Red Flags: How Qualitative Factors Can Help Assess Management Integrity
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MODERATOR:
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PANELISTS:
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David Woodcock, Regional Director, U.S. Securities & Exchange Commission
Agenda

• What is Management Integrity?
• What factors can be used to evaluate Management Integrity?
• Review statistics around various red flag factors
• Audit Firm Client Acceptance Process
• SEC interest in Management Integrity
• Discussion of failures of Management Integrity and Lessons Learned
• Discussion of current hot topics, including Cyber, Healthcare Reform, Financial Crisis/Recovery, Pandemic Planning
Management Integrity
Bridging from Reality to Disclosure

REALITY

Professionalism:
- Education
- Experience
- Culture

Complexity:
- Industry Structure and Competitive Analysis
- Industry and Product Life Cycle Considerations
- Legal and Regulatory Environment

DISCLOSURE

Ethics:
- Rules
- Principles
- Proper Conduct

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## Qualitative Factors to Assess Management Integrity

<table>
<thead>
<tr>
<th>Disclosure Quality</th>
<th>Gatekeeper Involvement</th>
<th>Management &amp; Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Restatements</td>
<td>- Auditors</td>
<td>- Director &amp; Officer Departures</td>
</tr>
<tr>
<td>- Revision</td>
<td>- Audit Fees</td>
<td>- Insider Trading</td>
</tr>
<tr>
<td>- Out of Period Adjustments</td>
<td>- Auditor Changes</td>
<td>- Shareholder Activism</td>
</tr>
<tr>
<td>- Change in Accounting Est.</td>
<td>- Auditor Ratification</td>
<td>- Related Party Transactions</td>
</tr>
<tr>
<td>- SOX 404 &amp; 302 Disclosures</td>
<td>- Regulators</td>
<td>- Management Compensation</td>
</tr>
<tr>
<td>- Late Filings (NTs)</td>
<td>- SEC Comment Letters</td>
<td>- Management Qualifications</td>
</tr>
<tr>
<td>- Auditor Opinion/Going Concern</td>
<td>- PCAOB Inspections</td>
<td>- Costumer Data Protection</td>
</tr>
<tr>
<td>- Benford’s Law (First Digit)</td>
<td>- Audit Committee</td>
<td></td>
</tr>
<tr>
<td>- Securities Litigation</td>
<td>- Outside Counsel</td>
<td></td>
</tr>
</tbody>
</table>

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Events Preceding within One Year of Litigation

- Companies Researched: 5,927 Accelerated Filers.
- Total Cases Analyzed: 1,487 cases against 1,250 unique companies (analyze one year prior to case).
- Companies without Litigation: 4,667 Accelerated Filers (analyze average one-year window).

### Percentage of Events Occurring within One Year Window

- Restatements: 22.19%
  - With Litigation: 6.19%
  - Without Litigation: 7.53%
- Auditor Departure: 19.48%
  - With Litigation: 5.87%
  - Without Litigation: 8.39%
- CEO Departure: 18.47%
  - With Litigation: 9.17%
  - Without Litigation: 3.48%
- CFO Departure: 12.24%
  - With Litigation: 1.61%
  - Without Litigation: 2.30%

- 44.32% of the cases were preceded by one or more of the negative events listed above.
### Events Preceding within One Year of Litigation

- **Companies Researched:** 5,927 Accelerated Filers
- **Total Cases Analyzed:** 1,487 cases against 1,250 unique companies.

<table>
<thead>
<tr>
<th>Event Count</th>
<th>Number of Events Within One Year Prior</th>
<th>One-Year Average for Companies without Litigation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Within One Year of Litigation</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Number</td>
<td>%</td>
</tr>
<tr>
<td>Restatements</td>
<td>330</td>
<td>22.19%</td>
</tr>
<tr>
<td>Auditor Change</td>
<td>112</td>
<td>7.53%</td>
</tr>
<tr>
<td>CEO Departures</td>
<td>193</td>
<td>19.48%</td>
</tr>
<tr>
<td>CFO Departures</td>
<td>183</td>
<td>18.47%</td>
</tr>
<tr>
<td>NT with an Item 4.3</td>
<td>182</td>
<td>12.24%</td>
</tr>
<tr>
<td>Going Concern</td>
<td>24</td>
<td>1.61%</td>
</tr>
</tbody>
</table>

- 44.32% of the cases were preceded by one or more of the negative events listed above.

**Note:** Because the disclosure requirement for CEO and CFO departures became effective on August 23, 2004, the percentage for these two categories are based on 991 cases (cases filed on or after August 23, 2005) instead of 1,487 cases. The percentage for companies without securities class action litigation based on the auditor opinion count of the population of 4,677.
# KBR, Inc.

## Chronology of Flagged Events

<table>
<thead>
<tr>
<th>Event Type</th>
<th>Date</th>
<th>Filing</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Out-of-Period Adjustment</td>
<td>10/24/2012</td>
<td>10-Q</td>
<td>Out-of-period adjustments in deferred tax accounts that increased current tax expenses by $3 mil</td>
</tr>
<tr>
<td>Comment Letter</td>
<td>4/1/2013</td>
<td>UPLOAD</td>
<td>SEC requests disclosure of the effects of any material revisions in contract estimates; letter was made available to the general public 2013/06/07</td>
</tr>
<tr>
<td>Change in Accounting Estimate</td>
<td>4/25/2013</td>
<td>10-Q</td>
<td>Change in accounting estimate related to contract accounting; $38 mil positive impact on Q1 net income</td>
</tr>
<tr>
<td>Change in Accounting Estimate</td>
<td>7/25/2013</td>
<td>10-Q</td>
<td>Change in accounting estimate related to contract accounting; $13 mil positive impact on Q2 net income</td>
</tr>
<tr>
<td>Change in Accounting Estimate</td>
<td>10/24/2013</td>
<td>10-Q</td>
<td>Change in accounting estimate related to contract accounting; $90 mil positive impact on Q3 net income</td>
</tr>
<tr>
<td>Change in Accounting Estimate</td>
<td>2/27/2014</td>
<td>10-K</td>
<td>Change in accounting estimate related to contract accounting; $150 mil positive impact on annual 2013 gross profit</td>
</tr>
<tr>
<td>SOX 404 ICFR Weakness</td>
<td>2/27/2014</td>
<td>10-K</td>
<td>Material weakness in internal controls over financial reporting related to contract accounting</td>
</tr>
<tr>
<td>Revision Restatement (8-K, Item 4.02)</td>
<td>5/5/2014</td>
<td>8-K</td>
<td>Revenue recognition restatement related to contract accounting; cumulative negative impact of $154 mil</td>
</tr>
<tr>
<td>Securities Class Action</td>
<td>5/9/2014</td>
<td>Press Release</td>
<td>Filed in the United States District Court for the Southern District of Texas alleging a series of misrepresentations that artificially inflated the stock price</td>
</tr>
<tr>
<td>Change in Accounting Estimate</td>
<td>6/19/2014</td>
<td>10-Q</td>
<td>Change in accounting estimate related to contract accounting; $13 mil positive impact on Q3 net income</td>
</tr>
</tbody>
</table>

**Notes:**
1) Other flagged events, not shown above, include Recent Disclosure Controls Issues, Recent Non-Timely Filing and Material Legal Proceedings.

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Quality of Financial Reporting – During the Last Four Years, the Quantity of Total Restatements Appears to have Leveled Off.

**Total Restatements by Year**

**2013 Restatements**

- 759 Unique Filers
- 846 Restatements

Source: *2013 Financial Restatements; A Thirteen Year Comparison* published April 2014 by Audit Analytics.
Restatement Severity

The Following Indicators of Severity Show that Restatements Disclosed during 2013 were Generally Low in Severity:

• Negative Impact on Net Income
• Average Cumulative Impact on Net Income per Restatement
• Restatements with No Impact on Income Statements
• Average Number of Days Restated
• Average Number of Issues per Restatement

Source: 2013 Financial Restatements; A Thirteen Year Comparison published April 2014 by Audit Analytics.
Reissuance Restatements

A focus on Reissuance Restatements (those that undermine reliance on past financials) shows that the number of Reissuance Restatements have been low the last 5 years.

![Reissuance Restatements Graph](image)

Note: A registrant is required, within four business days, to disclose in an 8-K, Item 4.02 when it is determined that a past financial statement should no longer be relied upon.
Revision Restatements

The percentage of restatements that were Revision Restatements (that undermine reliance on past financials) has trended higher since the disclosure requirement first came into effect in August 2004 and reached the value of 68.83% in 2013.
Restatement’s Effect

- If financial misstatements were not, to some extent, caused by human nature (e.g. over optimism), one would expect an even number of positive adjustments and negative adjustments.

- Negative adjustments occur over six times more than positive adjustments.
## Restatement’s Effect

<table>
<thead>
<tr>
<th>Year</th>
<th>Positive Effect</th>
<th>Negative Effect</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>110</td>
<td>736</td>
<td>846</td>
</tr>
<tr>
<td>2012</td>
<td>108</td>
<td>730</td>
<td>838</td>
</tr>
<tr>
<td>2011</td>
<td>114</td>
<td>730</td>
<td>844</td>
</tr>
</tbody>
</table>

### Notes:
1) The data above are based on the researched perform to produce the following report: *2013 Financial Restatements; A Thirteen Year Comparison* published April 2014 by Audit Analytics.
2) The counts above include both Revision and Reissuance Restatements.
Out-of-Period Adjustments

Out-of-period Adjustment – When an error in previous and current financial statements does not significantly affect past or present financials. Due to the low level of significance, these error corrections do not require a restatement. These errors are corrected through a one-time charge in the current period, and must be disclosed since corrections affect comparability between periods.

- During the 3 years from 2011 to 2013, inclusive, 615 companies disclosed a total of 781 out-of-period adjustments.

- Out of these 615 companies, a total of 119 companies disclosed two or more out-of-period adjustments.
## Out-of-Period Adjustments

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<table>
<thead>
<tr>
<th>Year</th>
<th>Positive</th>
<th>Negative</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>93</td>
<td>172</td>
<td>265</td>
</tr>
<tr>
<td>2012</td>
<td>111</td>
<td>188</td>
<td>299</td>
</tr>
<tr>
<td>2011</td>
<td>71</td>
<td>146</td>
<td>217</td>
</tr>
</tbody>
</table>

**Notes:**

1) The out of period adjustments disclosed in the three years above, a total of 781 adjustments, were disclosed by 615 companies. A total of 119 companies disclosed two or more adjustments.

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Changes in Accounting Estimates That Affected Net Income

- During the three years from 2011 to 2013, inclusive, 509 companies disclosed a total of 866 Changes in Accounting Estimates that affected net income.

- Out of these 509 companies, a total of 123 companies disclosed two or more Changes in Accounting Estimates.
Changes in Accounting Estimates
That Affected Net Income

• During the three years from 2011 to 2013, inclusive, 509 companies disclosed a total of 866 Changes in Accounting Estimates that affected net income.
• Out of these 509 companies, a total of 123 companies disclosed two or more Changes in Accounting Estimates.

<table>
<thead>
<tr>
<th>Year</th>
<th>Positive Effect On Net Income</th>
<th>Negative Effect On Net Income</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>209</td>
<td>143</td>
<td>352</td>
</tr>
<tr>
<td>2012</td>
<td>166</td>
<td>115</td>
<td>281</td>
</tr>
<tr>
<td>2011</td>
<td>138</td>
<td>95</td>
<td>233</td>
</tr>
</tbody>
</table>

Notes:
1) The counts above are based on a review of periodic filings with additional detection provided by SEC Comment Letter analysis of corresponding filing date windows.
2) The counts above do not include 57 changes in accounting estimates whose effect on net income, if any, could not be determined.
Benford’s Law Analysis of Financial Statements

Benford’s Law establishes the expected frequency distribution of the first digit contained in naturally occurring set of numbers.

![Using Benford's to Detect Financial Statement Errors (10%)](chart)

As shown above, companies that failed the 10% Confidence Interval are more likely (21% vs. 17% for 2010) to disclose a restatement within 2 years.

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SOX 302 & SOX 404 Disclosures
Self Disclosure vs. Independent Auditor Input

• A SOX 302 and SOX 404 review assesses a company's controls and procedures used to develop financial statements and other forms filed with the SEC.

• The graph quantifies occurrences when the first negative disclosure was filed (the prior filing was positive).

• Initial A disclosures in a 10-K or 10-K/A frequently involved input from the independent auditor.

• In contrast, a disclosures in a 10-Q typically reveal problems identified and disclosed by management on its own and thus indicates management willing to be transparent.
SOX 302 & SOX 404 Disclosures
Self Disclosure vs. Independent Auditor Input

• Initial disclosures in a 10-K or 10-K/A frequently involved input from the independent auditor, but those in a 10-Q typically reveal problems identified and disclosed by management on its own and thus indicates management willing to be transparent.

<table>
<thead>
<tr>
<th>Year</th>
<th>Disclosed in a 10-K</th>
<th>Disclosed in a 10-K/A</th>
<th>Disclosed in a 10-Q</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>49</td>
<td>28</td>
<td>93</td>
</tr>
<tr>
<td>2006</td>
<td>143</td>
<td>50</td>
<td>77</td>
</tr>
<tr>
<td>2007</td>
<td>149</td>
<td>42</td>
<td>81</td>
</tr>
<tr>
<td>2008</td>
<td>124</td>
<td>20</td>
<td>49</td>
</tr>
<tr>
<td>2009</td>
<td>65</td>
<td>23</td>
<td>35</td>
</tr>
<tr>
<td>2010</td>
<td>52</td>
<td>19</td>
<td>27</td>
</tr>
<tr>
<td>2011</td>
<td>57</td>
<td>18</td>
<td>21</td>
</tr>
<tr>
<td>2012</td>
<td>63</td>
<td>14</td>
<td>27</td>
</tr>
<tr>
<td>2013</td>
<td>81</td>
<td>24</td>
<td>21</td>
</tr>
<tr>
<td>2014</td>
<td>73</td>
<td>17</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td><strong>856</strong></td>
<td><strong>255</strong></td>
<td><strong>436</strong></td>
</tr>
</tbody>
</table>
Risk Management
Cyber Security: Data Breaches of More Than 100,000 Records

As of October 2014, a total of 11 companies each disclosed to the SEC data breaches in 2014 that exposed over 100,000 records: 6 included financial information and 5 accessed personal information.

### 2014 Hacks

#### Financial Data:
- Aaron Brothers
- Home Depot
- Michael Stores
- Neiman Marcus
- TripAdvisior
- United Parcel Service

#### Personal Data:
- AOL Inc.
- CBS Corp
- Dominos Pizza Inc
- Ebay Inc
- JP Morgan Chase
SEC Comment Letters
Risk Assessment Inquiries: Data Protection and Security Breaches

• During 2012, there was a spike in the number of companies that received an SEC comment letter inquiring about the company’s risk assessment regarding data protection and security breaches.

• The number for 2013 should increase because SEC does not release comment letter correspondence until 20 business days after the last letter is reviewed.

SEC Data Breach Inquiries per Year

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Conversations Initiated</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>2</td>
</tr>
<tr>
<td>2010</td>
<td>8</td>
</tr>
<tr>
<td>2011</td>
<td>13</td>
</tr>
<tr>
<td>2012</td>
<td>70</td>
</tr>
<tr>
<td>2013</td>
<td>16</td>
</tr>
</tbody>
</table>
Total Going Concerns Per Year
A Breakdown of New GCs and Repeated GCs (Year 2013 Estimated)
Companies that Filed a GC for the Year then No GC the Year After (Classified by Outcome: Subsequent Improvement or Disappearance)

The 2007 bar indicates that fiscal year 2007 received 997 GCs from companies that did not file a GC in 2008 and 200 of these companies filed a clean audit opinion in 2008 (improved) while 797 failed to file an audit opinion.
Academic Research Regarding SEC Comment Letters and Insider Trading:

- Empirical evidence suggests that insiders benefit from delayed release of comment letters.
- Insider sales intensify 5 days prior to the public disclosure of Revenue Recognition comment letters.
- Insiders that wait, and legally trade immediately after the release date, also benefit from a delayed stock price response.
- Abnormal increases in insider sales are more common for firms with high short interest and firms with high discretionary accruals.

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**Paper:** SEC Comment Letters and Insider Sales

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**Alastair Lawrence**  
University of California, Berkeley - Haas School of Business

**James Ryans**  
University of California, Berkeley - Haas School of Business

**July 5, 2014**

**Abstract:** The Division of Corporation Finance at the Securities and Exchange Commission (SEC) reviews company filings and where appropriate, issues comment letters to elicit better compliance with applicable disclosure requirements and Generally Accepted Accounting Principles. Since 2005, the Division’s staff publicly discloses comment letters and companies’ responses to those letters no earlier than 45 days (20 business days after January 1, 2012) following the review completion. We provide evidence of increases in insider sales prior to the public disclosure of comment letters relating to revenue recognition. Moreover, pre-disclosure insider sales are more pronounced for firms with financial reporting and valuation concerns. We provide evidence of a delayed negative stock price response to revenue recognition comment letters particularly those where insiders sell and financial reporting and valuation concerns are more acute. Our findings suggest that the information advantage concerning the content of comment letters combined with the time delay in comment letter disclosure provides opportunities to strategically profit from insider trading.


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Auditor Independence: Audit Fees versus Non-Audit Fees

Over the Last 9 Years, Non-Audit Fees (Audit-Related, Tax, and Other Fees) have Leveled Off at about 21% of Total Fees.

Notable Thresholds/Flags:
- Audit-Related Fees + Tax Fees + Other Fees over Audit Fees Only > 50%
- Tax Fees over Audit Fees > 30% and > 100% (not a concern if a subsidiary acquisition or sale occurred)
- Other Fees over Audit Fees > 5%.
Auditor Ratification

- Companies that put their auditor up to a shareholder ratification vote are less likely to have restatements. (Dao, Raghunandan, & Rama. (2012). *The Accounting Review*. 87 (1), 149-172.)

- Over 90% of the Russell 3000 request shareholder ratification of the auditor.

- It is very rare for an auditor to receive more than 5% votes against ratification, as the histogram at right indicates. About 95% of all votes receive less than 5% votes against.
Audit Firm Client Acceptance & Continuance
Professional standards – audit firm client acceptance

AICPA QC Sec. 10A, A Firm’s System of Quality Control

- Audit firms must establish policies and procedures that provide the firm with “reasonable assurance” that it will undertake or continue client relationships only where the firm:
  - Has considered the integrity of the client, including its management and others
  - Is competent to perform the engagement and has right the capabilities and resources
  - Can comply with legal and ethical requirements
- Defines considerations in accepting or continuing a client relationship, e.g., the firm:
  - Has personnel with knowledge of relevant industries/subject matters and experience
  - Has specialists and engagement quality control reviewers available, if needed
  - Is able to complete the engagement within the reporting deadline
Acceptance protocol – how we comply in practice

• Large audit firms use an established, consistent process to evaluate client acceptance and continuance decisions, which consists of (as applicable):

  1. Assessment of general information, such as financial statements, business plans, relationships, quality of people

  2. Consideration of risk factors, such as management integrity and commitment to GAAP and ICFR, financial results and viability, business relationships and related parties

  3. Approvals by client engagement partner, office leadership, industry expert for certain engagements, senior leadership for engagements with certain characteristics

  4. Consultation with National Office if certain risks are identified
Continuance protocol – how we comply in practice

• Annually, large audit firms reassess the risk profile of each client to determine whether circumstances justify continuance
• Leadership reviews the overall client portfolio and finalizes the continuance decisions/risk assessments in a series of meetings
• Additional oversight by experienced personnel is provided for higher risk engagements
## Performing audits – market realities

<table>
<thead>
<tr>
<th>Market environment</th>
<th>Competitive market, other firms standing ready to bid on work alongside us</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential claims</td>
<td>At extreme, claimed damages could be in excess of market cap</td>
</tr>
<tr>
<td>Risk management</td>
<td>Multi-step procedures in place to comply with professional standards and to manage risk</td>
</tr>
<tr>
<td>Pricing pressure</td>
<td>Prices are constrained by competition and regulations prohibiting, for example, contingent fees for audits</td>
</tr>
<tr>
<td>Regulatory oversight</td>
<td>Federal/national (SEC, PCAOB, AICPA) and state (state boards) oversight; professional standards govern client acceptance process</td>
</tr>
</tbody>
</table>

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