The Metropolitan
Corporate Counsel®

National Edition www.metrocorpcounsel.com

Volume 22, No. 2 February 2014

More Than A Machine: "Robocop" Stole The Headlines, But The Financial Reporting And Audit Task Force Is The Real Driver Behind The SEC's Refocus On Accounting Irregularities

Christopher L. Garcia
Paul Ferrillo
Weil, Gotshal & Manges LLP

Matthew Jacques
AlixPartners LLP

Christopher L. Garcia

Paul Ferrillo

Matthew Jacques

On July 2, 2013, the United States Securities and Exchange Commission (the SEC) announced two new initiatives aimed at preventing and detecting improper or fraudulent financial reporting.[1] We previously noted that one of these initiatives, a computer-based tool called the Accounting Quality Model (AQM, or "Robocop"),[2] is designed to enable real-time analytical review of financial reports filed with the SEC in order to help identify questionable accounting practices.

In addition to the AQM, the SEC announced the creation of the Financial Reporting and Audit Task Force (the Task Force). The Task Force comprises 12 experts from across the SEC's Enforcement Division whose mission will be to "concentrate on expanding and strengthening the Division [of Enforcement's] efforts to identify securities-law violations relating to the preparation of financial statements, issues of reporting and disclosure, and audit failures."[3] To fulfill this mission, the Task Force, which includes both forensic and GAAP accountants, will be responsible for "closely monitoring high-risk companies to identify potential misconduct, analyzing performance trends by industry, reviewing class action and other filings related to alleged fraudulent financial reporting, tapping into academic work on accounting and auditing fraud, and conducting street sweeps in particular industries and accounting areas."[4] In carrying out these tasks, the Task Force will be aided by other critical offices and divisions within the SEC, including the Office of the Chief Accountant and the Division of Corporate Finance. Together, the Task Force and those assisting it constitute a veritable A-Team focused on rooting out accounting improprieties and fraud.

Why Corporate Directors Must Take Note Of The Task Force

There is little question that corporate directors should take note of this substantial deployment of SEC resources. In 2010, the SEC created five specialized units in areas of market abuse, structured and new products, asset management, foreign corrupt practices, and municipal securities and public pensions. In the succeeding years, each of the units utilized the very strategies that the Task Force has been asked to exploit, including monitoring high-risk companies, analyzing performance trends by industry, and conducting street sweeps in particular industries. The result was an increase in inquiries made by the SEC, not to mention several significant enforcement actions, including a withering assault on insider trading; settled actions against banks, including most notably Goldman Sachs, relating to complex structured products; and a high-water mark in FCPA- related enforcement actions.

We anticipate a similar result in the area of financial reporting and disclosures as a consequence of the creation of the Task Force. Indeed, in a speech last fall, Andrew Ceresney, co-director of the Division of Enforcement, explicitly noted that the goal of the Task Force will be to "focus on case generation" and "generat[ing] new accounting fraud investigations for staff in the Division to pursue."[5] In the same speech, Mr. Ceresney went so far as to describe the Task Force as the SEC's "Apollo 13 moment": "Often, when you get a group of smart people in a room focused on a problem, you can find the answer. Kind of reminds me of that scene in Apollo 13 where they bring all of the disparate tools available on

Christopher L. Garcia *is a Partner in Weil's Litigation and White Collar Defense and Investigations practices, where he focuses on defending companies and individuals in connection with regulatory and criminal investigations, conducting internal investigations, and litigating securities class actions in state and federal courts.* ***Paul Ferrillo*** *is Litigation Counsel at Weil, where he focuses his practice on complex securities and business litigation, including representing public companies in shareholder class and derivative actions.* ***Matthew Jacques*** *is a Director in AlixPartners' Financial Advisory Services Group in Boston. He has over 14 years of experience as an advisor, regulator and public accountant.*

Please email the authors at christopher.garcia@weil.com, paul.ferrillo@weil.com or mjacques@alixpartners.com with questions about this article.

the space capsule into a room, dump it on to a table in front of a bunch of smart people, and say find a way to fix the problem. And so we created the Financial Reporting and Audit Task Force to ..."[6] The problem the Task Force solves for the Enforcement Division is how the SEC can better marshal resources to identify accounting issues; the result, if past is prologue, will be increased engagement by the Commission with public companies concerning such issues.

Potential Areas Of Emphasis Of The Task Force

Based on our study of comments made by various SEC officials, we believe that the new Task Force will be focused on a few key areas described below. While it may be prudent for directors to attempt to ensure that their organizations steer clear of financial reporting deficiencies, it may also be important to pay particular attention to the areas of the Task Force's focus in order to stay out of its crosshairs:

Not Just Fraud – It is easy to look back at certain headline-grabbing frauds of the past (Adelphia, Worldcom, Enron, etc.) and think "Well, that's not our company." However, recent SEC actions demonstrate that the SEC is not merely interested in pursuing cases that rise to the level of fraud; the Enforcement Division has brought a number of non-fraud actions against companies and individuals. For example, in June 2013 the Commission brought a settled action against PACCAR Inc. for having ineffective internal controls over the financial reporting process – without any allegations of fraud or intentional wrongdoing.

Getting Caught with a Hand in a Cookie Jar – Accounting guidance requires companies to record expenses when they are probable and estimable through the establishment of an accrual (or reserve) on the books. Setting these reserves, and reversing them, requires professional judgment. As we have already reported, the SEC has indicated that the AQM will be used to detect potentially problematic accrual and reserving practices. The Task Force will similarly be focused on identifying such practices.

Valuation Questions – Management judgment likewise plays an important role in determining the value of assets or securities on a company's balance sheet. Andrew Ceresney noted in his September 19, 2013, speech with respect to losses and reserves: "We recognize that accounting requires that management (and auditors) use their professional judgment but we will not tolerate decisions that are reached in bad faith, recklessly or without proper consideration of the facts and circumstances."[7] In the same speech, Mr. Ceresney noted that the SEC's focus on such accounting errors extends beyond management to audit committees: "We have brought actions against audit committees in the past for failing to recognize red flags and we intend to continue holding committees and their members accountable when they shirk their responsibilities."[8]

Revenue Recognition Issues – Reserve issues and valuation issues play into the broader question of whether a company is taking measures to "smooth earnings." As Margaret McGuire, vice chair of the Task Force, recently noted, "*revenue recognition is always an issue*."[9] With the recent growth of social media companies and cloud-based computing services, many companies are faced with difficult questions about how to account properly for these new technologies.[10]

Material Weaknesses and Internal Controls – Material Weaknesses and Internal Controls present another area of renewed emphasis for the SEC. As Brian T. Croteau, deputy chief accountant of the SEC, was recently quoted saying: "[I] continue to question whether all material weaknesses are being properly identified. It is surprisingly rare to see management identify a material weakness in the absence of a material misstatement. This could be either because the deficiencies are not being identified in the first instance or otherwise because the severity of deficiencies is not being evaluated appropriately."[11]

Multiple revisions of financial statements over a short period of time – Though sometimes multiple revisions of financial statements happen with good reason, the SEC considers this area to be a "warning sign" that the company involved might not be maintaining appropriate books and records and will likely draw the scrutiny of the Task Force.

Making Good Use Of Peacetime

What does all of this mean for corporate directors? It means that there is no better time than the present – during peacetime, before any inbound inquiries from the SEC are received – to have "tough" discussions with management around the areas of focus identified above, as well as the areas with which directors normally concern themselves. Audit Committee members should have detailed discussions with management and the company's auditors regarding these issues, not only to make sure that practices are appropriate, but also to identify "red flags" or "warning signs" in their financial statements that might attract SEC attention, whether by the Division of Corporation Finance, the Office of the Chief Accountant, or the Division of Enforcement. Similarly, companies should take proactive measures to ensure and encourage full and candid internal reporting and communications up the ladder so potential issues are not overlooked, ignored or "missed," and also revisit their "whistleblower" practices to make sure internal reports of potential wrongdoing are dealt with efficiently and effectively (and without fear of retaliation). Indeed, dealing effectively and appropriately with whistleblowers alleging accounting irregularities is more important now than ever before. In fiscal year 2012, the SEC received more whistleblower complaints in the area of financial reporting and disclosures (18 percent) than in any other area.[12]

In sum, renewed attention to accounting issues on the part of directors – to match the renewed attention being paid by the SEC – will undoubtedly pay dividends if the SEC ever comes knocking, which seems increasingly likely in the current environment.

This article was originally published on January 14, 2014, in The D&O Diary.

1. https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171624975.

2. http://www.weil.com/news/pubdetail.aspx?pub=12359.

3. https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171624975; http://www.trustedprofessional.com/2013/08-August/newsmakers/stories/newsmaker.html.

4. http://www.sec.gov/News/Speech/Detail/Speech/1370539845772.

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.* (emphasis added).

10. *See, e.g.*, Frier, "IBM Defends Cloud-Computing Accounting Amid SEC Probe," http://www.bloomberg.com/news/2013-07-31/ibm-says-sec-investigating-its-cloud-computing-revenue-figures.html.

11. *Id.* at fn. 4.

12. *See, e.g.*, SEC 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program, http://www.sec.gov/about/offices/owb/annual-report-2013.pdf.