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SEC Picks Up The Pace On Financial Reporting Fraud Efforts

Law360, New York (October 26, 2015, 11:03 AM ET) --

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Since 2013, with the bulk of its cases arising out of the financial crisis largely complete, the U.S. Securities and Exchange Commission's Division of Enforcement has publicly heralded its renewed focus on public company accounting and disclosures. Among other things, the SEC formed a new Financial Reporting and Audit Task Force dedicated to ferreting out potential frauds. After several years during which these cases represented a significantly smaller component of the SEC's enforcement docket, it was an open question whether the agency was missing serious frauds, or the industry was simply on much better behavior than in the era of Enron and Arthur Andersen. For the most part, the jury is still out, and while the number of financial reporting enforcement actions has risen over the past year, most are relatively smaller actions.

However, since September 2015, the SEC has filed a number of notable actions, suggesting that the Division of Enforcement's initiatives are bearing fruit. The spate of recent cases provide several important insights for public companies and their auditors to consider if they want to stay off the division's radar screen.

The Importance of Internal Controls

Traditionally, SEC enforcement actions against public companies and their executives have sought to emphasize outright fraud, with passing reference to any accompanying internal controls weaknesses. Recently, however, the SEC has shown an increased willingness to bring standalone internal controls cases to emphasize the importance of a company's compliance procedures (though perhaps driven in part by a relative absence of more serious fraudulent schemes).

For example, on Oct. 5, the SEC instituted settlement proceedings against a Cayman Islands-based home

loan servicing company, alleging that the company, which engaged in a number of related party transactions, lacked written policies or procedures on recusals for related-party transactions notwithstanding public representations to the contrary.[1] In addition, the SEC found that because of its "lax controls environment," the company failed to properly value its primary asset in public filings. The company paid a $1.5 million penalty without admitting or denying the findings.

Similarly, on Sept. 22, a discount retailer settled allegations that the company had insufficient internal controls over its inventory valuation, resulting in materially overstated pre-tax income.[2] In the company's restatement, it acknowledged that it not only had a material weakness in its internal control over financial reporting but also in "its control environment related to the level of information and communication between the finance department and other departmental functions."[3] Without admitting or denying the findings, the company paid an $800,000 penalty for violations of the reporting, books and records, and internal control provisions. In agreeing to the settlement, the SEC acknowledged the company's cooperation, enhancement of internal controls, and addition of accounting personnel, noting that the decision to categorize the markdown of certain inventory was handled by the merchandising department, with no knowledge of the relevant accounting principles.

Aggressive Posture Toward Outside Auditors

While the SEC has always considered the role of a company's auditors in accounting fraud cases, the agency appears to be taking a particularly aggressive stance toward auditors in recent months. Most notably, on Sept. 9, the SEC instituted settled proceedings against audit firm BDO USA and five of its partners for their alleged failure to exercise professional skepticism.[4] The matter arose out of an investigation of a staffing services company (described further below), in which $2.3 million in cash (about half the company's assets) had gone missing and then mysteriously reappeared. The SEC's order found that the audit firm issued an unqualified opinion in the face of multiple, allegedly conflicting accounts by company management about the missing money. According to the SEC, the firm demanded an independent investigation into the matter by the audit committee, yet subsequently withdrew its demand.

Notably, the SEC pursued the enforcement actions not only against the partners on the engagement team, but also against certain regional and national leadership personnel within the firm who were consulted on the engagement. The audit firm agreed to retain an independent compliance consultant and paid just over $2.1 million to settle the proceeding, and the individuals, without admitting or denying the findings, also paid a combined $75,000 in fines. The SEC's settlement order also includes specific compliance undertakings, including training requirements, compliance certifications by its CEO and chief compliance officer, and an evaluation of its audit and interim review quality controls and policies.

Outside the realm of public company actions, but still indicative of the SEC's scrutiny of the accounting profession, the SEC on Sept. 4 instituted settled proceedings against two auditors of an investment fund, finding they failed to obtain sufficient evidence of investment, thereby permitting a client's fraudulent activities to continue undetected.[5] In the order, the SEC highlighted the engagement partner's alleged failure to properly supervise the members of the engagement team. The SEC found the auditors engaged in improper professional conduct and suspended them from appearing before the SEC for a period of three years.

Significantly, in a case against an accountant who conducted audits of a large number of small issuers, the SEC charged him with scienter-based fraud, finding that the audits for at least eight issuers were so

deficient that "they amounted to no audits at all." The individual was permanently barred from appearing before the agency as an accountant under Rule 102(e) and was sanctioned a total of $149,662.[6]

Finally, auditor independence is another significant SEC focus in recent enforcement actions. On Oct. 1, the SEC charged two Grant Thornton member firms with auditor independence violations when two partners served on the boards of the firm's audit clients and performed nonaudit services, including controlling bank accounts and having authority to act on the audit client companies' behalf.[7] The member firms paid a combined $240,085 in disgorgement and prejudgment interest and penalties totaling $125,000. Notably, the SEC acknowledged Grant Thornton's remedial efforts, including imposing new firm-specific actions such as training and certification requirements.

Old-Fashioned Earnings Management Is Here to Stay

Recent SEC enforcement actions confirm that companies continue to engage in some of the same earnings management tricks that led to so many high-profile financial fraud cases in decades past, including improper revenue recognition and concealment of expenses.

On Sept. 8, the SEC charged the CEO and chief financial officer of a now-bankrupt online video company for, among other things, allegedly paying the company's own money into a secret "slush fund" to make payments back to the company in an effort to create the appearance the company was being paid for its products.[8] The SEC further alleged that the company improperly recognized revenue on sales where it failed to deliver products, altering documents to conceal the fraud. The matter is being litigated. On Sept. 25, the SEC sued four executives of an energy company for allegedly inflating revenues through fraudulent billing practices.[9] That case, as well, is being litigated.

On Sept. 30, in yet another litigated action, the SEC charged the CEO and CFO of a now-bankrupt Internet service provider with "fabricating nearly all of the company's revenue" through a series of sham transactions.[10] And on Oct. 6, the SEC filed a litigated action against the CEO of (yet another) now-bankrupt company, a computer memory seller, for alleged "channel stuffing" by shipping a customer more product than it could resell and concealing product returns. The SEC separately settled with the company's CFO for failing to implement adequate internal controls and false or misleading accounting and disclosures.[11]

While not necessarily a "trend," the SEC has shown continuing interest in cases involving disclosures of executive perks. Following a high-profile executive perks case back in March, the SEC on Sept. 8 charged sports supplement company MusclePharm and four executives for allegedly failing to disclose nearly a half-million dollars in perks provided to its executives, include payments to its CEO for cars, clothing and golf club memberships.[12] The SEC also alleged that the company also failed to disclose related party transactions, and overstated revenue by inappropriately accounting for advertising and promotional costs. The SEC emphasized that, when the company became public in 2010, "it was unprepared for the Commission's reporting requirements and lacked sufficient infrastructure to support its rapid growth."[13] Without admitting or denying the allegations, the company agreed to pay $700,000 and retain an independent compliance monitor for a year, while the individual officers agreed to various sanctions as well.

Charging the Gatekeepers

Finally, the SEC continues to highlight its scrutiny of gatekeepers — not just outside auditors, but senior

executives and board members who are in a position to prevent misconduct. For example, in the above-referenced MusclePharm case, the SEC sued not just the individual officers, but the company's audit committee chair. According to the SEC, the chair knew or should have known that the company's financial statements failed to disclose executive perks such as private jet use and executive golf memberships, alleging that he "substituted his wrong interpretation of SEC rules for the views of the experts the company had hired."[14] Without admitting or denying the findings, the audit committee chair paid $30,000 to settle the matter.

Similarly, in a separate action arising out of the BDO auditor case referenced earlier, the SEC charged the chairman of the board of the issuer with making misleading statements to the auditors and signing the company's annual report despite knowing that it included misleading statements about "dubious" related party transactions involving $2.3 million missing from the company.[15] The action against the chairman is in litigation.

Conclusion

The SEC's recent wave of filings should leave little doubt that the Division of Enforcement is intensely focused on identifying and bringing financial reporting cases. With the freeing up of extensive resources tied up in recent years by investigations (now largely complete) arising out of the financial crisis, combined with the more proactive efforts of the Task Force, the number of cases involving public companies and auditors is only going to rise. At the same time, memories are short, and for many companies — including their employees, executives and boards — the scandals of the early 2000s are part of the distant past. Public companies and the audit firms that serve them need to be taking steps to ensure their internal controls, corporate governance structures, and compliance and training programs are in place and effective, or risk becoming part of the next enforcement dragnet.

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[1] SEC Press Release, SEC Charges Home Loan Servicing Solutions for Misstatements and Inadequate Internal Controls (Oct. 5, 2015), available at www.sec.gov/news/pressrelease/2015-230.html.

[2] SEC Press Release, SEC Charges Retailer for Improper Valuation and Inadequate Internal Accounting Controls (Sept. 22, 2015), available at www.sec.gov/news/pressrelease/2015-200.html.

[3] In the Matter of Stein Mart, Inc., Proceeding File No. 3-16826 (Sept. 22, 2015), available at www.sec.gov/litigation/admin/2015/34-75958.pdf.

[4] SEC Press Release, SEC Charges BDO and Five Partners in Connection with False and Misleading Audit Opinions (Sept. 9, 2015), available at www.sec.gov/news/pressrelease/2015-184.html.

[5] SEC Press Release, SEC Charges Seattle-Area Hedge Fund Adviser with Taking Unearned Management Fees (Sept. 4, 2015), available at www.sec.gov/news/pressrelease/2015-178.html.

[6] In the Matter of Terry L. Johnson CPA, Proceeding File No. 3-16820 (Sept. 17, 2015), available at www.sec.gov/litigation/admin/2015/33-9915.pdf.

[7] SEC Press Release, SEC Charges Two Grant Thornton Firms with Violating Auditor Independence Rules (Oct. 1, 2015), available at www.sec.gov/news/pressrelease/2015-225.html.

[8] SEC Press Release, SEC Charges Video management Company Executives with Accounting Fraud (Sept. 8, 2015), available at www.sec.gov/news/pressrelease/2015-183.html.

[9] SEC Press Release, SEC Charges Former Officers of SMF Energy with Fraud (Sept. 25, 2015), available at www.sec.gov/news/pressrelease/2015-210.html.

[10] SEC Press Release, SEC Charges Executives for Defrauding Investors in Financial Fraud Scheme (Sept. 30, 2015), available at www.sec.gov/news/pressrelease/2015-224.html

[11] SEC Press Release, SEC Charges Former Executives with Accounting Fraud and Other Accounting Failures (Oct. 6, 2015), available at www.sec.gov/news/pressrelease/2015-234.html.

[12] SEC Press Release, SEC Charges Sports Nutrition Company with Failing to Properly Disclose Perks for Executives, (Sept. 8, 2015), available at www.sec.gov/news/pressrelease/2015-179.html.

[13] In re MusclePharm Corp., Admin. Proceeding File No. 3-16788 (Sept. 8, 2015), available at www.sec.gov/litigation/admin/2015/33-9903.pdf.

[14] See supra note 13.

[15] See supra note 4.

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