

Ten things about financial
statement fraud — third edition
*A review of SEC enforcement releases,
2000–2008*



Company officers were named in 81% of the enforcement releases the SEC issued in 2008 that we analyzed in our study.

Ten things about financial statement fraud — third edition (updated through 2008)

Despite stringent legislation, such as the Foreign Corrupt Practices Act and the Sarbanes-Oxley Act aimed at combating fraud — and despite enforcement efforts by the Securities and Exchange Commission (SEC) and the Department of Justice — financial statement fraud remains a public concern.

But just what types of fraud is the SEC alleging in its enforcement actions? Are some industry sectors more prone to alleged fraud than others? Have alleged fraud scheme preferences and industry patterns changed over time? What were the roles of the individuals who were alleged by the SEC to have been involved in financial statement fraud?

To learn how alleged fraud schemes have evolved over the current decade, the Deloitte Forensic Center has analyzed hundreds of SEC enforcement releases issued from 2000 through 2008.

These findings may have significance for the global effort to develop more robust business processes for managing the risk of financial statement fraud — and mitigating it. The efficacy of such processes may be enhanced by understanding the alleged fraud schemes typically committed and the industry-specific patterns in the occurrence of those schemes.

Methodology

The SEC reports on its administrative enforcement actions through its Accounting and Auditing Enforcement Releases (AAERs). The Deloitte Forensic Center's staff reviewed more than 1,700 AAERs issued by the SEC from January 2000 through December 2008. For our analysis, we considered, where possible, the AAERs that most comprehensively addressed particular instances of alleged financial statement fraud at SEC-registered companies. This resulted in the inclusion of more than one AAER for some companies, when the SEC issued multiple AAERs detailing multiple, discreet alleged fraud schemes. We excluded releases that repeated alleged fraud schemes we had already identified, or which dealt with alleged insider trading, actions against vendors, or auditors. This filtering process resulted in the 430 AAERs relating to 392 companies that are the subject of this study.

We sorted companies into nine industries, using categories we developed, as well as noting subindustries as appropriate:

- Aviation and Transport Services
- Consumer Business
- Energy and Resources
- Financial Services
- Life Sciences and Health Care
- Manufacturing
- Public Sector
- Real Estate
- Technology, Media, and Telecommunications

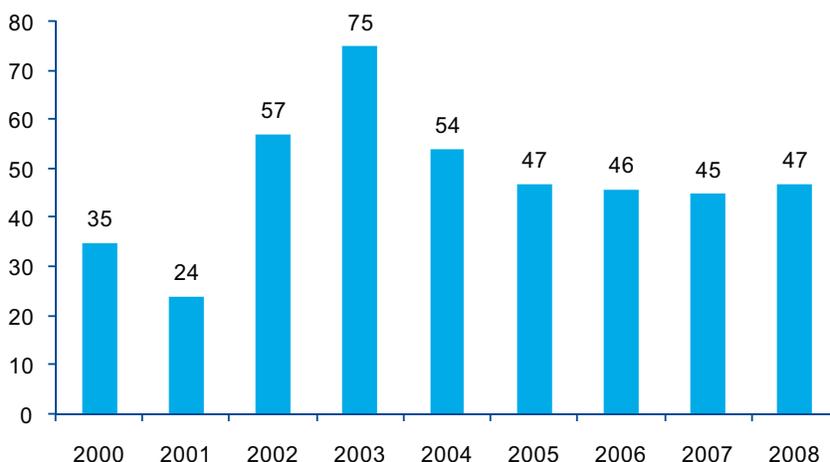
We classified the alleged frauds identified into 12 categories and 61 subcategories based on how the alleged fraud was committed. AAERs typically describe more than one alleged fraud scheme active in a company in a given period. The 12 main categories are:

- Aiding and Abetting
- Asset Misappropriation
- Bribery and Kickbacks
- Goodwill
- Improper Disclosures
- Investments
- Manipulation of Accounts Receivable
- Manipulation of Assets
- Manipulation of Expenses
- Manipulation of Liabilities
- Manipulation of Reserves
- Revenue Recognition

We also compared the length and time between the first alleged commission of fraud to the issuance date of the latest related AAER included in our study.

1. How many enforcement releases alleging new financial statement fraud schemes has the SEC issued?

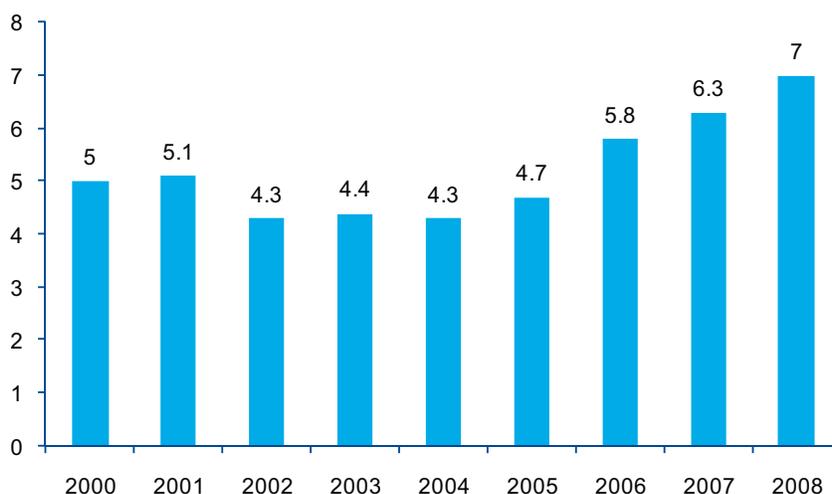
Chart 1: AAERs issued by the SEC alleging financial statement fraud schemes, by year



- Using the filtering process in the methodology described herein, we identified 430 Accounting and Auditing Enforcement Releases (AAERs) issued by the SEC from 2000 through 2008 relating to instances of alleged financial statement fraud schemes at SEC-registered companies.
- In the years following the Enron and WorldCom collapses, the number of AAERs issued by the SEC more than doubled, from 35 in 2000 to 75 in 2003.
- The number of AAERs related to alleged financial statement fraud schemes has since fallen to fewer than 50 per year beginning in 2005 and remained quite consistent through 2008.

2. What is the average duration, in years, from the start of the alleged fraud scheme to the latest related AAER in our study?

Chart 2: Average duration, in years, from the first alleged commission of a fraud scheme to the issuance of the AAER included in our study



- We determined the time between the start date of each alleged fraud scheme, as described in the AAER, and the issuance date of the AAER. This is an approximate measure of the length of the time during which a business may be affected by the alleged fraud.
- The average duration has been steadily increasing since 2004, reaching seven years in 2008, a record for this decade. This represents an increase of approximately 63% since 2004.
- The seven-year average duration means that alleged financial statement fraud reported in 2008 AAERs started, on average, in 2001. Of course, recent AAERs may not indicate future trends for alleged financial statement frauds.

3. How many alleged fraud schemes were identified per company?

Chart 3a: Number of companies with alleged fraud schemes

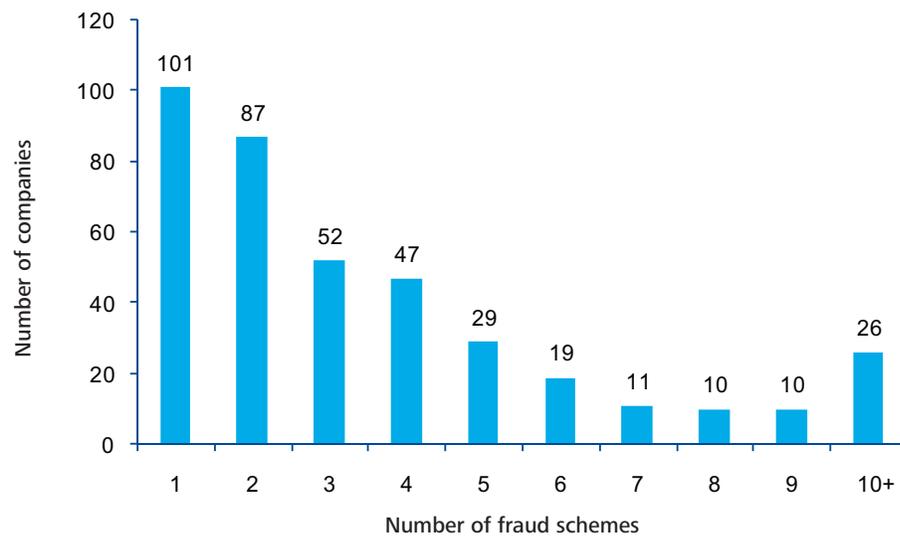
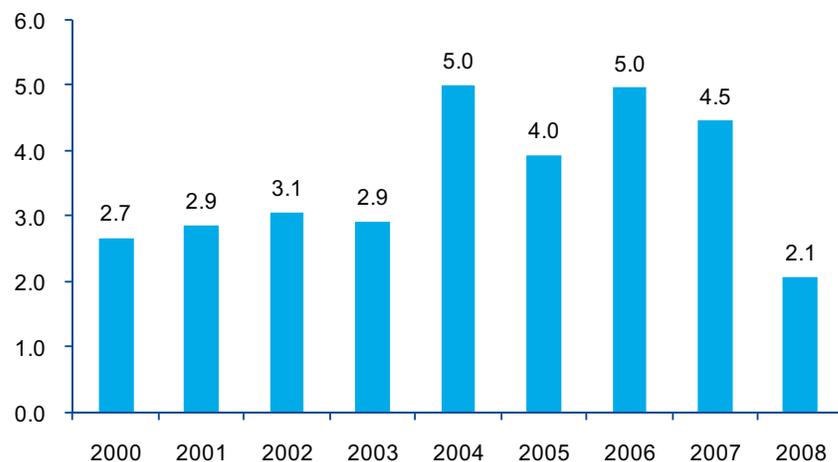


Chart 3b: Average number of alleged fraud schemes per company



- Of the 392 companies identified in the 430 AAERs in this study, 74% had more than one alleged fraud scheme identified in the AAERs — with 26 companies (7%) having 10 or more.
- Four of the 26 companies in the 10 plus group had 20 or more alleged fraud schemes described in the SEC releases.
- The average number of alleged fraud schemes identified by the SEC per company declined by approximately 53% from 2007 to 2008, from 4.5 to 2.1.

4. Was the subject of the SEC's alleged financial statement fraud enforcement release a company, a company officer, or both?

Chart 4a: Distribution of AAERs with each category of subjects, by year

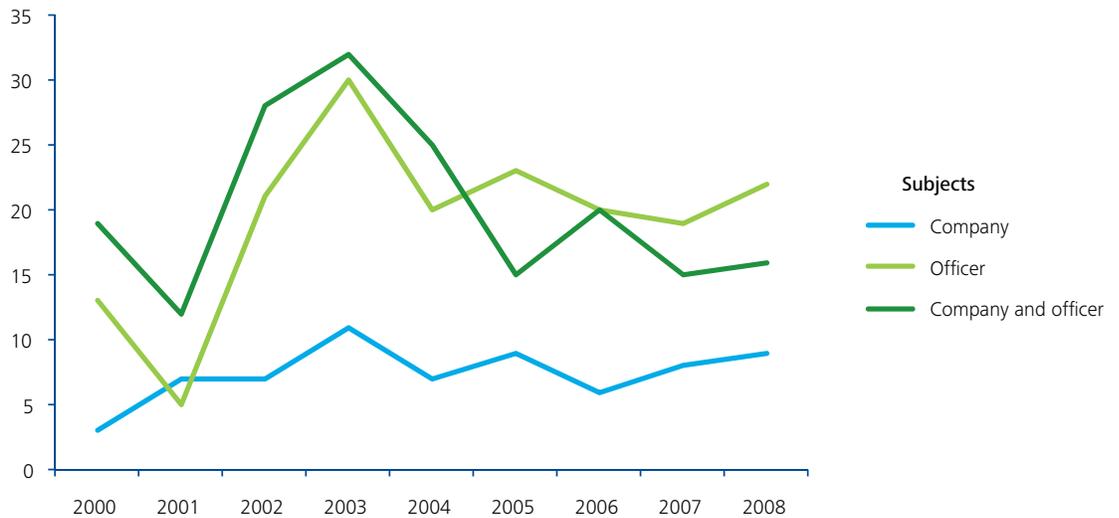
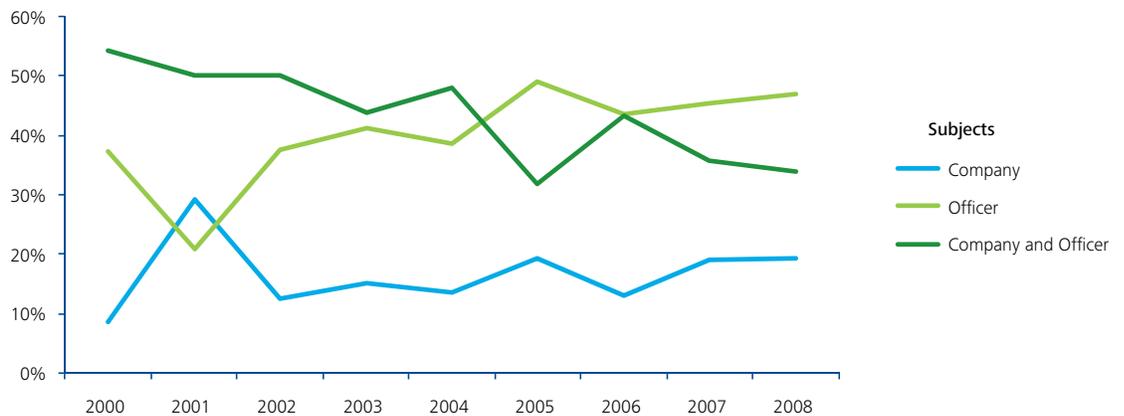


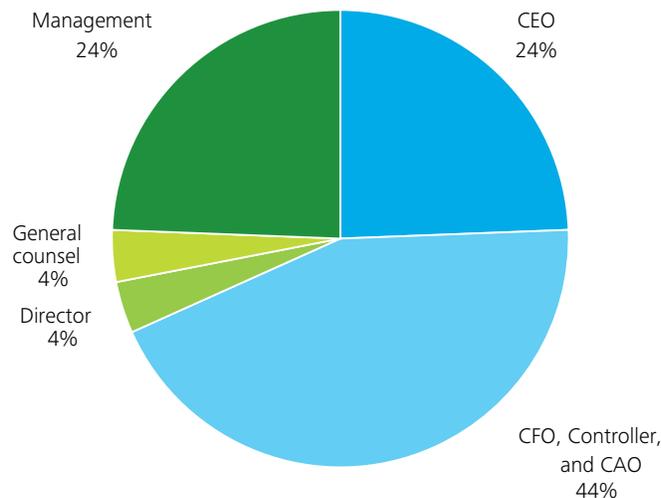
Chart 4b: Distribution of AAERs with each category of subjects, by year



- The SEC issues enforcement releases, for example, identifying a company, one or more officers of a company, and sometimes both.
- Since 2001, the percentage of alleged financial statement fraud AAER subjects who are company officers has increased. This may denote greater emphasis by the SEC on holding company officers personally accountable for incidents of alleged financial statement fraud at their companies.
- In 2008, company officers were named, either individually or along with the company itself, in 81% of the AAERs included in our study.

5. What were the roles of the individual subjects of SEC alleged financial statement fraud enforcement releases in 2008?

Chart 5: Roles of individual subjects of SEC alleged financial statement fraud AAERs issued in 2008



- Forty-four percent of the individuals identified in the SEC's alleged financial statement fraud enforcement releases we analyzed for 2008 had the role of chief financial officer (CFO), chief accounting officer (CAO), or controller. Chief executive officers (CEOs) accounted for 24%.
- Other members of management alleged by the SEC to be involved in the financial statement frauds included those in sales, operations, and planning. Many held the title of vice president or senior vice president. Collectively, they represented 24% of individuals identified in the SEC's enforcement releases in 2008 — the same proportion as CEOs.
- Directors and general counsel were each identified as subjects of 4% of the financial statement fraud enforcement releases we analyzed for 2008. This indicates a willingness of the SEC to pursue charges against parties allegedly involved in financial statement fraud, other than the traditional targets of CEOs and financial executives.

6. What were the most common financial statement fraud schemes alleged by the SEC?

Chart 6a: Proportion of financial statement fraud schemes represented by each alleged fraud scheme in AAERs from 2000 through 2008

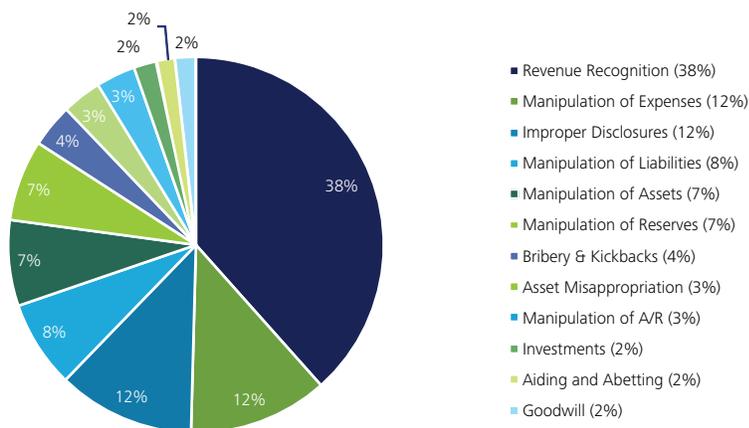
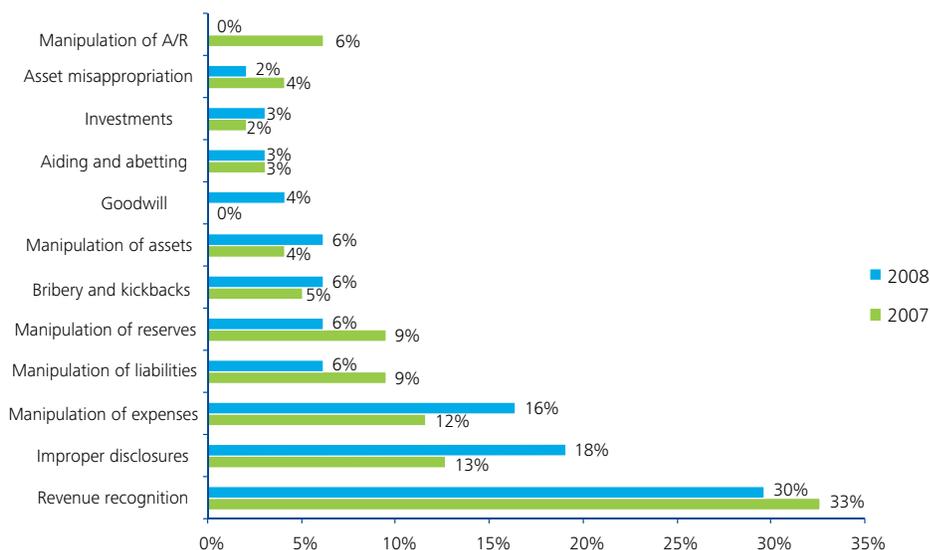


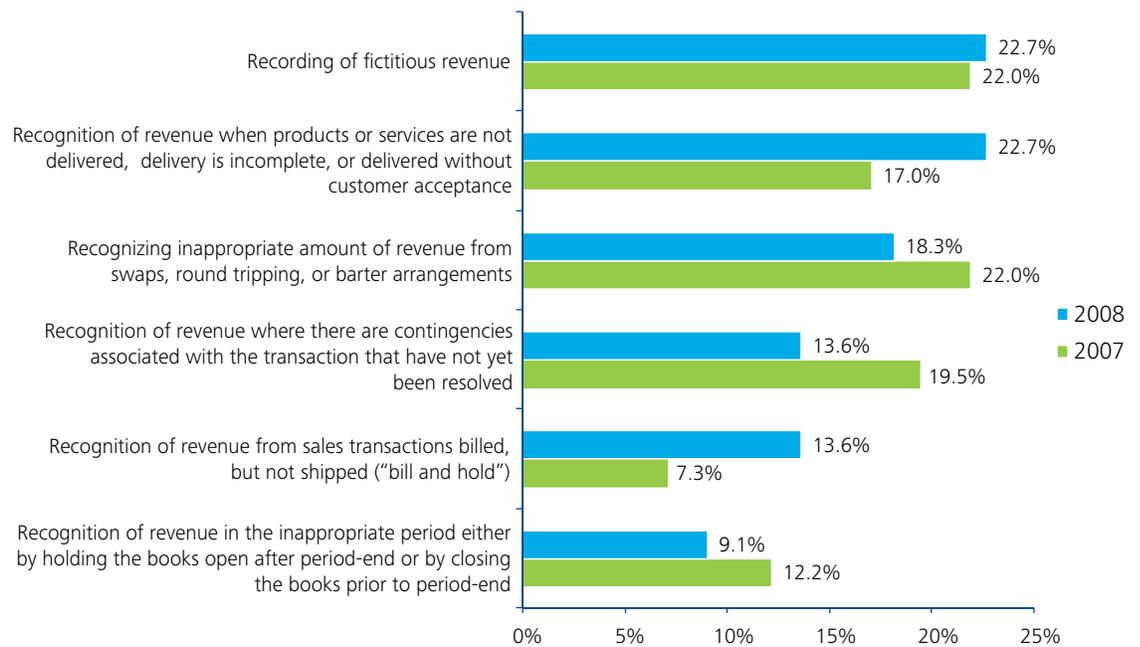
Chart 6b: Proportion of alleged financial statement fraud schemes represented by each such fraud scheme in 2007 and 2008 AAERs



- Of the SEC enforcement releases in our study from 2000 to 2008, 38% identified alleged fraud schemes related to revenue recognition fraud, making this the most common alleged financial statement fraud scheme identified in AAERs. But for 2008 alone, just 30% of the enforcement releases related to revenue recognition, down from 33% in 2007. The change from 2007 to 2008 is part of a broader trend beginning in 2003, seen on Chart 8.
- Improper disclosures formed the second most common scheme alleged by the SEC for 2008, accounting for 18% of financial statement fraud schemes in 2008 enforcement releases, up from 13% in 2007.
- Alleged manipulation of accounts receivable (A/R), liabilities, and reserves decreased in 2008 from 2007, while alleged manipulation of expenses and goodwill increased.

7. What were the most common types of revenue recognition fraud alleged by the SEC in 2007 and 2008?

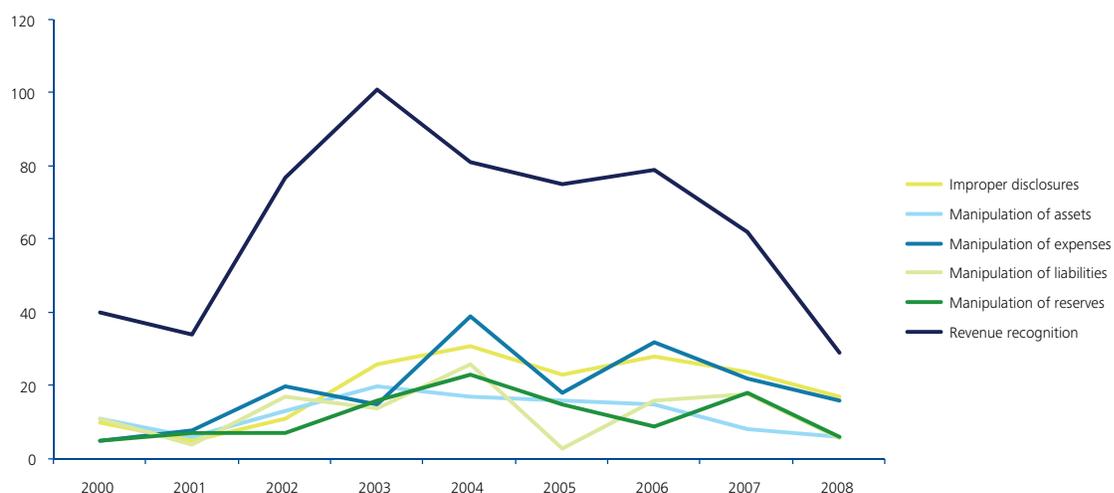
Chart 7: Most common types of revenue recognition fraud alleged in 2007 and 2008 AAERs



- The six types of revenue recognition schemes depicted above account for 76% of all alleged revenue recognition schemes identified in the 2008 AAERs we analyzed and 66% of all alleged revenue recognition schemes in 2007 AAERs.
- The most common alleged revenue recognition schemes in the 2008 AAERs were recognition of fictitious revenue and recognition of revenue when products or services are not delivered, delivery is incomplete, or items are delivered without customer acceptance.
- Recording of fictitious revenue was also the most common type of revenue recognition fraud scheme alleged by the SEC in AAERs overall from 2000 through 2008, followed by recognizing inappropriate amounts of revenue from swaps, round-tripping, or barter arrangements.

8. What are the trends for the “top” six alleged financial statement fraud types?

Chart 8: Incidence of top six alleged fraud schemes, by AAER release date



- While revenue recognition fraud continues to be the most common financial statement fraud scheme alleged by the SEC in AAERs from 2000 through 2008, the number of such schemes has declined in all but one year since 2003.
- If alleged revenue recognition frauds continue to decline, they could soon be at a level similar to that of other alleged financial statement fraud schemes, rather than being several times more common as has been the case during most of this decade. This may have implications for corporate fraud risk assessments and for regulatory policy.
- The remainder of the top six alleged financial statement fraud schemes have fluctuated inconsistently during this period, making it harder to predict where future alleged financial statement frauds may lie.

9. How are alleged financial statement fraud schemes distributed across industries?

Chart 9a: Number of alleged fraud schemes by industry identified in AAERs from 2000 to 2008

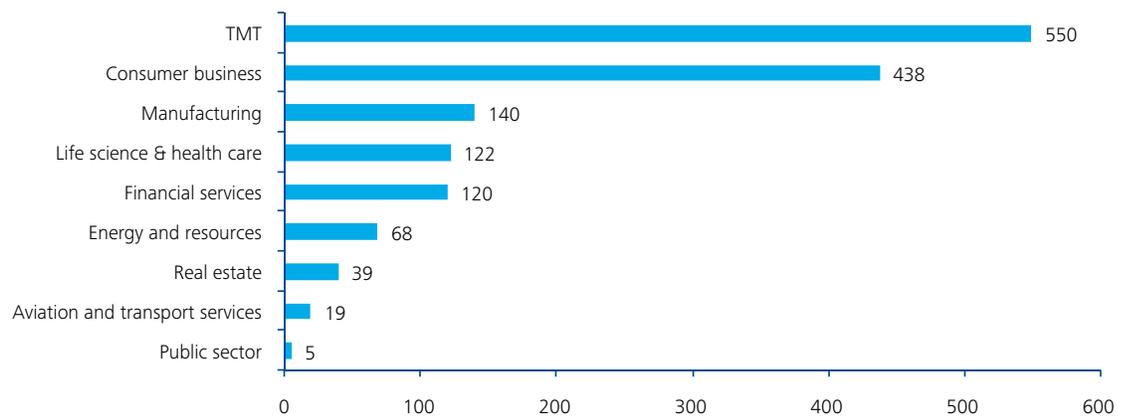
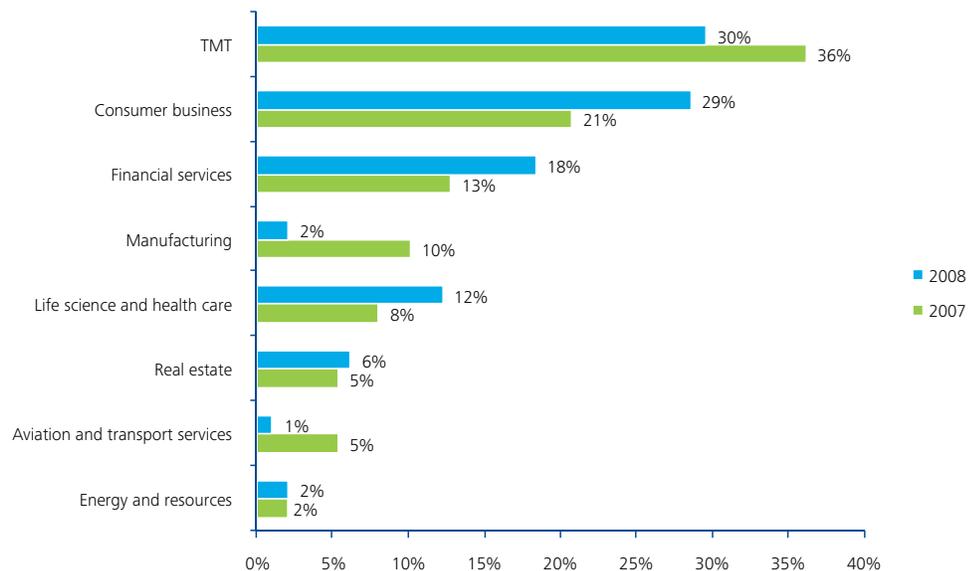


Chart 9b: Proportion of alleged fraud schemes in each industry identified in AAERs in 2007 and 2008



- Of the 1,501 alleged fraud schemes identified in the 430 AAERs from 2000 to 2008 that we analyzed for this study, two-thirds were accounted for by two industries: TMT (technology, media, and telecommunications) had 37% and consumer business had 29%.

- The consumer business, financial services and life science and healthcare industries showed at least one-third growth in their share of alleged fraud schemes in 2008 AAERs as compared to 2007 AAERs. This may be in part due to growing regulatory attention being given to the financial services and life science and healthcare industries.

10. In the “top” three industries, how are the alleged schemes distributed across subindustries in 2007 and 2008?

Chart 10a: Number of alleged financial statement fraud schemes in segments of each “top” industry identified in AAERs from 2000 to 2008

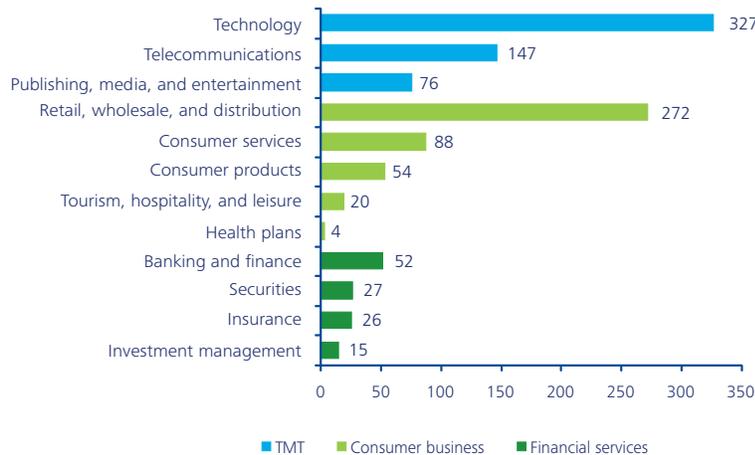
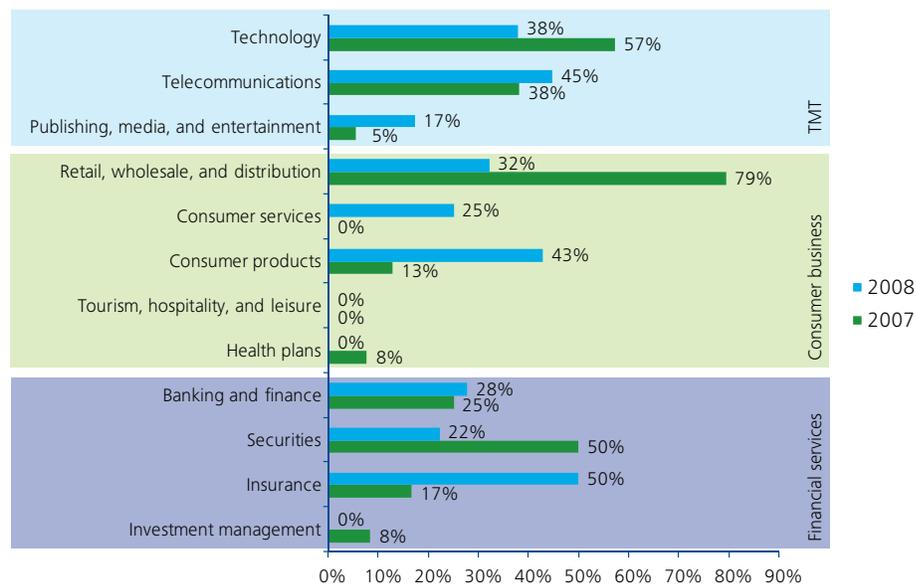


Chart 10b: Number of alleged financial statement fraud schemes in each “top” industry identified in AAERs in 2007 and 2008



- From 2000 to 2008, alleged fraud schemes in the TMT (technology, media and telecommunications) and consumer business industries as identified by the SEC in AAERs were predominantly in the technology subindustry. But in 2008, AAERs were more evenly distributed among subindustries.
- In 2008, in the consumer business industry, 43% of identified alleged fraud schemes occurred in the consumer products subindustry, more than three times the level of 2007.
- In 2008, in the financial services industry, 50% of identified alleged fraud schemes occurred in the insurance subindustry, an increase from 17% in 2007. In contrast, the securities subindustry fell from 50% to 22% of alleged fraud schemes in this industry.

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- The Fraud Enforcement and Recovery Act "FERA"
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 - Fraud Investigation and Corrective Action
- Ten Things About Fraud Control

Notable material in other publications:

- Mapping Your Fraud Risks, *Harvard Business Review*, October 2009
- Listen to Your Whistleblowers, *Corporate Board Member*, Third Quarter, 2009
- Use Heat Maps to Expose Rare but Dangerous Frauds, *HBR NOW*, June 2009
- Essentials of Fraud Detection Monitoring, *White-Collar Crime Fighter*, May 2009
- Bankruptcy and Fraud, *The Bankruptcy Strategist*, April 2009
- Bankruptcy and Fraud: The Ties That Bind?, *Business Crimes Bulletin*, February 2009

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