

SEC Financial Reporting and Audit Task Force

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Margie Reinhart, CPA, CFF, CFE

Grant Thornton - Director



Margie Reinhart
Director
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Margie Reinhart is a Director in our Forensic, Investigative and Dispute Services practice in Dallas, Margie has devoted her 19 year career to be highly skilled in the multi-facets of forensic investigation, expert services, forensic data analytics, fraud consulting and white collar investigations. She spent over 11 years at a Big Four accounting firm and over two years running boutiques forensic investigation firms.

Margie works closely with government agencies, corporate executives and law firms practicing in both the U.S. and Canada, and has testified as a fact and expert witness. She brings extensive knowledge of a variety of white-collar civil and criminal matters, including internal corporate and financial fraud investigations. She has conducted and coordinated multi-faceted investigations involving retail, manufacturing, fraud against the government, real estate and many other industries.

Certifications and Memberships

- Certified Public Accountant
- Certified in Financial Forensics
- Certified Fraud Examiner
- Member of the Association of Certified Fraud Examiners
- Member of the American Institute of Certified Public Accountants

Education

- Ryerson Polytechnic University, Toronto, Canada
- Bachelor of Business Management

Ed Tomko, Senior Counsel

Dykema - Member



Ed Tomko
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Ed Tomko Tomko is a member of Dykema's Business Litigation Group whose practice is focused on federal and state white collar crime cases involving government contracts, financial institutions, securities, environmental and health care issues.

Ed has also represented clients federal and state administrative actions by banking regulators, securities regulators, and suspension and debarment authorities. In addition, he has handled federal civil cases such as *qui tam* and other False Claims Act actions, securities litigation including FINRA arbitration actions, contract suits involving fraud or breach of contract allegations, RICO actions, and regulatory recovery actions.

For almost 20 years prior to his legal career in the private sector, Mr. Tomko held various positions in the Department of Justice and the Securities and Exchange Commission as well as serving as Assistant District Attorney in Pittsburgh, Pennsylvania.

Memberships & Involvement

- American Bar Association White Collar Crime Section and Business Law Section (White Collar Crime and Corporate Compliance Subcommittees);
- Dallas Bar Association (Securities law Section).
- Texas Bar Association

Awards & Recognition

- Named a Texas Super Lawyer by *Law & Politics*
- Named one of "The Best Lawyers in Dallas" by *D Magazine*
- Named to Litigation Counsel of America

John C. Dickey, Senior Counsel

Grant Thornton - Member



John Dickey
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John Dickey a member in Dykema's Dallas office, concentrates his practice on securities, corporate finance, antitrust, and commercial law. He is a member of Dykema's Corporate Finance Practice Group and Dental Service Organization Group. Mr. Dickey is experienced in securities regulation, both at the state and federal levels, as well as in equity and hedge fund regulation, debt and equity offerings, venture capital financings, mergers and acquisitions, joint ventures, partnerships and general corporate matters.

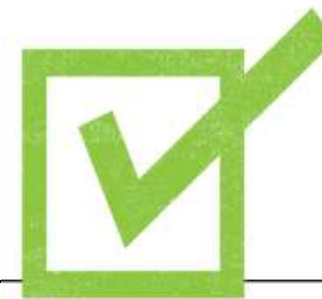
Mr. Dickey has experience representing clients across a wide variety of industries, including the defense, homeland security, software, internet, telecommunications, pharmaceutical, biomedical, aerospace, technology, software, consumer products, food, hospitality, energy and service industries.

He counsels both private and public companies in a variety of corporate law matters including in such areas as formation, public and private financings, restructuring, stock splits, spin-offs, regulatory compliance, intellectual property and strategic alliances. He has also managed commercial and distribution/licensing matters within the United States and throughout the world.

Select Experience

- Successfully defended corporation in Texas State Securities Board investigation regarding sale of unregistered securities.
- Conducted hostile tender offer and proxy fight for public company.
- Successfully formed private equity funds for several clients.
- Completed multiple acquisitions of cable television networks.
- Accomplished leveraged management buy-out of high-tech manufacturer.
- Represented national retailer in spin-off of one of its major business units.
- Lead legal counsel for public royalty trust with numerous public filings and registrations.

Learning Objectives



- Identify emerging SEC initiatives and missions related to fraud
- Gain an understanding of the SEC's Center for Risk and Quantitative Analytics & Accounting Quality Model
- Discuss possible criteria the SEC can utilize to prioritize investigations
- Design pro-active steps that can be taken to reduce higher SEC fraud risk scoring and scrutiny

Agenda

1. Background
2. Financial Reporting and Audit Task Force
3. Center for Risk and Quantitative Analytics
4. Corporate Profiling
5. FRAT Focus Areas
6. Staying Under the Radar



Background



Background – Evolution of SEC Enforcement



- **May 2000** - SEC creates Financial Fraud Task Force
 - oversee and coordinate investigations of possible financial frauds
- **August 2009** - New SEC Enforcement Director, Robert Khuzami, creates 5 specialized units
 - none focused on financial fraud
 - in 2010 Financial Fraud Task Force was dissolved
- **June/July 2013** - New SEC Chairman, Mary Jo White, announces renewed focus on financial statement and accounting fraud
 - new initiatives include:
 - Financial Reporting and Audit Task ("FRAT") Force
 - Center for Risk and Quantitative Analytics ("CRQA")

SEC - Renewed Commitment to Fraud

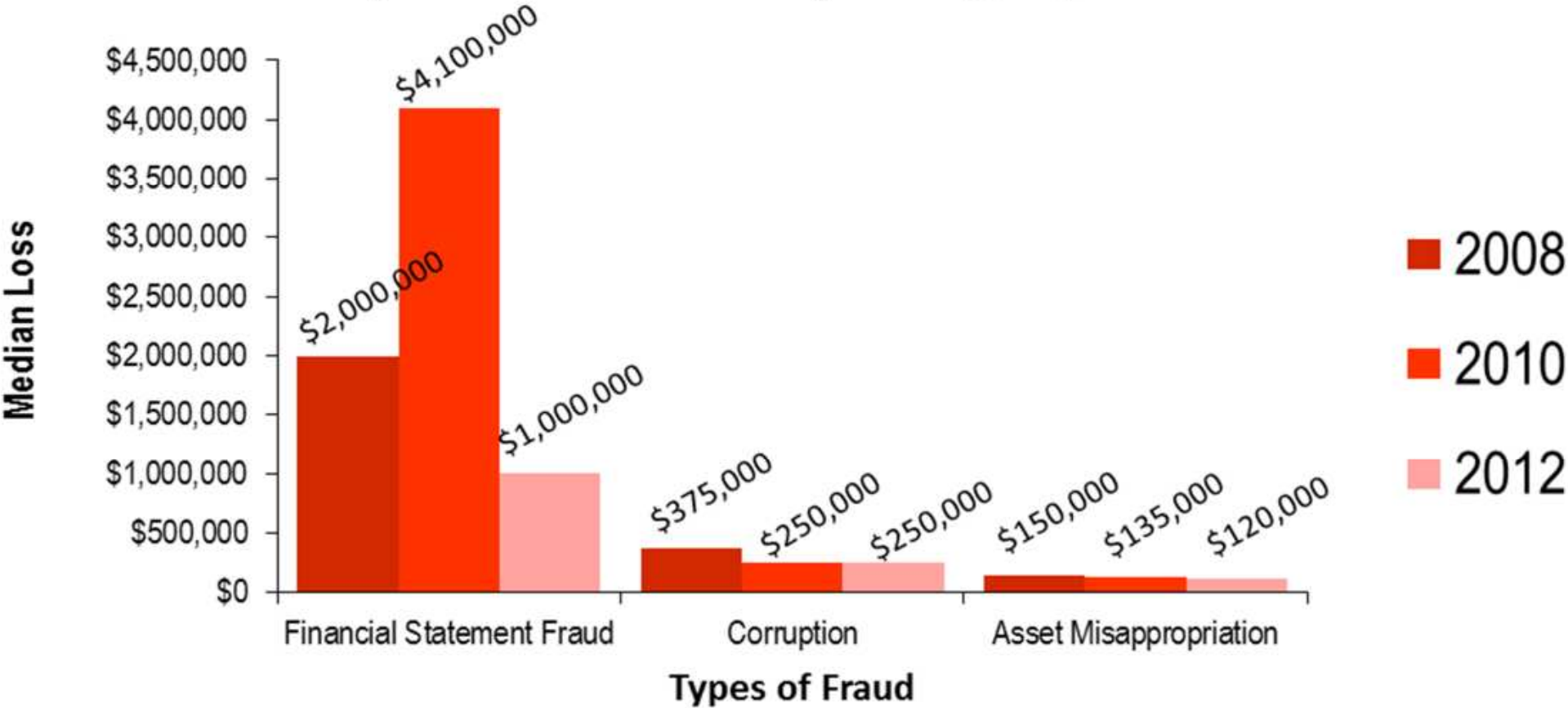
Types of SEC Enforcement Actions - 2003 to 2013



www.sec.gov/news/newsroom/images/enfstats.pdf

Median Loss by Fraud Type

Occupational Frauds by Category - Median Loss



ACFE 2012 Report to the Nations

SEC FRAT & CRQA



SEC - Financial Reporting and Audit Task Force (FRAT)

- FRAT initiative:
 - Headed by **David Woodcock** (Fort Worth Regional Office)
 - Prior to SEC:
 - partner at Vinson and Elkins
 - specialized in securities litigation and SEC enforcement
 - financial and IT auditor at PWC and Ernst and Young
- FRAT to consist of Attorneys and Accountants
 - "Best and most aggressive staff"



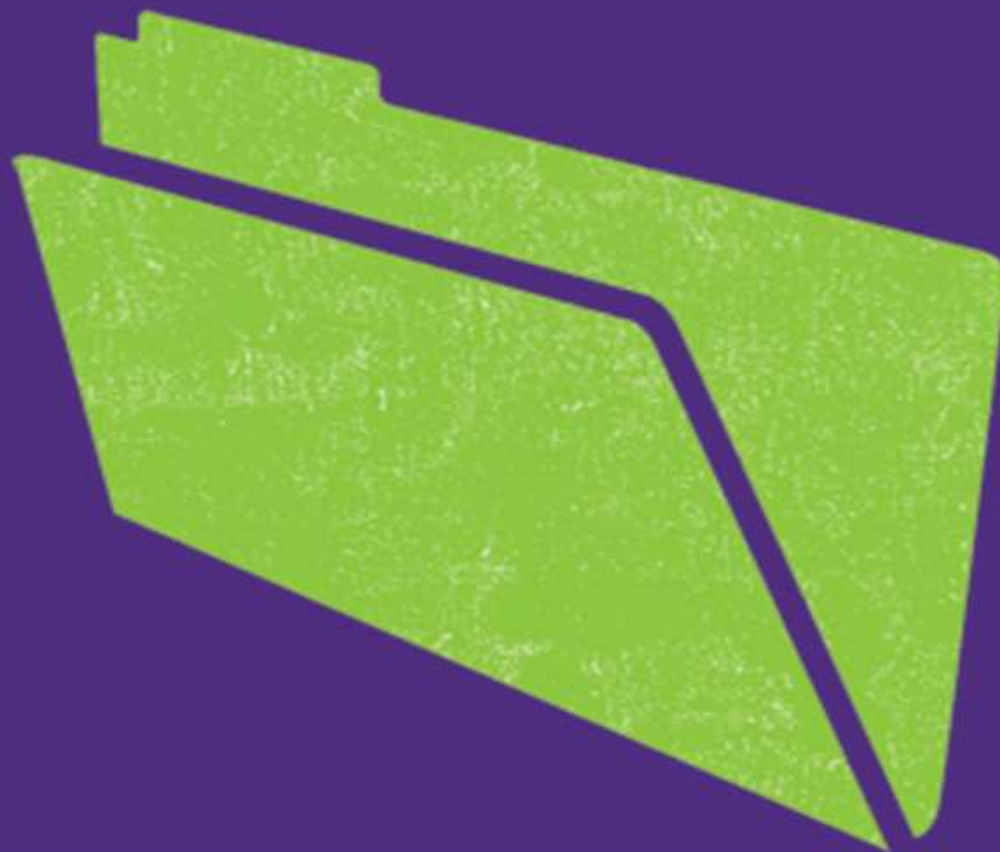
"Task Force will feel pressure to produce more investigations and bigger cases."

SEC - Center for Risk and Quantitative Analytics (CRQA)



- CRQA
 - Lead by **Lori Walsh**
 - Economist
 - Deputy Chief, SEC Enforcement Division, Office of Market Intelligence
- CRQA key objectives:
 - assist staff members by bringing analytical techniques
 - add computing capacity with special expertise in data mining
- CRQA will share information and coordinate with:
 - FBI
 - Consumer Financial Protection Bureau (CFPB)
 - Other SEC offices and divisions

SEC Corporate Profiling



SEC - Corporate Profiling and the AQM System

- Accounting Quality Model (AQM)'s objectives:
 - Identify earnings management
 - Analyze Management's Discussion and Analysis (MD&A) searching for criteria that is frequently associated with fraudulent filings
- FRAT will utilize new AQM to prioritize investigations and concentrate review efforts



"Companies able to minimize their risk score will be less likely to face unnecessary SEC audits for innocent activity."

SEC - Considerations for Ranking Investigations

"SEC Division of Enforcement Manual" indicates the following criteria will be used to rank potential cases for investigation:

1. Opportunity to send a particularly strong and effective **message of deterrence**
2. Particularly egregious or extensive **misconduct**
3. Widespread and extensive **harm to investors**
4. **Misconduct** by positions of substantial authority or those with fiduciary duty
5. Potential **wrongdoing** under newly enacted legislation or rules
6. Significant **risks for investors** or a systemically important sector of the market
7. Substantial number of potential **victims** or particularly vulnerable victims
8. Products, markets, transactions or practices that the Division has identified as **priority areas**
9. Opportunity to pursue **priority interests** shared by other law enforcement agencies on a coordinated basis



Discussion

What immediate concerns do you have related to the FRAT Force?

Does your company currently perform any analytical techniques to identify fraud?

What are you going to do to prepare your company for potential risks?



SEC - FRAT Focus Areas

FRAT has indicated staff will focus on the following:

- Revenue recognition
- Asset and liability valuation
- Capitalized vs non-capitalized expenses
- Reserves
- Acquisition accounting
- Disclosures



Examples of FRAT Focus Areas:

Revenue Recognition



SEC - Revenue Recognition

"The financial fraud and mismanagement which led to the financial crisis did not only occur at megabanks and corporations. Corporate executives at all levels of business and banking had a responsibility to their customers and employees."

Zane David Memeger

U.S. Attorney for the Eastern District of Pennsylvania (2010 – present)

<http://www.stopfraud.gov/iso/opa/stopfraud/PAE-1209111.html>

SEC - Revenue Recognition

- Revenue recognition most common financial fraud and most investigated.
 - over 60% of alleged SEC fraud from 1998 to 2007*
- Most fraudulent financial reporting schemes investigated involved earnings management



"SEC has cautioned that compliance with GAAP is not a protection against an enforcement action if financial performance is distorted"***

**Committee of Sponsoring Organizations ("COSO") Treadway Commission – Fraudulent Financial Reporting: 1998 – 2007 an Analysis of US Public Companies (2010)*

***Accounting and Auditing Enforcement (AAE) Rel. No. 1555 (May 14, 2002)*

SEC - Revenue Recognition Example



Enron Financials – Revenue increases while net income percentage of revenue stays relatively the same.

(\$ Millions)	FY 1996	FY 1997	FY 1998	FY 1999	FY 2000
Revenues	\$ 13,289	\$ 20,273	\$ 31,260	\$ 40,112	\$ 100,789
Net Income (NI)	\$ 584	\$ 105	\$ 703	\$ 893	\$ 979
Cash Flow From Operations	\$ 742	\$ 276	\$ 1,873	\$ 2,228	\$ 3,010
NI as % of Revenue	4.4%	0.5%	2.2%	2.2%	1.0%
CF From Ops as % of Revenue	5.6%	1.4%	6.0%	5.6%	3.0%

- Enron's principal method of financial fraud involved the use of Special Purpose Entities (SPEs)

Examples of FRAT Focus Areas:

Reserves



SEC - Reserves

"I'd like to talk to you about another widespread, but too little-challenged custom: earnings management.

This process has evolved over the years into what can best be characterized as a game among market participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system."

Arthur Levitt

SEC Chairman (1993 – 2001)

<http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>

SEC - Reserves

- Reserves are management estimates about the reported value of assets and liabilities
- Under-reserved amounts overstate the balance sheet and inflate reported earnings



SEC - Reserves (Example; Dell)



- In 2010 Dell Computers settled allegations of "cookie jar" accounting with the SEC for \$100 million.
 - Dell made an agreement with Intel
 - Dell executives failed to disclose the payments to investors.
- At their peak, the exclusivity payments from Intel represented 76% of Dell's quarterly operating income.

Examples of FRAT Focus Areas:

Disclosures



SEC - Disclosures

- Misrepresentation, 'selective' disclosure or omission of facts and circumstances "behind" the numbers
- News reports, interviews, websites, footnotes to financials, social media, and annual reports
 - Management discussion and analysis
 - Industry specific disclosures
 - Geographic, segment, other disclosures
 - Market share, competitive environment, contracts, objectives, and strategy



Staying Under the "Radar"



Keys to Staying Off the SEC's Radar:



- Report material weaknesses and improve internal controls
- Use similar accounting policies to industry peers
- Reduce off-balance sheet transactions
- Be conservative with discretionary accruals

Introductions – Grant Thornton

Forensic Investigative and Dispute Practice

How we can help

Investigations

- Accounting irregularities and restatements
- Anti-fraud solutions
- Full-scale investigations
- Comprehensive response to whistleblower letters

Anti-corruption

- Global investigations
- Anti-bribery
- Anti-money laundering
- Asset tracing
- Foreign Corrupt Practice Act
- Office of Foreign Assets Control
- Third-party due diligence
- Background investigations

Disputes

- Business disputes – damages/lost profits quantification
- Litigation support and expert testimony
- Economic analysis and modeling
- Intellectual property
- Shareholder disputes
- Insurance consulting – business interruption claims
- Alternative dispute resolution/arbitration
- Post-acquisition disputes
- Complex accounting
- Tax controversies
- Valuation

Forensic technology

- Computer forensics
- eDiscovery
- Data analytics (predictive coding)
- Expert testimony
- Record and risk management
- Incident response and data breach investigations

Introductions – Grant Thornton

Forensic Investigative and Dispute Practice

- Over 56 offices across 30 States



	Grant Thornton International Ltd ¹	Grant Thornton LLP ²
Revenues	U.S. \$4.2 billion	\$1.25 billion
Personnel ³	35,721	6,214
Partners	2,839	509
Offices	637	54
Statistics as of:	Sept. 30, 2012	Dec. 31, 2012
¹ Collective figures of Grant Thornton International Ltd member firms ² U.S. member firm of Grant Thornton International Ltd ³ Including partners		

Closing and Questions

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- "Validating Early Fraud Prediction Using Narrative Disclosures" , Lee, Churyk, Clinton - Journal of Forensic Investigative Accounting Vol. 5, Issue 1, January – June 2013
- "What accounting risk factors will attract SEC's attention?", Ken Tysiac, Journal of Accountancy, December 13, 2013