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Financial Reporting and Accounting Fraud

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I. **Introduction**

Thank you for that kind introduction. At the outset, let me give the requisite reminder that the views I express today are my own and do not necessarily represent the views of the Commission or its staff.

It is great to be here today. I am excited to speak about a topic that is near and dear to me – financial reporting and accounting fraud, and the SEC's efforts to combat it. I recently read a *New York Times* article with a headline about the SEC bringing sexy back and referencing our efforts to combat accounting fraud – I had a hearty chuckle over that. I couldn't stop laughing about both the idea that the SEC was sexy and that the sexiness was due to a focus on accounting fraud. But I guess it is all about context – you definitely take that kind of press whenever you can get it. Better for the press to be talking about us as sexy than lots of other things.

My own experience with accounting fraud goes way back. When I was at the U.S. Attorney's Office, I investigated one of the early pre-Enron accounting fraud cases – Aurora Foods. This was a good old-fashioned accounting fraud involving the under reporting of trade marketing expenses, resulting in the CEO, CFO and others going to prison.

And then I tried one of the first pre-Enron accounting fraud cases against a CEO – Mickey Weissman, the former CEO of American Banknote. It was a great trial, as it involved a timing issue in the recognition of revenue – essentially it turned on a 2-week period at the end of one year and beginning of the next, and revenue being shifted back to the prior year, which helped make the financials for that year look better in connection with a planned IPO. Getting a jury to understand the importance of that sort of timing issue was difficult, and opposing counsel, the former US Attorney in the SDNY was a challenge, but we were successful – Mr. Weissman was convicted. To tell you the truth, sometimes I wish I were back trying those kinds of cases because I am a trial lawyer at heart and I find accounting fraud cases so interesting – although calling the work sexy might still be a stretch.

And in private practice, I also did some accounting fraud work, representing accounting firms and issuers.

II. **Accounting Fraud**

In the wake of the financial crisis, the SEC was very focused on financial crisis cases – cases involving CDOs, RMBS, Ponzi schemes, and other transactions that resulted in massive losses to investors. Consequently, we devoted fewer resources to accounting fraud. During this period, we have had fewer accounting fraud investigations. So for example, in FY2012, we opened 124 financial fraud/issuer disclosure investigations compared to 304 in FY2006 and 228 in FY2007. As for accounting fraud cases, we saw a reduction here as well: we filed 79 financial fraud/issuer disclosure actions in FY2012 compared to 219 in FY2007.

Another trend we have seen over the last few years is a reduction in restatements. So for example, across all public companies, restatements fell from a peak of 1,771 in 2006 to 768 in 2012.[1] Although I should also note that the number of large companies (market capitalization over $75 million) restating their financials actually jumped from 153 in 2009 to 245 last year.[2]

Some have suggested that these reductions resulted from Sarbanes-Oxley and the improvement in financial reporting caused by related reforms. Sarbanes was indeed very significant - the enhancements in auditing, the creation of the PCAOB, the implementation of certification requirements of financial statements, the establishment of testing and certification of internal controls over financial reporting, the enhancements to corporate governance and audit committees - all were very significant changes. And there is no question we are in a better place today than we were pre-Sarbanes. The transparency with which companies report their financial results has definitely improved. Indeed, I would venture to say that the focus on accounting issues has increased significantly in the last 10 years.

But I have my 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. It may be that we do not have the same large-scale accounting frauds like Enron and Worldcom. But I find it hard to believe that we have so radically reduced the instances of accounting fraud simply due to reforms such as governance changes and certifications and other Sarbanes-Oxley innovations. The incentives are still there to manipulate financial statements, and the methods for doing so are still available. We have additional controls, but controls are not always effective at finding fraud.

In the end, our view is that we will not know whether there has been an overall reduction in accounting fraud until we devote the resources to find out, which is what we are doing.

A. Renewed Focus

The importance of pursuing financial fraud cannot be overstated. Comprehensive, accurate and reliable financial reporting is the bedrock upon which our markets are based because false financial information saps investor confidence and erodes the integrity of the markets. For our capital markets to thrive, investors must be able to receive an unvarnished assessment of a company's financial condition. Financial reports must provide transparency for investors, and must not obscure the truth, even if that truth is inconvenient. The last decade is full of painful reminders of how important reliable information is to investors, to markets and to regulators. And so, in a post-crisis world, the SEC must renew its focus on financial reporting and accounting so that investors and regulators receive the accurate information that sustains our markets.

We decided the best way to pivot away from the financial crisis cases and refocus on accounting fraud was through the task force model. As you know, three years ago, we created five specialized units to handle specific areas of the securities laws. We did not at that time create an accounting fraud unit. There were many reasons for that, including that such a unit would need to be very large, would have to include many lawyers and accountants, and that accounting fraud cases are the bread and butter of many different parts of the Division. Those same concerns are still with us now, as we look to the future. We decided instead that what we needed was a small group of people focused on case generation – on exploring proactive initiatives that would generate new accounting fraud investigations for staff in the Division to pursue.

There are a lot of promising methods out there for determining the companies on which we should be focused. We have new ways of crunching data that allow us to isolate potential red flags and trends; other regulators are uncovering potential issues; whistleblowers are bringing us invaluable information (18.2% of FY 2012 whistleblower reports related to corporate financial and disclosures); and we have significant sources of information throughout the Agency. But we thought we needed a group of people to focus on harnessing all of these resources.

Often, when you get a group of smart people in a room focused on a problem, you can find the answer. Kind of reminds me of that scene in Apollo 13 where they bring all of the disparate tools available on the space capsule into a room, dump it on to a table in front of a bunch of smart people, and say find a way to fix the problem.

And so we created the Financial Reporting and Auditing Task Force – what we like to call the Fraud Task force. This is our Apollo 13 moment.

B. Fraud Task Force

The task force has about 12 staffers, both lawyers and accountants. Its objective is to improve our ability to detect and prevent financial statement and other accounting fraud. It will be devoted to developing state-of-the-art methodologies that better uncover accounting fraud and incubating cases that will then be handled by other groups within the Division.

To fulfill its mandate and find promising investigations, the Task Force plans to launch various initiatives. These may include closely monitoring high-risk companies to identify potential misconduct, analyzing performance trends by industry, reviewing class action and other filings related to alleged fraudulent financial reporting, tapping into academic work on accounting and auditing fraud, and conducting street sweeps in particular industries and accounting areas.

The Task Force will also utilize recently developed technologies such as our Accounting Quality Model and related tools, which uses data analytics to assess the degree to which a company's financial statement appears anomalous. With this tool, we can better compare performance among firms and detect outliers that suggest possible fraud.

As for specific areas of focus, I anticipate that the Task Force and our investigative staff will continue to cover a wide variety of issues. For example:

- We are very interested in the manner in which management and auditors make decisions with respect to reserves. Over the past year, we have brought several cases involving erroneous judgments regarding losses and reserves, including actions against Capital One Bank, TierOne Bank, Anchor Bancorp Wisconsin and several former executives at those institutions. And we will continue to pursue actions against individuals and entities that ignore inconvenient truths about losses and the need to increase reserves. We recognize that accounting requires that management (and auditors) use their professional judgment but we will not tolerate decisions that are reached in bad faith, recklessly or without proper consideration of the facts and circumstances.
- Revenue recognition issues will remain a staple of our financial fraud caseload – this fraud often takes many forms, whether by recognizing revenue through sham transactions, prematurely recognizing revenue, distorting percentage of completion accounting, using schemes to inflate sales numbers, or billing for uncompleted products through a "pre-booking" scheme.
- We are also focused on investigating independence violations. Although our actions against auditors for violating the SEC's independence rules typically involve public companies, such rules are not limited to public company audits. Auditors for broker-dealers must also be independent from their audit clients. In fact, this summer we brought an action against an audit firm and a partner because the partner allegedly performed Financial and Operations Principal services for a broker-dealer client, while his firm was serving as the broker-dealer's auditor. I anticipate that we will be investigating these types of conflicts of interest with increased frequency.
- I think it is also important to focus on Audit Committees, which serve as a sort of gatekeeper for audit quality. These committees play a critical role by overseeing and monitoring the financial reporting process. We have brought actions against audit committees in the past for failing to recognize red flags and we intend to continue holding committees and their members accountable when they shirk their responsibilities.
- And our Cross-Border Working Group has been, and will remain, quite busy as it focuses on companies with substantial foreign operations that are publicly traded in the U.S. To date, the Group's efforts have enabled the SEC to file fraud cases against more than 65 foreign issuers or executives and deregister the securities of more than 50 companies.
- In addition, we will continue to focus on auditors. As the Supreme Court noted nearly thirty years ago in *U.S. v. Arthur Young & Co.*, 465 U.S. 805 (1984), auditors play a crucial role in the financial reporting process by serving as the "public watchdog." So, it is important that we carefully monitor their work and ensure that they fully comply with their professional obligations. If there is a significant restatement or if we learn about improper accounting from a whistleblower, our proactive efforts, or the media, then you can expect that we will scrutinize not only the CEO, CFO and Controller, but also the engagement partner, engagement quality reviewer, and the auditing firm as a whole. We are going to probe the quality of the audit and determine whether the auditors missed or ignored red flags, whether they have proper documentation, and whether they followed the professional standards.
    - And it is important to remember that our ability to bring Rule 102(e) bars

against auditors extends beyond instances where there are accounting irregularities at a public company. Our Rule 102(e) program is remedial in nature and meant to protect the integrity of the Commission's processes. As a result, we can and have investigated auditors when their audits fail to meet the most basic standards, regardless of whether there was an actual problem with the auditing client. By pursuing actions over these bad audits, we can fully leverage the Division's resources and close off access to those who shirk their responsibilities as gatekeepers to the securities markets.

While we expect that the Task Force will develop additional methodologies for uncovering fraud, and will generate additional cases, it is also important to note that we recently brought several significant financial reporting cases and have plenty more in the pipeline.

For example, we charged three top executives at a publicly-traded fund with overstating the company's assets during the financial crisis by failing to fairly value its debt securities and certain collateralized loan obligations. We also charged BP with misleading investors during the Deepwater Horizon oil spill by significantly understating the oil flow rate in multiple reports filed with the SEC. And we charged a Fortune 200 company for various accounting deficiencies that distorted their financial reporting to investors in the midst of the financial crisis. We also brought an action against the Chinese affiliates of the Big Four accounting firms for refusing to produce audit work papers and other documents related to China-based companies under investigation by the SEC for potential accounting fraud against U.S. investors. The coming weeks will see some additional accounting fraud and disclosure cases being brought.

Ultimately, the Task Force demonstrates our renewed commitment to prosecute those who betray the trust of the public markets. But bringing actions after the fact is no substitute for full and honest disclosure at the outset. Enforcement actions are little comfort for investors who lost their savings after relying on misrepresentations and half-truths. Shareholders should be able to rely on accurate accounting, effective auditing, and transparent financial reporting. And we believe that our renewed focus on accounting and financial reporting fraud will result in better compliance within the industry by sending a clear, strong message that deters both current and future wrongdoers.

Finally, let me be clear that we will use all the tools in our arsenal, including disgorgement, monetary penalties and 102(e) bars against accountants. Sarbanes Section 304 also provides us with the ability to claw back bonus money or the proceeds of stock sales that resulted from overstated financial statements. And in appropriate cases we will exercise this authority.

I should add that accounting fraud cases take lots of resources and effort. They often require a lot of financial analysis, mounds of documents, and lots of testimony. But we are prepared to devote the resources. These are important cases and our performance should be judged by the quality, and not the quantity, of our cases.

III. **Admissions Policy**

And we will in appropriate cases seek admissions to the misconduct under our new settlement approach of seeking admissions of facts in certain types of cases.

As many of you know, our settlement approach, much like numerous other federal regulators, had been to settle essentially all of our cases on a no-admit-no-deny basis. The SEC has been incredibly successful in achieving great settlements with this policy and it will still be an important approach that applies in most cases. This settlement approach has allowed us to achieve quick results and provide prompt relief to investors, while also allowing us to conserve resources and eliminate litigation risk. This interest in obtaining quick relief, conserving resources, and avoiding litigation risk will typically trump the need for admissions in order to better achieve the goals of our enforcement program.

We recently modified our traditional approach in cases where there has been a criminal or regulatory settlement with admissions. In such cases, we have eliminated the no admit/no deny language and referenced the admissions.

But there is also a group of cases where a public airing of unambiguous facts – whether through admissions or a trial – serve such an important public interest that we will demand admissions, and if the defendant is not prepared to admit the conduct, litigate the case at trial. I analogize to a guilty plea in a criminal case – there is a certain amount of accountability that comes from a defendant admitting to unambiguous, uncontested facts. It is in many respects a cathartic moment. And there can be no denying the facts under those circumstances.

This could include matters involving a large number of harmed investors, where the conduct presented a significant risk to the market, where admissions would safeguard the investing public from risks posed by defendants, and where a recitation of unambiguous facts is important to send a message to the market about a particular case. At the same time, the majority of cases will continue to be resolved on a no admit no deny basis, as the interest in quick resolutions and settlements will, in most cases, outweigh the interests in obtaining admissions. We believe this new policy will strengthen our hand in enforcement actions without hampering our ability to effectively and efficiently enforce our securities laws.

And the policy is already starting to bear fruit as we recently had our first instance of obtaining these sorts of admissions. In the Harbinger case, Mr. Falcone agreed to admissions in connection with both the loan and short squeeze cases against him – serious misconduct that amounted to violations of the securities laws. In particular, Falcone improperly borrowed $113.2 million from his fund, at an interest rate less than his fund was paying to borrow money, to pay his personal tax obligation, at a time when Falcone had barred other fund investors from making redemptions, and did not disclose the loan to investors for approximately five months. In that case, we felt that the egregiousness of the conduct, as well as the fact that Falcone is still dealing with investors who should know the unvarnished truth, justified this approach and that admissions brought accountability and acceptance of responsibility.

By implementing this change we have no desire to delay or prolong the resolution process. We still want to achieve settlements promptly where we can and we do not believe this new policy will necessarily change that. But the possibility of more litigation does not deter us from implementing this change – perhaps that's just the former prosecutor in me. If we end up litigating more frequently, we will shift around resources as necessary. I have great confidence in our trial team and I am more than willing to try more cases – particularly if they all go as well as the Tourre trial.

Ultimately, our goal is to send the message that every potential defendant should think twice before engaging in misconduct.

IV. **Conclusion**

To wrap this all up, our markets depend not only on strong regulators but on confident investors – investors who have the information necessary to compare performance, evaluate risk, and make rational decisions. Although effective enforcement can increase the confidence that investors bring to the markets, ultimately we will only succeed if investors believe the numbers reported on the bottom line. So it is imperative that we amplify our efforts to root out financial fraud and ensure that investors receive accurate, transparent, and complete financial information.

I generally like to say that the SEC is back and better than ever – and that certainly is the case when it comes to pursuing financial reporting and accounting fraud.

Thanks again for letting me talk to you today.

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[1] Audit Analytics, *2012 Financial Restatements: A Twelve Year Comparison* (March 2013).

[2] *Id.*

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