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"Robocop" on the Beat: What the SEC's New Financial Reporting and AQM Initiative May Mean for Public Companies

By Christopher L. Garcia, Paul Ferrillo and Matthew Jacques[1]

Since her confirmation as Chair of the U.S. Securities and Exchange Commission ("the SEC"), Mary Jo White has made clear that her administration will focus on identifying and investigating accounting abuses at publicly traded companies, a focus that has been echoed by Chairperson White's co-Directors of Enforcement, George Canellos and Andrew Ceresney.[2] This renewed focus is perhaps unsurprising: whistleblower complaints relating to corporate disclosures far outstrip complaints in other popular enforcement areas, such as insider trading and FCPA, and yet the last several years have witnessed a steady decline in accounting fraud investigations and enforcement actions.[3]

Accordingly, on July 2, 2013, the SEC announced two initiatives in the Division of Enforcement designed to support this renewed focus on uncovering and pursuing accounting abuses in public companies:

- The Financial Reporting and Audit Task Force ("the Task Force"), "an expert group of attorneys and accountants" dedicated to detecting fraudulent or improper financial reporting;[4] and
- The Center for Risk and Quantitative Analytics, which is dedicated to "employing quantitative data and analysis to high-risk behaviors and transactions" in an effort to detect misconduct.[5]

While the Task Force portends a new era in accounting fraud enforcement by creating a veritable "SWAT Team" tasked with reviewing financial restatements and class action filings, monitoring high risk companies, and conducting street sweeps,[6] the announcement that the SEC is employing "data analytics" in order to detect indicia of accounting fraud is potentially the more significant development.

First dubbed the "Accounting Quality Model" ("AQM") by the SEC's Chief Economist Craig M. Lewis, and later coined "Robocop" by the media, the use of data analytics represents advances in enforcement techniques made possible by a prior SEC compliance initiative called XBRL (eXtensible Business Report Language), which mandated a standardized format for public companies to report their results. This article attempts to bring together all of the concepts related to the AQM in an understandable way for directors and officers of public companies. In short, the AQM may mean that companies may receive more frequent inquiries from the SEC based upon the substantive quality of their financial statements alone. Though just one tool in the SEC's enforcement tool box, the SEC's AQM initiative certainly represents how 21st Century information gathering may give the SEC a leg up in detecting accounting fraud.

What is XBRL?

First, a brief word about XBRL, which has made the SEC's AQM initiative possible. In mid-2009, the SEC mandated the use of XBRL (XBRL was voluntary beginning in 2006) for most companies reporting financial information to the SEC. According to the SEC's XBRL web site, "Data becomes interactive when it is labeled using a computer markup language that can be processed by software for sophisticated viewing and analysis. These computer markup languages use standard sets of definitions, or taxonomies, to enable the automatic extraction and exchange of data. Interactive data taxonomies can be applied — much like bar codes are applied to merchandise — to allow computers to recognize that data and feed it into analytical tools. XBRL (eXtensible Business Reporting Language) is one such language that has been developed specifically for business and financial reporting."[7] Put differently, financial information is essentially "coded" or "tagged" in a standardized fashion to allow the SEC to understand it more readily. For example, an accrual, like an executive compensation accrual, is identified and coded as an accrual, along with other types of accruals. In short, XBRL is like as a hyper-advanced Twitter hashtag for the financially savvy that allows financial information reported to the SEC to be categorized and sorted quickly and effectively for further analysis.

Standardized Financial Reporting Facilitates the AQM Initiative

So how does mandatory financial reporting using XBRL make AQM possible? Through the standardization of reporting, tagging and coding of terms through XBRL, the SEC is able to quantify or "score" the degree to which a company may be engaged in any number of problematic accounting practices. For example, the model analyzes SEC filings to estimate the number and size of discretionary accruals within a company's financial statements. Discretionary accruals are accounting estimates that are inherently subjective and susceptible to abuse by companies attempting to manage earnings. Once anomalous accrual activity is detected, the model then considers other factors that are "warning signs" or "red flags" that a company may be managing its earnings. The SEC has publicly provided limited examples of these factors, which include: the use of "off-balance sheet" financing, changes in auditors, choices of accounting policies and loss of market share to competitors. Ultimately the AQM quantifies how a company's discretionary accruals and red flags compare to those of other companies within that company's industry peer group. Outliers (those with financial statements that "stick out") in the peer group possess qualities that indicate possible earnings management. As SEC's Dr. Lewis summed up in December 2012: "[AQM] is being designed to provide a set of quantitative analytics that could be used across the SEC to assess the degree to which registrants' financial statements appear anomalous."[8]

It is then up to the SEC to take "the next step," which could vary from company to company. In some cases, a "high score" might warrant a letter from the SEC's Department of Corporate Finance ("Corp Fin") asking for explanations regarding potential problem areas. More dramatically, a "high score," alone or in conjunction with other information, including information provided by a whistleblower, may result in an informal inquiry by the staff of the Enforcement Division, with attendant requests for documents and interviews, or, worse, a formal investigation. Thus, problems for a Company could escalate dramatically with cascading effects, including difficult discussions with the incumbent auditor, and, worst case scenario, a full blown audit committee investigation.

What AQM Could Mean for Public Company Directors and Officers

A few years ago, AQM may have been viewed no differently than any of the laundry list of items public company officers and directors need to worry about.

But arguably in the last 12 months the world has changed: The Division of Enforcement has announced a renewed focus on rooting out accounting fraud, the Task Force the SEC has formed is deploying new strategies to detect and investigate accounting irregularities, and whistleblowers are incentivized to bring allegations of accounting improprieties to the attention of regulators.

So is there a silver bullet to the AQM? How should companies respond to the renewed focus of the SEC on accounting fraud and earnings management issues? There are no right answers to these questions, only perhaps some prudent advice:

- **Get your XBRL reporting right the first time.** There are many reports that public companies are continuing to make numerous XBRL coding mistakes. It is likely the AQM will not be able to identify an innocent coding mistake. Such mistakes, however, may land a company on the top of SEC's "Needs Further Review" list. Though the audit firms have apparently steered away from giving advice on XBRL, there are numerous experts and boutique firms that can help provide guidance to registrants. Making errors in this area, even if innocent, is simply not an option in this new era.
- **Consider all of your financial disclosures.** The AQM focusses on identifying outliers. One easy way to become an outlier is to be opaque with disclosures where other companies are transparent. Take a fresh look at your financial disclosures for transparency and comparability across your industry.
- **Listen to the SEC's guidance.** As we have noted above there are a number of new SEC programs and initiatives focused on detecting financial reporting irregularities. Stay current on SEC activity to avoid surprises.
- **It is not just the SEC.** XBRL is available to the public. As a greater library of XBRL financial statement data is created, analysts, investors, other government agencies, media outlets and others will build their own versions of the AQM. Be prepared for greater scrutiny and inquiries from these groups.
- **Be conscious of red flags.** For example, a change in auditor is thought to be a significant red flag that might warrant further attention from the SEC.

Finally as we explained above, times have changed and the SEC, upon implementation of the AQM, is ever more likely to knock on your door. Be prepared for interactions with the SEC, in particular the Enforcement Division, that are not in keeping with historical experience. As we advised with the new whistleblower program, be prepared to respond quickly and substantively to any potential SEC inquiry that might have been generated solely by the AQM or one of the many other new tools being employed by the staff. Elevate those inquires, as appropriate, to the Audit Committee and handle them with the requisite diligence. Further, have your crisis management plan ready, just in case there is a genuine and serious accounting issue that needs attention. Given the potential damage an accounting problem can have on a company's reputation, its investors, and its stock price, have internal and external crisis advisors ready to act if necessary to investigate quickly any potential impropriety. Also have your disclosure lawyers and crisis management advisor ready to communicate with the marketplace in whatever ways are appropriate and at the appropriate time. Indeed, in light of the SEC's renewed focus on accounting improprieties, today, more than ever, a crisis management plan to deal with a potential accounting failures is absolutely essential.

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1. This article was originally published on December 6, 2013 in The D&O Diary. Matthew Jacques is a Director at AlixPartners.
2. *See e.g.* Speech of Mary Jo White to the Council of Institutional Investors Fall Conference, dated September 26, 2013.
3. *See* Henning, The S.E.C. is 'Bringin' Sexy Back' to Accounting Investigations, NY Times.com, at http://dealbook.nytimes.com/2013/06/03/the-s-e-c-is-bringin-sexy-back-to-accounting-investigations/?_r=0.
4. *See* Remarks of Chair Mary Jo White at the Securities Enforcement Forum, October 9, 2013, at http://www.sec.gov/News/Speech/Detail/Speech/1370539872100.

5. *See* SEC Release 2013-121, "SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis," July 2, 2013.
6. *See* Speech of Co-Director of Enforcement, Andrew Ceresney, dated September 19, 2013, at http://www.sec.gov/News/Speech/Detail/Speech/1370539845772.
7. *See* http://www.sec.gov/spotlight/xbrl/what-is-idata.shtml.
8. *See* speech of Craig Lewis, entitled "Risk Modeling at the SEC: The Accounting Quality Model," dated December 13, 2012, at https://www.sec.gov/News/Speech/Detail/Speech/1365171491988.

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