

Fraud Panel Presentation and Discussion – Part 1

Panelists

- Dana Hermanson, Dinos Eminent Scholar Chair and Professor of Accounting, Kennesaw State University
- Dan Mahoney, CFRA
- Matt Lombardi, Partner, Hemming Morse

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Auditors and Fraud: Don't Forget the People

Public Company Accounting Oversight Board SEIAG Meeting

May 9, 2024

Dana R. Hermanson



The Fundamental Question

“What is the #1 cause of fraud?” – David Wolfe

People

Which people?

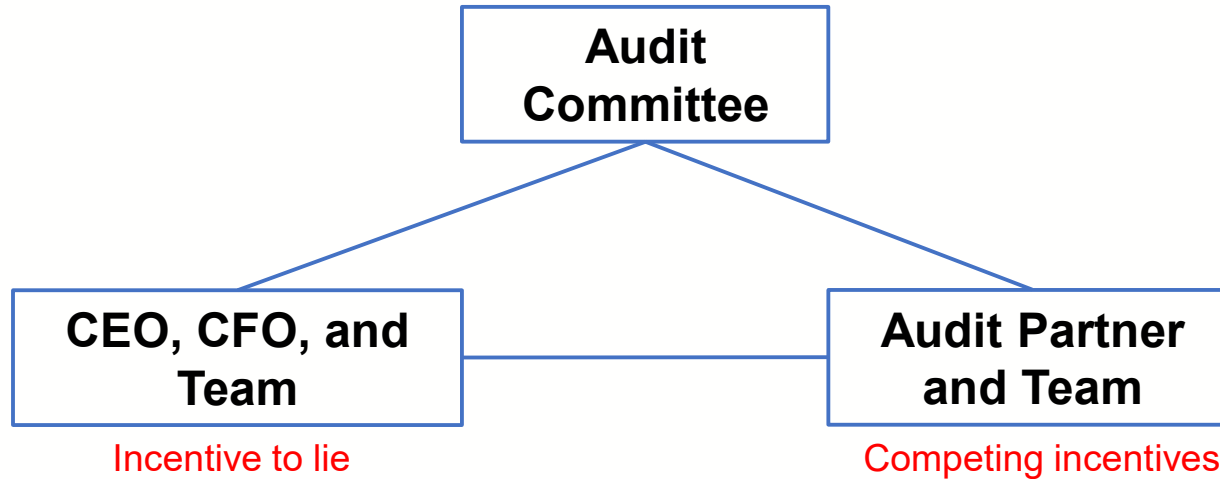
CFO and CEO



See Beasley et al. (1999, 2010), Wolfe and Hermanson (2004), Ramamoorti and Olsen (2007), Ramamoorti et al. (2013), Anti-Fraud Collaboration (2021), Grandstaff and Solsma (2021), and Hermanson (2021).

Core of the Issue: These People

Substantive, ceremonial?

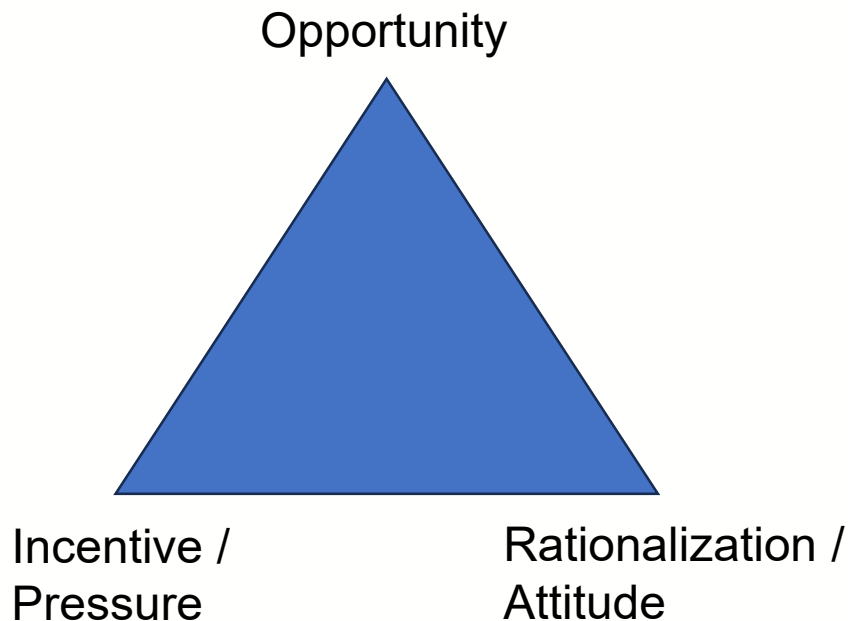


Also:

- Controls
- Systems
- Numbers
- Assertions
- Analytics
- AI
- Standards
- Regulators
- Company risk
- Industry risk
- Etc.

See Beasley et al. (2009), Cohen et al. (2010), Feng et al. (2011), Brazel et al. (2016, 2019), and Hermanson et al. (2024).

Focus of Current Fraud Standard



Focuses primarily on the **situation** (incentive / pressure) and **setting** (opportunity), with only rationalization / attitude addressing the characteristics of the potential **fraudster**.

Thus, this model **focuses very little on people**, and many may struggle with the rationalization / attitude side.

Gap: We have a people problem, but a standard that largely ignores people.

One Alternative: Fraud Diamond (Wolfe and Hermanson 2004)

EXHIBIT 1
THE FRAUD DIAMOND

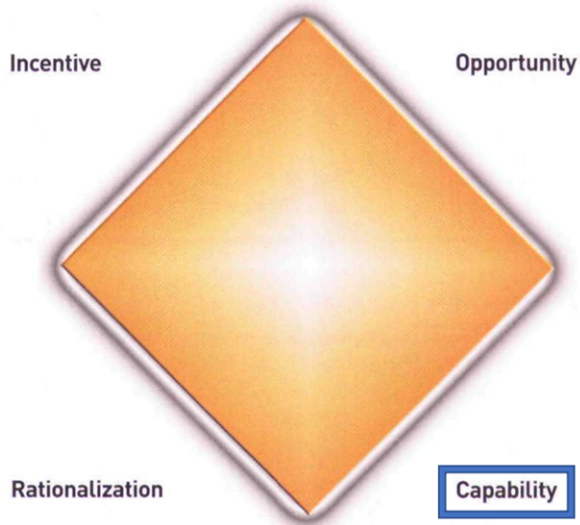


EXHIBIT 2
THE COMPONENTS OF CAPABILITY

Position/function
Brains
Confidence/ego
Coercion skills
Effective lying
Immunity to stress

Also see:

- Dark Triad – narcissism, Machiavellianism, and psychopathy.
- Other fraud model shapes – pentagon, hexagon, octagon...
- Capability through collusion.

Some Evidence About Capability

- Auditors who use a **fraud diamond** practice aid (which focuses them on **capability**) assess fraud risk **17% higher** than auditors who use a **fraud triangle** practice aid; **capability** and **rationalization / attitude** are one element. Boyle et al. (2015)
- Executives' **accounting competence** (an element of capability) interacts with compensation incentives to increase the risk of misstatements. Albrecht et al. (2018)
- Distressed-firm managers with **higher ability** (capability) are associated with higher audit fees and a greater risk of restatement. Gul et al. (2018)
- **Intelligence** and **confidence / ego** are positively related to the likelihood of fraud. Arel et al. (2023)
- **Dark triad** personality types are linked to **aggressive financial reporting**. Majors (2016)

Addressing Capability

- **Explicitly assess capability** – spend time with people, look for signals, and assess what others say about a person.
- **Adjust when high capability presents risk**
- **Continually reassess capability**
- **Consider how capability interacts with other elements**
- **View capability as a double-edged sword**
- **Consider risks of remote auditing**

See Wolfe and Hermanson (2004) and Hermanson and Wolfe (2024).



The Potential Remote, Tech Audit Tradeoff

Potential Good:

Data analytics and AI – test more, find more, and prevent more.

→ Reduce fraud risk

See Fotoh and Lorentzon (2023).

Potential Bad:

Lose focus on the people and what's happening in the organization and the audit team.

→ Reduce ability to assess people (capability, etc.)

See Barnes and Hermanson (2023), Hermanson and Wolfe (2024), and Tighe (2024).



Conclusion

- Research has **moved well beyond the traditional fraud triangle**, which largely ignores the human element of fraud.
- Epstein and Ramamoorti (2016, 21) state, “The...Fraud Triangle is too basic and does not consider abnormal or deviant personalities...it is people who commit fraud: internal controls should not be people-neutral, and neither should the auditing profession.”
- **Don't forget the people – capability, Dark Triad, etc., are important considerations for auditors.**

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Presentation for PCAOB SEIAG

May 9, 2024

PRESENTER: **Dan Mahoney, CPA, CFA**

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About CFRA

- Since 1994, CFRA has been **the recognized leader in forensic accounting and quality of earnings research**
- **Aggressive accounting practices** can be used to mask business deterioration
- We **uncover underappreciated differences** between reported financial results and underlying economic reality

Why Are We Here

Background



Accounting requires judgment, estimates, and interpretation of rules.



A continuum between conservative and fraud.

Most companies we write on are not frauds.



Companies stretching is commonplace, so what is the problem?

It becomes concerning when a company stretches more than it did last year.

Ultimately untenable.

Focus on prevention

When I was the United States Attorney, I understood that when small or what some would consider relatively minor crimes are not addressed, or worse, tolerated in a community, it fosters an attitude that allows more serious crimes to occur. We have taken the same approach at the SEC. We are trying to prevent smaller securities violations from becoming more serious ones, and trying to stop individuals who are prepared to commit minor violations from moving on to bigger ones.

- Mary Jo White
Chairwoman, Securities and Exchange Commission
March 24, 2014

Focus on Prevention

...always be monitoring clients...

Have a dedicated group act as independent “risk manager”:

- Use quantitative tools to spot red flags
 - Accruals, working capital trends, cash flows
 - Peer analysis
 - Flagging of changes in disclosure, compensation policies
 - Executive turnover, insider selling
 - Rising short interest
- Year-round monitoring, not just annual analysis
- Monitor conference calls, press releases as well as financials
- Ask questions of audit teams
- Use third-party services with expertise

Hiring and Staffing:

- Hiring and Training are as important as tools and techniques
 - Technical acumen is important but not everything
 - Case studies during hiring process to gauge thinking of candidates? Do they ask the right questions?
 - Training should include both historical understanding of fraud and technical tools to detect
- Staffing
 - Staff should be industry experts - need to understand the industry dynamics, not just the accounting
 - Who is asking the questions around fraud?

What is the Company's "Story"?

- Fraud or stretching is more likely to occur in areas that drive stock performance
- Focus on accounts and metrics that management focuses on, especially where change occurs
- Does management communication with market match what is in the filings?
- Watch for companies that are overly concerned with price stock reaction

- Achieved GAAP EPS of \$1.24 and Adjusted EPS of \$0.76 Per Diluted Share
- Order intake was USD 818.9 million, a book to bill ratio of 0.95
 - Committed backlog up 7.1% year-over-year to USD 2.51 billion
- Net revenue reached USD 862.8 million, increasing 3.4% in constant currency
 - Adjusted EBITDA up 16.9% to USD 124.9 million, a margin of 14.5%; includes one-off gain of USD 5.6 million resulting from a Brazilian VAT court case ruling (13.8% excluding the VAT court case ruling)
 - Sales of £759.1 million, reflecting a 1% LFL¹ sales increase

"We are pleased to have delivered results that met our financial guidance for the eleventh consecutive quarter."

High Level Company Considerations

- Understand the incentive structure – fraud is not only for monetary gain
 - Management Performance Factors/Incentives
 - How are lower level managers evaluated/compensated?
- Point in cycle – fraud/misstatements tend to peak at end of boom
 - Pressure on managers to keep good times going
 - Investor, regulator complacency
- Firm performance relative to peers
- High external financing needs
- M&A Activity
- Industry Risk Assessment
 - Is accounting complex?
 - What are the key valuation metrics? Growth industry or established? How have stocks fared?
 - Have there been frauds in industry? Other important news or regulation?

Quantitative Screening Overview

How to find red flags

- At a high level, what are we generally screening for?
 - Increases in operating assets
 - Decreases in operating liabilities
- Abnormal increases/decreases in these operating accounts can uncover a vast array of earnings quality issues:
 - More aggressive revenue recognition
 - Increases in cost capitalization
 - Excess production/inventory overhang
 - Under-accrual of accounting reserves subject to estimate

Metrics Focus on Balance Sheet and Cash Flows

- **Increase in Accruals**
 - CFFO – Net Income
- **Quality of Revenue**
 - Accounts Receivable (DSO)
 - Contract Assets (unbilled DSO)
 - Contract Liabilities/Deferred Revenues in days sales (DSDR)
 - Remaining Performance Obligations
- **Quality of Earnings**
 - Inventory (DSI)
 - DSI vs. Gross Margins
 - DSI vs. Accts. Payable (DSP)
 - Inventory to Forward Sales
- **Provision Expenses**
 - Allowance for doubtful accounts /GAR
 - Bad Debt Expense/Sales
 - Inventory Obsolescence Provisions
 - Warranty Expense/Sales

Multi-Variable Screens

How to find red flags

- Multi-variable screens include different inputs and weights, depending on industry and analyst preference.
- This example includes CFFO to Net Income shortfall, DSO, and DSI.

Industrials Screen - u	YoY	Sequential	TTM CFFO	DSO Chg	Seq DSO	DSO -	DSO -	DSO -	DSI YOY	
Dan	Change In CFFO - Net	Change in YoY	SHTFL - 03036937	YOY- 03036937	Chg- 03036937	Period 0	Period - 1	Period -4	Change- 03036937	
	Income / % oF Assets	Change in CFFO - Net								
NYSE:EAF	GrafTech International Ltd.	0.026	-0.051	0.063	5	2	54	52	49	91
NasdaqGS:MRCY	Mercury Systems, Inc.	0.025	0.004	0.037	76	57	198	141	122	21
NasdaqGS:AXON	Axon Enterprise, Inc.	0.070	-0.014	0.025	64	9	184	175	120	23

Example: Includes CFFO to Net Income shortfall, DSO, and DSI

Industry Comparisons



INDUSTRY REPORT: Industrials

April 10, 2024

Using RPOs to Assess the Risk of a Revenue Shortfall

KEY TAKEAWAY

In this report, we compare Remaining Performance Obligations (“RPOs”) expected to be recognized as revenue relative to consensus revenue expectations for firms with a meaningful balance of RPOs. The analysis of RPOs is of particular interest at companies that generate a substantial amount of revenue from long-term contracts. In analyzing RPOs, we attempt to identify situations where revenue expectations appear too aggressive relative to the current level of RPOs. Although we suggest follow-up on all companies showing deterioration in RPO coverage, we provide additional details in this report on **ACM, ARRY, DRQ, ESE, FLR, NPO, PLUG, STEM, TGLS, and TPC.**

COMPANIES

ACA	FLNC	NPO
ACM	FLR	NVEE
ACN	FLS	NXT
AIN	GD	OSK
AIR	GE	OTIS
AMRC	GTLS	PBI
APD	GVA	PH
APOG	HCSG	PLUG
AROC	HEI	PRIM
ARRY	HI	PSN
ATRO	HII	PWR

Table 1: Next Twelve Month RPOs Relative to 12-Month Forward Sales¹

	4Q22	4Q23	YoY		4Q22	4Q23	YoY
STEM	54.8%	25.8%	-29%	FIX	54.6%	55.2%	1%
ARRY	45.6%	27.3%	-18%	CHPT	18.9%	19.7%	1%
FLR	86.4%	73.5%	-13%	ROK	6.8%	7.7%	1%
ACM	83.1%	75.1%	-8%	LMT	82.1%	83.2%	1%
NPO	27.3%	19.5%	-8%	VRSK	11.8%	12.9%	1%
ESE	59.3%	53.3%	-6%	IR	8.0%	9.3%	1%
DRQ	14.1%	8.3%	-6%	NVEE	70.5%	72.3%	2%
HCSG	6.2%	0.8%	-5%	NOC	80.1%	82.0%	2%
PH	44.9%	39.5%	-5%	BALL	10.2%	12.9%	3%
IESC	40.8%	35.8%	-5%	RBC	14.1%	17.1%	3%
MEG	12.6%	8.1%	-4%	LDOS	56.4%	59.6%	3%
ATRO	65.5%	61.7%	-4%	MRCY	41.5%	45.0%	3%
KBR	59.6%	57.5%	-2%	SAIC	53.7%	58.3%	5%
EMR	39.2%	37.1%	-2%	WAB	68.2%	73.2%	5%
AIR	14.1%	12.1%	-2%	DY	82.8%	87.8%	5%
HI	52.6%	49.9%	-3%	PSN	57.7%	64.2%	6%
APOG	35.3%	33.9%	-1%	EME	48.7%	55.8%	7%
RTX	63.5%	62.2%	-1%	PRIM	40.6%	47.9%	7%
SPXC	6.6%	5.3%	-1%	GVA	51.3%	58.9%	8%
ROP	47.1%	45.9%	-1%	J	47.3%	57.5%	10%
NXT	7.4%	6.3%	-1%	PWR	30.4%	41.1%	11%
ETN	40.3%	39.5%	-1%	STRL	49.8%	61.5%	12%
AMRC	50.3%	49.8%	-1%	B	10.8%	24.1%	13%
TDY	41.8%	41.2%	-1%	AXON	58.8%	73.4%	15%
HON	50.0%	49.5%	0%	GTLS	41.8%	58.0%	16%
KAMN	64.8%	64.9%	0%	TTEK	50.7%	73.0%	22%
CAT	9.1%	9.3%	0%	GE	81.1%	106.2%	25%
BV	8.7%	9.1%	0%	MOG.A	67.0%	93.6%	27%



INDUSTRY REPORT: Beverages

April 12, 2024

Bottoms Up! Beverage Companies' Working Capital & Cash Flow Trends

KEY TAKEAWAY

U.S. beverage companies, both alcoholic and non-alcoholic, remain under pressure from both changing consumer tastes and an increasingly competitive food retail landscape. In this report, we examine working capital trends, provisioning, and leverage & cash flow at U.S.-listed beverage companies. Based on our data set and analysis of these factors, we believe the most concerning companies are **BF.B, CELH** and **KDP.**

COMPANIES

Brown-Forman Corporation
Celsius Holdings, Inc.
The Vita Coco Company, Inc.
Coca-Cola Consolidated, Inc.
National Beverage Corp.
Keurig Dr Pepper Inc.
The Coca-Cola Company
Monster Beverage Corporation

Word Searches and Disclosure Analysis

- Use key-word searches and textual analysis to identify:
 - Changes in accounting policies (changes in rev rec, depreciation periods, etc.)
 - Language suggesting more aggressive operational practices (use of financing, discounts, etc.)
 - Search both public statements by management and footnotes
 - **More advanced search tools can identify changes to number of words in a footnote, removed disclosures, or changes to disclosures.**

Diving into the accounts

- Focus on
 - Revenues – policies and practices; accuracy vs. substance
 - Accounts subject to discretion - bad debts, warranties, fair value assumptions, stock comp., pensions, etc.
- Disclosure policies – any questionable omissions?
- Changes in disclosures that impact key accounts
 - Use blackline tools to flag disclosure changes
- Investigate use of Non-GAAP Metrics
- Even if accounting is allowed, is it really best representation of transaction?
- Compare policies and practice to peers – i.e. is warranty expense in SG&A when peers include in COGS?
- Engaging the company: ask same question to multiple representatives
 - Compare responses to public comments
 - Focus on attitude – “everybody does it” or “it’s legal”

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Accounting Lens

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- Earnings and Cash Flow Scores

Q&A

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Damages

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PCAOB -SEIAG Meeting

A Forensic Accounting Perspective

May 9, 2024

Matthew J. Lombardi, Partner, CPA/CFF

Matthew J. Lombardi CPA/CFF

Matt Lombardi is a partner at Hemming Morse with more than 25 years of accounting-related forensic and auditing services. He is a Certified Public Accountant and has been designated by the AICPA as a CFF (“Certified in Financial Forensics”). Matt has worked on complex matters involving securities claims, economic damages, business valuation, stakeholder disputes, professional liability claims, and regulatory claims.

Matt has served as both a testifying expert and a consulting expert. His forensic accounting experience includes extensive analysis of financial reporting under generally accepted accounting principles and the application of professional audit standards. He has performed forensic accounting for companies in both the public and private sector and for various federal agencies (e.g., SEC, FDIC, and PCAOB).

Prior to joining Hemming Morse, Matt worked with a “Big Four” accounting firm as a Senior Manager. With a focus on thought leadership in the accounting industry, Matt has provided instruction as an Adjunct Professor at Golden Gate University on forensic accounting, published several articles, and currently serves as a member, and past Chair, of the Accounting Principles and Auditing Standards State Committee for the California Society of Certified Public Accountants (CalCPA).

The views expressed in this presentation are those of the presenter and not Hemming Morse or my colleagues.

Overview

1. The Mindset of a Forensic Accountant
2. Relevant Practices of a Forensic Accountant
3. Thoughts On An Auditors' Consideration of Fraud Risk

Mindset of a Forensic Accountant

1. Heightened risk and expectation of possible fraud/problem
2. Management is often not the client
3. Looking beyond the immediate accounting conclusions to better understand business process, purpose and risks
4. Identifying relevant information and sources
5. Identifying need for specialized skillsets
6. Heightened level of skepticism

Management Is Often Not the Client

1. Investors, creditors, regulators or other stakeholders are often the direct or indirect “client”
2. Management/company personnel are often not the “client”
3. Audit terminology may contrast with this notion:
 1. “Prepared By Client” or “PBC”
 2. “Client communications”
 3. “Illegal Acts by Clients”

Forensics -Looking Beyond the Immediate Accounting Conclusion

1. Understand a (set of) Transaction(s)

- a. What is the business purpose?
- b. Does the transaction affect/relate to other transactions?
- c. Does the structure/terms of the transaction (size, nature, timing) make sense?
- d. Is what I expect to see evident (processes, personnel, timing, size, etc.)? If not, why?
- e. If complex, atypical, or unusual, why is the transaction (or set of transactions) different?
- f. Do I sufficiently understand the parties involved and their respective roles?
- g. Do I have all relevant information about the transaction(s)?

2. Assess the appropriate accounting treatment

Forensics - Looking Beyond the Accounting Process Narrative

1. Understanding relevant business processes and risks

- a. Evident internal business processes/risks (e.g., risk management, executive, segment/region finance)
- b. Evident external business risks (e.g., analysts', regulatory, industry reporting)
- c. Influence of budget/forecast process (e.g., entity's, key customers)
- d. Influence of earnings guidance processes
- e. Influence of compensation structure
- f. Executives/management role in key business and accounting processes
- g. Deviations/exceptions from established processes

2. Understand and assess effectiveness of internal control for specific accounting/financial reporting processes

Identifying relevant information/sources

1. Internal information examples:

- a. Correspondence relating to transaction or set of transactions (*e.g.*, emails, drafts)
- b. Contemporaneous executive, segment and regional management meeting materials, minutes and notes
- c. Risk management committee (similarly management committee) materials and minutes
- d. Contemporaneous budget/forecast materials for significant segments, regions, and/or entity
- e. Earnings releases, guidance, and Q&A preparation materials
- f. Top-side or relevant journal entry activity
- g. Industry publications obtained/used by management
- h. Key customer/vendor information (*e.g.*, credit limit changes, invoiced payment terms reports, forecasting information, transaction specific correspondence, audit-related, customer/vendor listings)
- i. Whistleblower submissions/interview summaries
- j. Regulatory/inquiries/investigation related communications (company specific)

Identifying relevant information/sources

2. External information examples:

- a. Short-seller reporting
- b. Analysts reports
- c. Background checks/public record searches
- d. Credit reports
- e. Peer/competitor financial reporting
- f. Earnings/Investor presentation Q&A
- g. Industry publications
- h. Regulatory communications/inquiries/investigations (peer related)
- i. Legal complaints
- j. Whistleblower tips

Thoughts On An Auditors' Consideration of Fraud

1. Expand audit procedures to better understand key business processes and related risks
2. Develop specific procedures to identify inconsistencies
3. Expand use of forensic, industry, data analytics, and/or legal specialists
4. Incorporate professional skepticism into audit worksteps
5. Expand types of external confirmations (*e.g.*, sales terms, inventory levels) and legal letter inquiries (*e.g.*, regulatory-related communications, whistleblower tips/complaints)

Procedures to Understand Business Processes and Related Risks

1. Understand types/frequency/participants of key management meetings, with focus on meetings involving executive management
2. Review relevant internal information (see [slide 8](#))
3. Review relevant external information (see [slide 9](#))
4. Conduct face-to-face interviews/inquiries with non-accountant personnel (FP&A, Regional Managers, Sales managers, etc.)

Develop specific procedures to identify inconsistencies

1. Additional fraud brainstorming event near the end of the audit, with specific discussion of potential risk areas. For example:
 - a. Evident/possible inconsistencies or contradictory information obtained
 - b. Areas of staff confusion/uncertainties
 - c. Commercial substance concerns (*e.g.*, unique/complex transactions, etc.)
 - d. Original audit plan deviations (significant removal or expansion of audit procedures)
 - e. Possible regulatory concerns
 - f. Whistleblower submissions
 - g. Significant forecast/budget developments or changes (*e.g.*, F0 v. F1, F1 v. F2, etc.)
2. Review transaction correspondence for sample of significant, complex, or unique transactions
3. Targeted or periodic use of a forensic, industry, or legal specialist

Incorporate professional skepticism into audit worksteps

1. Incorporate professional skepticism in audit plan/procedure language:

- a. Critically assess ...
- b. Question the reasonableness ...
- c. Identify inconsistencies between ...

Comments and Questions

If you have any questions after the presentation, I can be reached at lombardim@hemming.com.