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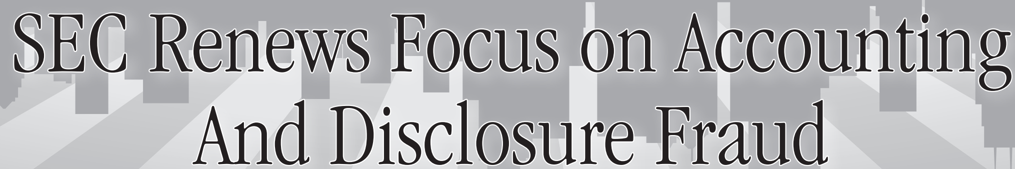

SEC Renews Focus on Accounting And Disclosure Fraud

BY MARK S. COHEN, SCOTT D. THOMSON AND JONATHAN S. ABERNETHY

Accounting fraud investigations have long been a mainstay of the SEC's enforcement program. In the aftermath of the financial crisis, however, statistics show that the SEC's focus on accounting fraud took a back seat to cases growing out of the crisis. In FY2012, the SEC opened 124 financial fraud/issuer disclosure investigations as compared to 304 in FY2006 and 228 in FY2007. The agency filed just 79 financial fraud/issuer disclosure actions in FY2012 compared to 219 in FY 2007.[1] Perhaps as a consequence of this diminished focus, accounting restatements also declined in this same period. Across all public companies, restatements fell from a peak of 1,771 in 2006 to 768 in 2012.[2]

Recent statements by SEC officials, however, suggest the pendulum may swing back to a renewed focus on accounting and disclosure fraud. In January 2014, SEC Chair Mary Jo White said that financial reporting fraud would be a priority going forward, including investigations of senior executives for possible misconduct.[3] In a September 2013 speech to the American Law Institute, SEC Enforcement Director Andrew Ceresney expressed "doubts about whether we have experienced such a drop in actual fraud in financial reporting as may be indicated by the numbers of investigations and cases we have filed."[4] Ceresney underscored that incentives to manipulate financial statements are still present, and that in 2012, the SEC Whistleblower Program received more tips alleging financial reporting misconduct than it received in any other category.[5]

The most tangible sign of the SEC's renewed commitment is a new Financial Reporting and Audit Task Force—the "FRAud Task Force." The Task Force will use recently developed data analytics to assess the degree to which a company's financial statements appear anomalous, including through comparisons of a company's filings with filings by other companies in the same industry.[6] The SEC also has promised to target accounting reserves, revenue recognition, and the role of audit committees.[7]

This article examines each of these three areas through the lens of three recent SEC enforcement actions: Capital One, ArthroCare, and AgFeed Industries.

Reserves Against Losses: Capital One

Prudent reserves against losses are a critical component of proper accounting. In his September 2013 speech, Ceresney emphasized the importance of the manner in which management and auditors make decisions with

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respect to booking reserves. Ceresney stated that, while the SEC recognizes that management and auditors must use their judgment, the SEC "will not tolerate decisions that are reached in bad faith, recklessly, or without proper consideration of the facts and circumstances."[8] As an example, he cited an April 2013 enforcement action against Capital One Financial Corporation (Capital One).[9]

In its Order Instituting Cease-and-Desist Proceedings (order), the SEC found that Capital One, a provider of commercial lending and diversified banking services, materially understated its loan loss reserves for its auto finance business, known as Capital One Auto Finance (COAF), and failed to maintain effective internal controls to ensure the appropriate and accurate recording and reporting of its loan loss expenses.[10] The SEC fined Capital One $3.5 million and also imposed civil penalties of $85,000 and $50,000, respectively, against its chief risk officer and COAF's divisional credit officer.[11]

By way of background, a company's best estimate of losses incurred in its loan portfolio as of any given reporting date is reflected in the allowance for loan and lease losses (allowance). The company's provision for loan losses, in turn, is the cost per quarter or per year of maintaining an adequate allowance. An increase to the allowance, or "allowance build," is recorded as an expense on the company's income statement; it decreases net income for the period.[12] Under Financial Accounting Standards (FAS) 5, in accounting for a loan loss expense, a company is obligated to record losses if they are both probable and capable of being reasonably estimated.

Beginning in October 2006, Capital One began experiencing higher, unexplained loan charge-offs and delinquencies in virtually all of its consumer lines of business. Given the breadth and magnitude of the losses, Capital One became concerned that it was facing a "credit turn," a phenomenon where there is a general worsening of the credit environment causing losses in consumer lending businesses.[13]

Conditions continued to worsen to the point that the company's credit risk management group estimated in 2007 that the allowance build would increase by $72 million by year-end based on the company's internal loss forecasting methodology.[14] Nevertheless, the chief risk officer and divisional credit officer decided not to include any of the $72 million in the allowance for the second quarter of 2007.[15] In the third quarter, COAF again suffered higher than expected loan losses and was facing an allowance build of up to $100 million.[16] The chief risk officer, however, decided to include only a fraction of that projected allowance for the quarter.[17]

As a result, the SEC found that COAF's allowance did not appropriately incorporate information necessary to determine incurred losses under GAAP.[18] Furthermore, the SEC found, the credit risk management group failed to adequately document its decisions to the Capital One Allowance Committee, which was responsible for ensuring that COAF's allowance complied with FAS 5.[19] The SEC sanctioned Capital One, the chief risk officer, and the divisional credit officer for violations of §§13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Securities Exchange Act, based on their failure to file accurate reports, keep accurate books and records, and maintain adequate internal controls.[20]

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There are at least two lessons from the Capital One enforcement action. First, companies should have clear methodologies for estimating necessary reserves and, if they depart from those methodologies, they should adequately document the reasons for the departure. Second, the SEC will not shy away from targeting individuals in cases involving reserves when they "ignore inconvenient truths about losses and the need to increase reserves."[21]

Revenue Recognition: ArthroCare

As Ceresney underscored in his September 2013 speech, revenue recognition fraud, long a "staple" of the SEC's caseload, can take many forms, including sham transactions, premature recognition of revenue, schemes to inflate sales numbers, and billing for uncompleted products.[22] The recent enforcement action against ArthroCare Corporation provides an example.

ArthroCare is a medical device company that develops and markets surgical products, including products with the name "SpineWands" that were used by surgeons to treat spinal injuries.[23] In its order against the company, the SEC found that between the fourth quarter of 2005 and the first quarter of 2008, ArthroCare materially overstated and prematurely recognized revenue, primarily on sales of SpineWands to certain distributors, including a company called DiscoCare. Most of these transactions occurred at or close to the end of a quarter and were intended to help ArthroCare reach aggressive internal revenue targets and satisfy analysts' revenue expectations.[24]

The SEC found that ArthroCare repeatedly turned to DiscoCare to help it overcome quarterly revenue shortfalls by recording revenue from large orders shipped to DiscoCare at or near quarter-end. The orders were initiated by ArthroCare employees. DiscoCare had no need for the excessive inventory and no reasonable likelihood of selling the products within a reasonable timeframe. ArthroCare provided DiscoCare with significantly extended payment terms, while also agreeing that DiscoCare did not have to pay for the products until it had sufficient funds to do so.[25] Accordingly, the SEC contended, it was improper under FAS 48 (which governs revenue recognition where a right of return exists) for ArthroCare to recognize revenue from these sales.[26]

In addition, shortly after the close of the second quarter of 2006, ArthroCare employees arranged for DiscoCare to return products shipped just before quarter-end, while concealing from ArthroCare's accounting staff the reason for the return of the products: that the shipments had caused ArthroCare to exceed analysts' revenue targets, and employees were concerned that this would cause analysts to set the following quarter's estimates too high. The SEC found that recognizing revenue from these sales violated GAAP.[27]

As with Capital One, the SEC found that ArthroCare violated §§13(a), 13(b)(2)(A), and 13(b)(2)(B).[28] The company, which provided "substantial" cooperation to the SEC and instituted remedial actions, was not required to pay a fine.[29]

The remedial actions that ArthroCare implemented may be useful for other companies, particularly start-ups and early stage companies, to help guard against revenue recognition problems. Among other things, ArthroCare expanded its internal audit function, implemented a sub-certifications process as part of its quarterly and annual reporting, enhanced its internal controls related to revenue recognition, and provided regular training to employees on revenue recognition and appropriate procedures for handling sales contracts.[30]

Audit Committee Responsibilities: AgFeed

In his September 2013 speech, Ceresney emphasized the importance of focusing on audit committees of boards of directors, "which serve as a gatekeeper for quality financial reporting" and play a "critical role by overseeing and monitoring the … reporting process."[31] He warned the SEC would crack down on audit committees that fell short.[32] It was not long before Ceresney's warning came to pass. In March 2014, the SEC charged the chair of the audit committee of AgFeed Industries (the chair) and AgFeed's former CFO with failing to disclose a massive accounting fraud in AgFeed's China operations while the company was trying to raise capital in 2011.[33] Interestingly, the SEC's complaint does not allege that the chair or CFO had any role in the fraud itself. Instead, it charges that they failed to aggressively investigate the fraud and disclose what they knew in filings accompanying securities offerings.[34] In the SEC's press release announcing the charges, Ceresney cited the case as "a cautionary tale of what happens when an audit committee chair fails to perform his gatekeeper function in the face of massive red flags."[35]

According to the complaint, filed in the Middle District of Tennessee, AgFeed executives began inflating reported revenues in 2008 after AgFeed acquired 29 Chinese farms for its new hog production division.[36] The inflated numbers included sales of nonexistent hogs and exaggerated weights for real hogs.[37] The company also recorded fictitious costs to partially offset its exaggerated revenues.[38] The SEC charges that AgFeed maintained two sets of books, an "outside" set provided to auditors and an "inside" set that contained accurate, lower numbers that were hidden from auditors.[39]

Relative to the size of the company, the alleged fraud was epic. The SEC contends that AgFeed's revenue was overstated by $239 million over a 3.5 year period. On an annual basis, between 2008 and 2010 the company's revenue was bloated by between 71 percent and 103 percent per year and gross profit inflated between 98 percent and 153 percent.[40]

According to the complaint, the fraud came to light within the company in 2011, and the chair and CFO then learned of the two sets of books and of executives' involvement in the fraud.[41] The SEC charges that instead of retaining outside counsel or commencing an investigation, the chair, along with the CFO, engaged in a scheme to minimize the fraud and delay disclosure to investors.[42] According to the SEC, the chair and CFO, among other things, failed to disclose to the company's outside auditors that an in-house attorney earlier that year had circulated a memorandum detailing how revenues had been falsified.[43] In addition, the SEC alleges that the chair and CFO assisted in drafting public statements that they knew or were reckless in not knowing contained false financial figures.[44] As a result, the SEC charged them with fraud and aiding and abetting AgFeed's fraud in connection with an offering of securities under §§10(b) and 20(a) of the Exchange Act and 17(a) of the Securities Act.[45] The SEC also charged them with, among other things, knowingly failing to implement a system of accounting controls to assure that AgFeed's financial statements were prepared in conformity with GAAP or knowingly falsifying books and records; deceit of auditors; and aiding and abetting AgFeed's violations of §§13(a) and 13(b)(2).[46]

The case is at a very early stage, the chair and CFO appear poised to fight the charges,[47] and it will be interesting to see whether the SEC's vow to go after audit committees proves successful in this instance. However the case is resolved, it serves as an important reminder that audit committees may increasingly be in the SEC's cross-hairs if, in the SEC's view, they ignore clear indicia of fraud. To guard against this, committees should consider hiring outside counsel and conducting thorough investigations whenever allegations of potential fraud come to light.

Conclusion

With financial crisis cases winding down, accounting and disclosure fraud investigations and cases will take on new prominence, as illustrated by SEC officials' statements and recent enforcement actions. Companies would be wise to review and, if necessary, strengthen their internal controls in this area.

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1. Andrew Ceresney, Financial Reporting and Accounting Fraud speech, American Law Institute Continuing Legal Education, Washington, D.C. Sept. 19, 2013 (Ceresney), available at http://www.sec.gov/News/Speech/Detail/Speech/1370539845772.
2. See id. at 2.
3. Mary Jo White, Keynote Address, 41st Annual Securities Regulation Institute, Coronado, California, Jan. 27, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370540677500.
4. Ceresney at 3.
5. Id. at 3-4; see also U.S. Securities and Exchange Commission, 2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program at 8.
6. Id. at 5.
7. Id. at 5-6.
8. Id.at 5.
9. Id. at 5; see Order Instituting Cease-and-Desist Proceedings, *In the Matter of Capital One Financial*, File No. 3-15299, Rel. No. 694442 (S.E.C. April 24, 2013).
10. Id. ¶ 1.
11. Id. ¶¶ 78C, 78D, 78E. Capital One neither admitted nor denied the findings.
12. Id. ¶ 9.
13. Id. ¶ 20.
14. Id. ¶ 28.
15. Id. ¶ 32.
16. Id. ¶ 34.
17. Id. ¶ 41.
18. Id.
19. Id. ¶¶ 63-64.
20. Id. ¶¶ 71-78. Section 13(a) requires issuers to file with the SEC such information, documents, and periodic reports as the Commission may require and, pursuant to Rule 12b-20, mandates that periodic reports contain such further material information as may be necessary to make the required statements not misleading. Section 13(b)(2)(A) of the Exchange Act requires issuers to keep books, records, and accounts that fully and fairly reflect their transactions and dispositions of their assets. Section 13(b)(2)(B) requires all reporting companies to devise and maintain a series of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP.
21. Ceresney at 5.
22. Id.
23. See Order Instituting Cease-and-Desist Proceedings, *In the Matter of ArthroCare*, File No. 3-14249, Rel. No. 3232 (S.E.C. Feb. 9, 2011) ¶ 1. The company neither admitted nor denied the findings.
24. Id. ¶ 3.
25. Id. ¶ 4.
26. Id. ¶ 4 n.2.
27. Id. ¶ 5.
28. Id. ¶¶ 8-10.
29. Id. at 4.
30. Id.
31. Ceresney at 6.
32. Id.
33. See SEC Charges Animal Feed Company and Top Executives in China and U.S. With Accounting Fraud, Press Rel. No 2014-47, March 11, 2014 at 1 (Press Release), available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541102314.
34. See Complaint, *S.E.C. v. AgFeed Industries*, et al. (M.D. Tenn. March 11, 2014) (Complaint), available at http://www.sec.gov/litigation/complaints/2014/comp-pr2014-47.pdf. The Complaint charges a number of former executives and the company itself.
35. Press Release at 1.
36. Id. ¶ 17.
37. Id. ¶ 18.
38. Id. ¶ 19.
39. Id. ¶ 21.
40. Id. ¶ 20.
41. Id. ¶ 44.
42. Id. ¶ 63.
43. Id. ¶ 67.
44. Id. ¶ 70.
45. Id. ¶¶ 88-104.
46. Id. ¶¶ 106-07, 112-13, 118-120, 129-131.
47. See "SEC Charges AgFeed Audit Committee Chair in Accounting Fraud Case," Reuters, March 11, 2014, available at http://www.reuters.com/article/2014/03/11/usa-sec-agfeed-idUSL2N0M81KK20140311.

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