY TOP IN-SCOPE FRAUD SCHEMES

+ When fraud occurs, the SEC often charges the issuer/company. With a consistent focus on holding individuals accountable, the SEC has also frequently charged company executives and employees for their conduct, either along with the company or independently. Due to the number of entities involved, each case often requires a significant amount of time from the onset of an investigation to when the SEC brings an action against the parties. As many cases involve several entities that can include company management, board of directors, auditors, financial institutions, stakeholders, and other third parties, the SEC can issue multiple enforcement actions that cover the same fraud.

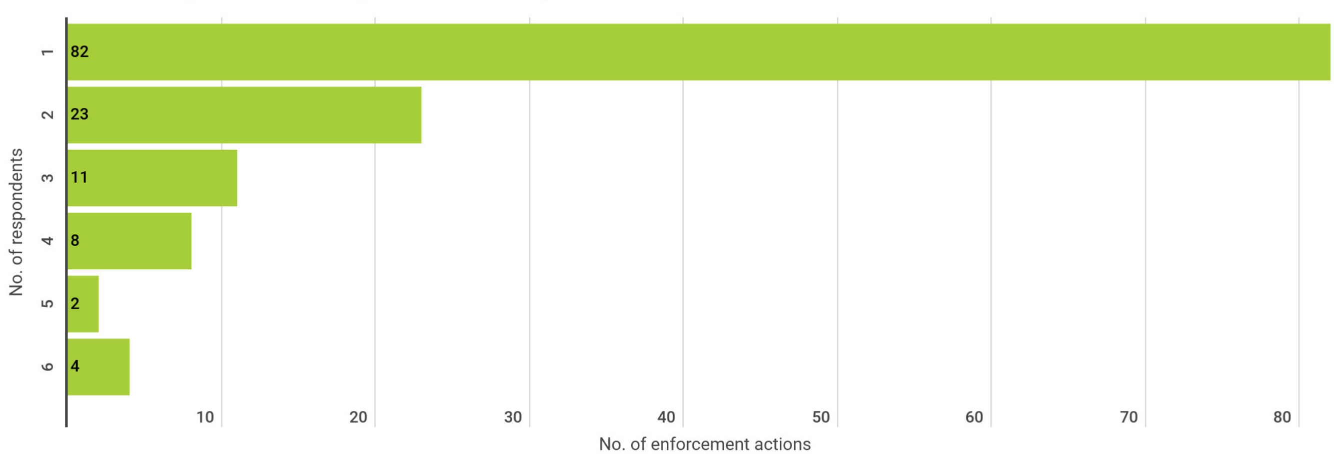
+ More than 90 percent of the total number of in-scope fraud schemes involved either one or two respondents per scheme. For purposes of the analysis, enforcement actions that were part of the same underlying fraud schemes or charges were grouped together. Instances in which the enforcement actions involved one respondent include either the issuer/company or an individual.

+ Of the 140 in-scope fraud schemes, 47 instances (34 percent) did not include charges against the issuer/company during the review period. We did not verify whether an issuer/company was charged

No. of Respondents by Top In-Scope Fraud Schemes



No. of Respondents per In-Scope Fraud Scheme



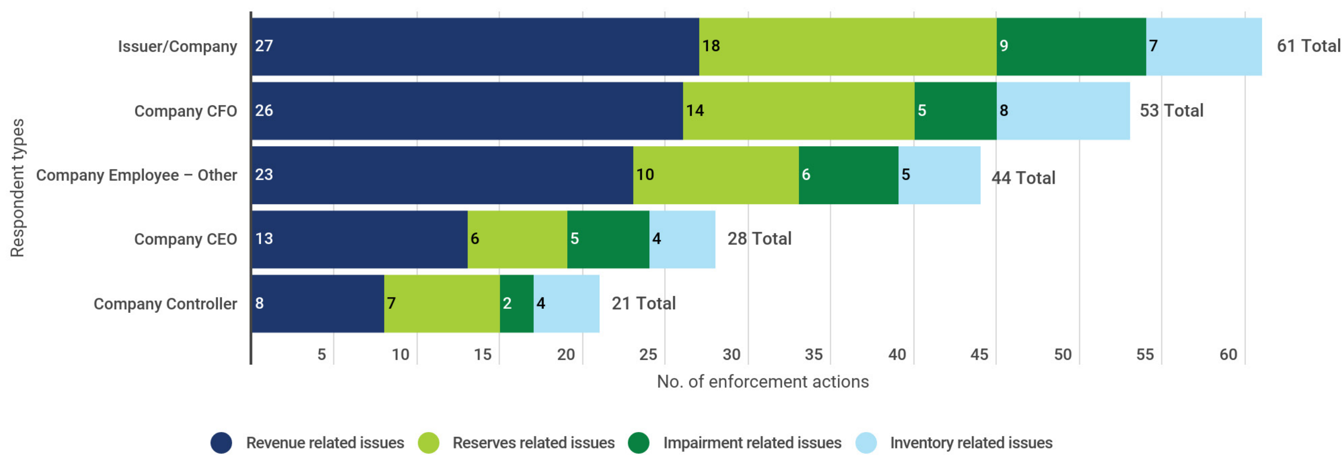
for the same fraud in a separate enforcement action prior to January 1, 2014 or after June 30, 2019.

+ When looking at the positions held by individuals identified in SEC enforcement actions, the Chief Financial Officer is most often named, followed by the Chief Executive Officer and the Controller. Other employees cited include those in finance and accounting functions such as the Finance Manager, Finance Director, Vice President of Finance, and Chief Accountant. We also noted that respondents cited in the enforcement actions could have more than one role, which would result in more than one designation illustrated herein. See section *SEC Enforcement Observations* in the AFC report (page 20) for additional information.

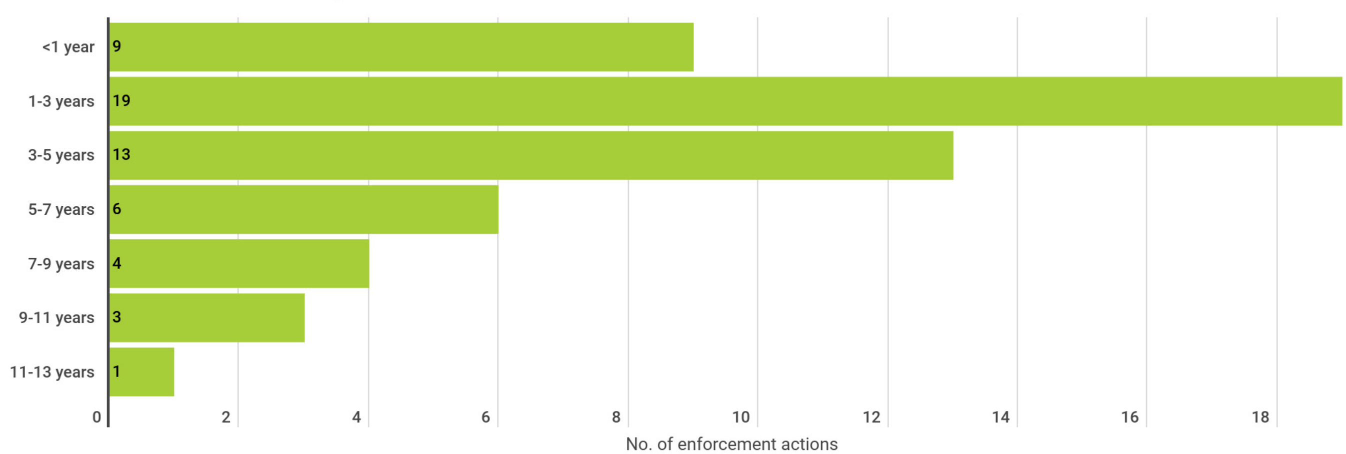
III. DURATION OF IN-SCOPE FRAUD SCHEMES

+ Most fraud schemes identified in the enforcement actions occurred over a period of time, typically between one and three years until the scheme was uncovered or ceased prior to its discovery. Eight of the enforcement actions in our study did not specify the time periods over which the fraud schemes occurred, and so those enforcement actions were excluded from the analysis below.
    - The most common fraud schemes were perpetrated for just over two years on average, with the exception of inventory related frauds, which tended to last 2.65 years.

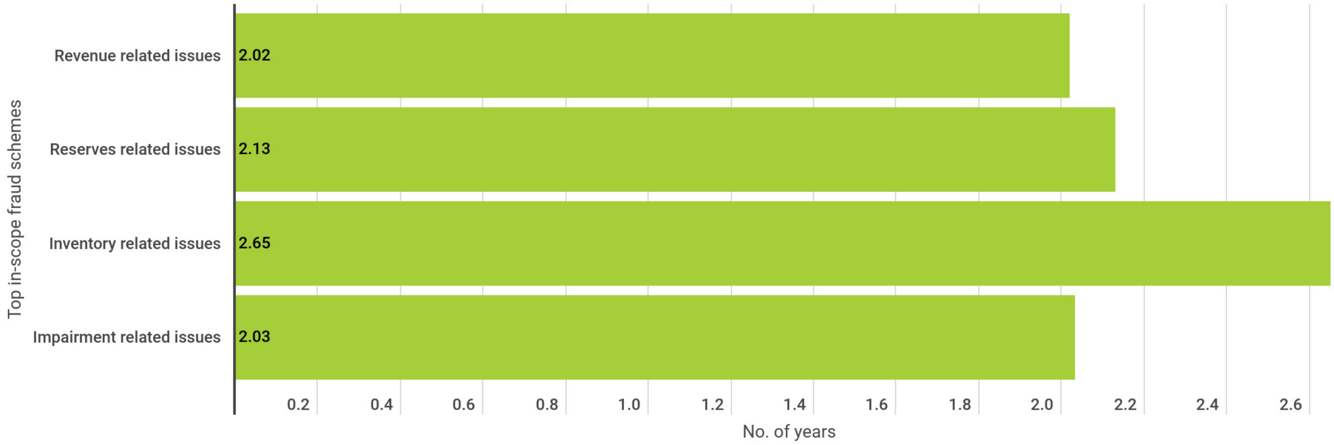
Respondent Types by Top In-Scope Fraud Schemes



Duration of In-Scope Fraud Schemes



Average Duration of Top In-Scope Fraud Schemes



+ While the fraud schemes tended to average just over two years in duration, the range in the duration of the frauds committed varied, from as short as under three months for three of the fraud schemes analyzed, to as many as 8.2 years for revenue related fraud schemes.

  - **Revenue related fraud issues** ranged from under 3 months to 8.2 years.

  - **Reserves related fraud issues** ranged from under 3 months to 7.5 years.

  - **Inventory related fraud issues** ranged from 1 year to 5.8 years.

  - **Impairment related fraud issues** ranged from under 3 months to 5.2 years.

+ Based on the analysis, it appears that financial statement frauds can be perpetrated for extended periods without being detected. This may be the case regardless of the commonality, complexity, and perceived risk of the accounting areas involved. The results of this supplemental analysis highlight the importance for gatekeepers to stay vigilant in conducting proactive and routine fraud risk assessments, and to commit to continually improving their organizations' fraud risk management practices and programs.

In order to glean insights from financial reporting supply chain members on the results of its analysis, the AFC facilitated a roundtable event. The objective was to discuss some of the common fraud schemes, the contributing factors identified in the analysis, and identify lessons learned from the perspective of their different roles. A summary of the key takeaways from the roundtable event, *Mitigating the Risk of Fraud: Practical Observations and Lessons Learned*, was released in June 2021.

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