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SEC, Financial Reporting, and Financial Fraud

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For those who have been through multiple business cycles, the SEC's recent focus on financial fraud and accounting irregularities is nothing new. While there have been periods of time during which the SEC focused on financial fraud, there are also intervals when other issues are more prominent, like the most recent financial crisis.

Nevertheless, it appears that the SEC is once again paying increased attention to financial reporting cases. In 2015, the SEC brought enforcement cases against 191 parties (in contrast to 128 parties in 2014), a significant increase over prior years. Simply scanning the list of settled enforcement cases supports SEC Chair White's recent statement that the SEC "has reinvigorated its investigative and enforcement efforts" in this area, and is closely scrutinizing "the gatekeepers of financial reporting, continuing to hold accountants, auditors, and audit committees accountable under appropriate circumstances."

Below, we will discuss the potential reasons for a renewed focus on financial reporting and financial fraud. We also will review recently reported settled SEC actions relating to financial fraud. Issuers need to be careful not to take shortcuts around recognized accounting rules or their accounting advisors.

The SEC's Renewed Focus on Financial Reporting and Financial Fraud Cases

There are numerous reasons why in every recent speech SEC Chair White, Director of Enforcement Andrew Ceresney and Margaret McGuire, Chair of the SEC's Financial Reporting and Audit Group ("the FRAud Group") are talking about accounting cases.

One driver may be the state of the economy in the United States today. As Chair White noted in a recent speech about the abundance of "unicorn" valuations among certain startup companies, over the last several years, the Internet has spawned many well-known companies. Indeed, as Chair White recently noted in a speech made in Silicon Valley (discussed on the Forum here),

> We all know the significant impact that technology innovation coming from Silicon Valley continues to have on our lives. We see the effect everywhere—companies that trace their start to basements, shared office spaces and classrooms are changing how we get

> around our cities, how we analyze big data, how we find places to stay when we travel, how we communicate with each other, and even how we put satellites in space.

But perhaps this technological innovation comes with certain costs. As Chair White noted, for as many companies that are monumental successes, there are a far greater number of failures. And for as many companies that are well funded, “70 percent of failed start-ups die within 20 months after their last financing, having raised an average of $11 million.” The race to start companies created the need to capitalize and fund them, and raising money from stockholders has required companies to make disclosures regarding their potential success. But as a result of this quest to tap the capital markets for funds, there are “implications of this trend for investors, including employees of these companies, who are typically paid, in part, in stock and options. These are areas of concern for the SEC and, I hope, an important focus for entrepreneurs, their advisers, as well as investors.”

Another impetus for more SEC cases involving financial reporting may simply be that technology has created a tremendous ability for the SEC to review terabytes of information in financial statements almost instantaneously. As noted in recent speeches by Mr. Ceresney and Ms. McGuire, the SEC has new tools such as the its Corporate Issuer Risk Assessment tool (“CIRA”), which through “Big Data” technology, allows the SEC to review more than 100 different accounting methods and metrics to examine whether “things look funny” or not, “at the click of a mouse.”

Recent SEC Enforcement Actions

On June 5, 2015, the SEC entered into a settlement with Computer Sciences Corporation (“CSC”) and some of its former executives for allegedly manipulating financial results and concealing problems related to the company’s largest and most valuable contract. CSC entered into a contract with the United Kingdom’s National Health Service (“NHS”) to build an electronic patient-record system. The parties amended the contract after CSC ran into problems developing the software, and it ultimately became clear that CSC was not going to be able to develop the system at all. In fact, CSC received several notices from the NHS that it was in default of the contract.

The SEC alleged that its disclosure rules and Generally Accepted Accounting Principles (“GAAP”) required the company to disclose the fact that it would likely experience material adverse financial consequences due to its failure to perform the NHS contract. However, CSC did not make any such disclosures despite having actual knowledge that it was in default on the NHS contract. To the contrary, CSC’s CEO Michael Laphen reported to investors that the contract was profitable and would be completed on schedule. CSC’s financial executives, including CFO Michael Mancuso, purportedly added items to the company’s accounting models that had no basis in reality, resulting in artificial and inflated income. Furthermore, the SEC alleged that with Laphen’s approval, CSC based its accounting models on the contract amendments it was proposing to the NHS rather than the actual contract.

The penalties for CSC were severe: although it did not admit to liability, CSC paid a $190 million fine. Five of the eight executives charged also agreed to settlements without admitting the charges. Laphen agreed to pay a $750,000 penalty and return to CSC more than $3.7 million

under the clawback provision of Sarbanes-Oxley. Similarly, Mancuso agreed to return $369,100 in compensation and pay a $175,000 penalty.

The SEC took aim at financial reporting again in an action against a consumer financial services company Bankrate and several of its executives. Former Bankrate CFO Edward DiMaria, along with former finance and accounting executives Matthew Gamsey and Hyunjin Lerner, allegedly schemed to artificially increase revenues and decrease expenses to meet analyst estimates for Bankrate's EBITDA. DiMaria purportedly directed two divisions of the company to book "round" dollar amounts of additional revenue with no support. The complaint also alleged that Bankrate improperly reduced certain expenses or failed to book them at all. When Bankrate's stock rose as a result of the inflated financial results, DiMaria allegedly sold more than $2 million in company stock.

Without admitting or denying the charges, Bankrate agreed to pay a $15 million penalty. In a separate complaint filed against DiMaria and Gamsey in the Southern District of New York, the SEC is seeking financial penalties, officer-and-director bars, and prohibitions in working in public company accounting. The SEC is also seeking to recover the profits obtained by DiMaria when he sold his stock following the release of the inflated financial results.

More recently, on March 31, 2016, the SEC charged Navistar International Corp. with misleading investors about its development of an advanced technology truck engine and its potential certification by the Environmental Protection Agency ("EPA"). Navistar settled the charges by paying a $7.5 million fine, without admitting or denying the charges. However, in a separate complaint filed in the Northern District of Illinois, the SEC charged former Navistar CEO Daniel Ustian with misleading investors and aiding and abetting violations.

The SEC alleged that Navistar and Ustian failed to fully disclose the company's difficulties in having its new truck engine meet U.S. emissions standards. The complaint alleges that the EPA reported to Navistar on several occasions that it had serious concerns about the company's engine and that the engine would not likely be approved by the agency. However, in the company's 2011 Form 10-K, Navistar reported that the company believed the engine met the EPA's certification requirements and that the agency was planning on certifying the engine.

Gatekeepers are in the Crosshairs Again

Like its historical attention to financial reporting and financial fraud in general, the SEC has always focused on "the gatekeeper," which includes audit committee members and a company's outside auditors. In his recent speech to the Directors Forum, Mr. Ceresney noted:

> Audit committee members and external auditors in particular are among the most important gatekeepers in this process, and each has a responsibility to foster high-quality, reliable financial reporting. We recognize that audit committee members and auditors exercise a significant amount of judgment on a day-to-day basis and we are not in the business of second-guessing good faith judgments. However, audit committee members who fail to reasonably carry out their responsibilities, and auditors who unreasonably fail to comply with relevant auditing standards in their audit work, can expect to be in our focus.

In this new era of technological innovation, it is likely the SEC will continue to focus on the gatekeeper function as a check against the rush to "unicorn" valuations and their eventual quest for a liquid exit.

There are lessons to be learned from recent SEC actions: (1) audit committee members need to insist on independence from their auditors, and listen to them when they push back on management calculations; (2) audit committee members need to insist on a robust financial reporting process and challenge management when necessary; and (3) when audit committee members learn of potential misconduct, they need to learn the facts before SEC filings are made.

"CIRA" Gives the SEC More Visibility into Financial Reporting Matters

It is not surprising that technology exists to automate the review of audited financial statements. As noted in many SEC speeches, they do exist and are being applied to audited financial statements that have been filed with the SEC. As Mr. Ceresney noted in his Directors Forum speech, "CIRA provides us with a comprehensive overview of the financial reporting environment of Commission registrants and assists our staff in detecting anomalous patterns in financial statements that may warrant additional inquiry. CIRA's multiple dashboards enable the staff to compare a specific company to its peers in order to detect abnormal, relative results, focus on particular financial reporting anomalies, and generate lists of companies that meet the criteria for further analysis."

In some cases, based upon the metric in question, there could be "false positives." CIRA is only as good as the search algorithm employed by the examiner and can only provide results that are "data" driven. In the case of a false positive, an issuer should generally have nothing to fear. The computation might be explainable with context and thus should not raise concern. There could also be a "positive" finding as well, indicating a potential anomaly in the issuer's financial statements. That might mean at the very least the issuer's file might find itself moved up in the review process. At the other end of the spectrum is a positive finding by CIRA, coupled with a whistleblower's allegations, which likely will draw the SEC's attention quickly. CIRA's big contribution to the SEC is its ability to do more with less, meaning in an era of flat budgets or reduced budgets, the SEC will still have the ability to monitor its registrants.

As noted by Chair White in her address in Silicon Valley, technological innovation has forever changed the United States and the world. Technological innovation has created some of the world's largest businesses and market capitalizations. It has also changed the method in which businesses conduct their day-to-day business. Businesses can take advantage of the latest tools to store, compile and use information, detect customer habits, and to run their businesses more efficiently and profitably. They can even conduct their businesses in the cloud and thus not be tied to any one location. However, issuers must recognize that the SEC has access to the latest technology, as well, which gives the Commission the ability to view—and in some circumstances, scrutinize—issuers' financial statements more readily and rapidly than before.

The complete publication, including footnotes, is available here.