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SEC Accounting Enforcement: Bigger and Badder
Tammy Whitehouse | September 29, 2015
Perhaps some public companies haven't yet taken to heart the (numerous) signals from regulators and auditors to button up their internal controls. A recent legal analysis of financial reporting and auditing enforcement actions from the Securities and Exchange Commission should do the trick.

Hoffman

Holland & Hart summarized SEC enforcements for 2014 and the first half of 2015 to provide a big picture of where the enforcement staff is focusing its efforts, and therefore where public companies should pay special attention to assure their own compliance. The message, says Brian Neil Hoffman, a partner at Holland & Hart, is a bit daunting.

"The SEC is effectively targeting all aspects of a company's financial reporting and auditing," he says. "Charges run the gamut."

When the firm annualized data from the first half of 2015 to compare it to 2014 and 2013, it found officers and directors are an increasingly popular target for SEC enforcement actions. If the trend for 2015 so far continues, the SEC might well bring cases against more than 60 individual officers and directors, the firm says. Individuals in other groups, such as auditors or audit committee members, might be targeted fewer than 10 times.

In the 18-month period the firm analyzed, the SEC sued almost 100 individuals for financial reporting and auditing matters, and 82 of them were public company officers or directors—typically CEOs, CFOs, controllers, and other finance professionals. "Perhaps 2015 will set new records in this area," the firm predicts.

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A recent alert from law firm Jones Day also suggests that individuals face some new risks after the Justice Department issued guidance recently emphasizing the prosecution of individuals. Investigations should focus on individuals, not just companies, from the inception, the department says in its "Yates Memo" issued earlier in September. And for companies to get any credit for cooperating in an investigation, they will be expected to investigate thoroughly themselves and share everything they know about individuals involved in any wrongdoing.

While 2014 brought a significant number of cases against audit firms, especially around auditor independence violations, 2015 will be focused more on allegations of accounting manipulations, disclosure issues, and misuse of corporate assets, the report says. "They're looking at all aspects of a company's public disclosures," Hoffman says. "There are the usual aspects: revenue recognition, understated expenses, overstated assets, reserves, accrual provisions, related-party transactions, perks. But they're also looking at qualitative disclosures about the business, the way companies have described what they're doing, who's doing it, and how it's going, among other issues."

Carr

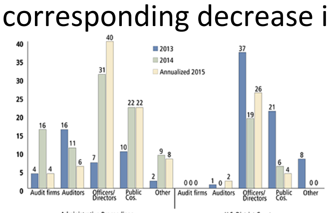
The penalties are getting bigger too, the analysis reveals. Even excluding a handful of huge outlier cases, the average civil penalty in 2014 was $278,320. In the first half of 2015, the average is trending at more than $1.7 million. Those kinds of penalties, along with the increasing use of bars and sanctions on individuals, sends a strong message to individuals, says Emre Carr, director of the capital markets group at Berkeley Research Group.

"For CPAs who have spent their whole lives doing this work, the penalties and sanctions are very significant," he says. "Your career dies. Your options are very limited afterward."

And it's not just fraud allegations that draw charges and penalties. Again excluding huge outliers, the average civil penalty for charges that didn't involve fraud allegations in 2014 was $273,731. In the first half of 2015, it grew to $321,267. "Certainly, there are instances where the SEC alleges out and out fraud," Hoffman says. "But they are also going after other types of violations that may not be so blatant, like controls violations or other technical violations.

NUMBER OF DEFENDANTS BY FORUM

The chart below shows The number of officers/directors and public companies named in SEC administrative proceedings increased significantly in 2014 and annualized 2015, coupled with a corresponding decrease in federal court actions.



Source: Holland & Hart.

Scanlon

That includes, of course, internal controls violations, says Michael Scanlon, a partner at Gibson, Dunn & Crutcher. While public companies have been pushing back lately against the heavy inspection focus placed on internal controls by the Public Company Accounting Oversight Board, the SEC has done a heavy push of its own through enforcement actions.

"In the past few years, the prominence of internal control claims in proceedings has increased," he says. "We're even seeing stand-alone internal control cases, not just instances where internal control claims are a tag-along to the more substantive accounting misconduct."

Another example of less egregious infractions drawing SEC enforcement, Scanlon says, are executive perks. "The SEC has brought two cases this year involving misstatements or omissions involving perquisites," he says. Historically, allegations of that type might appear only as secondary charges when there are bigger claims to pursue. "Certainly they are digging deeper and expecting companies to be vigilant in these areas."

Eberhardt

The SEC is pursuing more allegations at least partly because it can, says Anne Eberhardt, a forensic accountant and senior director at consulting firm Gavin/Solmonese. "The SEC's capacity for launching investigations has been helped by a couple of important things that have changed dramatically in the past few years," she says. She cites the use of ever-more powerful data analytics, and whistleblowers who are coming forward in bigger numbers under Dodd-Frank protections and incentives. "When a control breech occurs, the regulator is increasingly able to know that happens. And they're looking to hold individuals personally accountable for violations."

Tammy Bieber, a litigation partner at Thompson Hine, says companies need to be especially cautious about whether they are running afoul of reporting guidelines in the current market environment. "Now that the market is back, there's pressure to meet analyst expectations and budgets, and that leads to pressure to find the most favorable accounting treatment," she says. "The SEC often views that as not the most appropriate treatment."

The trends are yet another sobering reminder to companies to take the importance of good controls seriously, Eberhardt says. "I certainly think it's time for most companies to invest in data analytics themselves and do that analytical work internally, at least for the larger companies that can better afford it," she says. "They should be trying to figure out proactively what the regulators may be looking for. It would help them figure out what they are doing internally that might result in some high-level scrutiny."