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The SEC's Renewed Scrutiny on Accounting Cases: Expected Focus Areas and How Companies Can Prepare

The U.S. Securities and Exchange Commission (SEC or Commission) has announced plans to reinvigorate its enforcement efforts with respect to accounting issues. These plans include adding dedicated personnel and using data mining capabilities to identify suspicious activity and build cases against suspected wrongdoers.

Following a wave of tips to the SEC's whistleblower office alleging financial reporting misconduct in the past year, this renewed effort by the SEC likely will lead to an increase in the number of accounting investigations and subsequent enforcement actions against issuers and corporate officers, directors and employees. This shift in enforcement attention is of significant moment for all public companies and their management. Set forth below is an overview of the background and nature of the new initiative, and guidance regarding steps that companies can take now to attempt to minimize the risk of enhanced scrutiny of their financial results and to be prepared to address any questions raised by the SEC.

Background

A decade ago, blockbuster accounting and disclosure fraud cases, including actions involving public companies such as Enron, WorldCom, Adelphia, and HealthSouth, commanded public attention and defined the public face of the SEC. These cases constituted between 24 percent and 33 percent of all enforcement actions filed by the agency in fiscal years 2003 to 2007. However, in the wake of the global financial crisis, accounting cases receded as an enforcement priority, and resources and attention shifted to other areas. In the reorganization of the Division of Enforcement in 2010, the division's task force dedicated to investigating accounting matters was quietly disbanded. A sharp decline in the proportion of accounting-related enforcement actions by the SEC followed, with such cases representing only 11 percent of SEC enforcement actions in fiscal year 2012.¹

The SEC's New Financial Reporting and Audit Task Force

New SEC Chair Mary Jo White appears eager to renew the pursuit of accounting cases.² On July 2, 2013, the SEC announced the formation of a Financial Reporting and Audit Task Force (the Task Force) dedicated to detecting fraudulent or improper financial reporting.³ The Task Force will reportedly concentrate on expanding and strengthening the Division of Enforcement's efforts to identify securities law violations relating to the preparation of financial statements, issuer reporting and disclosure, and audit failures. In an apparent departure from the "specialty group" model created as part of the 2010 reorganization of the division, the co-director of the Enforcement Division, Andrew Ceresney, described the Task Force of about eight attorneys and accountants as an "incubator" to develop potential accounting cases, which would be handed over to larger units for full investigations.⁴

- 1 Year-by-Year SEC Enforcement Statistics, www.sec.gov/news/newsroom/images/enfstats.pdf, (last visited Sept. 23, 2013).
- 2 Jean Eaglesham, *Accounting Fraud Targeted*, WALL ST. J., May 27, 2013, <http://online.wsj.com/article/SB10001424127887324125504578509241215284044.html>; Joshua Gallu, *SEC to Move Past Financial Crisis Cases Under Chairman White*, Bloomberg.com, Apr. 18, 2013, <http://www.bloomberg.com/news/2013-04-18/sec-to-move-past-financial-crisis-cases-under-new-chairman-white.html>.
- 3 Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis, Rel. No. 2013-121 (July 2, 2013).
- 4 Emily Chasan, *New Fraud Crackdown Looms*, WALL ST. J., July 9, 2013, <http://blogs.wsj.com/cfo/2013/07/09/new-fraud-crackdown-looms/>.

According to the SEC announcement, the Task Force will focus on identifying and exploring areas susceptible to improper financial reporting. The Task Force is expected to identify issues by reviewing financial statement restatements and revisions, analyzing performance trends by industry and using technology-based tools, such as a newly developed accounting quality model. It will include enforcement attorneys and accountants from across the country, working in close consultation with the division's Office of the Chief Accountant, the SEC's Office of the Chief Accountant, the Division of Corporation Finance, and the Division of Economic and Risk Analysis.

Data Mining to Identify Potential Accounting Issues

More than a year ago, the director of the Commission's Division of Risk, Strategy and Financial Innovation commented on efforts to develop an analytic accounting quality model to assist in identifying companies that may be engaged in earnings management by scouring companies' SEC filings for a variety of risk factors.⁵ Although such analytic efforts are not new in the world of academic finance, the SEC staff acknowledged that such models generally had not been perceived to be reliable identifiers of earnings management. Nevertheless, the SEC staff believed that by drawing on the experience of personnel throughout the Commission, and considering criteria that it considered "risk indicators" (e.g., significant off balance sheet transactions, disputes with independent auditors, particular accounting policy choices) and "risk inducers" (e.g., declining market share or margins inferior to peer firms), it could develop a program to automate the identification of higher risk companies that might be candidates for closer scrutiny.

Although the precise parameters employed by the accounting quality model are not public, and the reliability of its output untested, it appears to have captured the interest of the SEC's Enforcement Division. David Woodcock, the newly appointed chairman of the Task Force, noted the reduced cost and increased power of electronic data analysis in describing it as a tool the Task Force will use, and pledged to work with the Commission's analytic staff on data mining efforts.

In that regard, another new resource in the SEC's new effort to detect accounting irregularities is the deployment of software that analyzes the management's discussion and analysis (MD&A) section of periodic reports. According to SEC officials, certain word choices made by companies in their analysis of the companies' performance may reveal warning signs of earnings manipulation.⁶ The SEC staff has suggested that companies engaged in misconduct may tend to overuse certain words and phrases that are associated with benign activities and under-disclose risks prevalent among their peers. Preliminary tests of the new software's ability to detect potential accounting irregularities by flagging suspect word or phrase choices reportedly have been positive. SEC officials have stated that, if the word-analysis software proves effective in tests, it will be added to the accounting quality model.

Increased Tips From Whistleblower Program

In addition to the SEC's new internal resources, the Enforcement Division is receiving a significant number of accounting-related tips through its whistleblower reporting program. In fiscal year 2012, the SEC received 547 claims alleging financial reporting misconduct.⁷ This was the biggest single category of tips under the SEC's whistleblower program, representing 18 percent of all complaints received. This flow of tips likely will continue in the coming year, given the significant financial incentives for whistleblowers to report issues, and the most actionable tips will then be investigated by the new Task Force.

5 Craig M. Lewis, Chief Economist and Dir., Div. of Risk, Strategy, and Fin. Innovation, SEC, Speech to Financial Executives International Committee on Finance and Information Technology: Risk Modeling at the SEC: The Accounting Quality Model (Dec. 13, 2012).

6 Eaglesham, *supra* note 2.

7 U.S. Sec. & Exch. Comm'n, *Annual Report on the Dodd-Frank Whistleblower Program – Fiscal Year 2012*, published November 2012.

Potential Areas of SEC Focus

It is expected that the new Task Force's investigations will focus on common problem areas that have been the subject of enforcement action in the accounting arena over the years: revenue recognition, valuation, capitalized versus non-capitalized expenses, reserves, acquisition accounting and the use of non-GAAP performance benchmarks. Recent statements by SEC officials provide some guidance regarding how they view these issues and specific areas of likely enforcement activity.

- **Revenue Recognition:** This has long been an active area for SEC enforcement action, with a focus on areas of frequent misconduct including bill-and-hold arrangements, consignment sales, side letters and round-trip transactions. It is expected that the Enforcement Division will continue to pursue cases related to these issues, as well as scrutinize revenue recognition in more complex areas. For instance, there have been reports of the SEC investigating the manner in which cloud computing service providers recognize "cloud related revenue."⁸ There also have been reports of SEC and U.S. Department of Justice investigations of revenue recognition related to software licenses, as well as bug fixes, upgrades and other customer arrangements. Given the complex accounting rules in these areas, technology and other companies with complex sales transaction models may receive increased scrutiny from the SEC.
- **Goodwill Impairment Charges:** In recent months, companies have reported receiving letters from the SEC Division of Enforcement requesting information regarding goodwill impairment charges. These inquiries follow statements by SEC staff members that the Commission is worried that some companies are too "vague" when reporting the reasons for goodwill impairments, and that companies should let investors know sooner when circumstances are pointing to a goodwill write-down.⁹ The SEC staff said it wants companies to present the "whole story" about their write-downs, and that disclosures about decreased valuations are not enough to explain them.
- **Accrued Liabilities:** A goal of the SEC's new accounting effort is to identify judgmental accounting determinations that may be susceptible to earnings management, and a primary target is questionable choices regarding discretionary accruals. SEC officials have indicated that they will use the Commission's accounting quality model software to identify discretionary accruals that indicate a company may be attempting to smooth income and, therefore, manage earnings.¹⁰
- **"Revision Restatements":** Observers have noted an increase in companies that disclose revised financial information in revision restatements, which, unlike reissuance restatements, do not require a filing on Form 8-K,¹¹ and expressed skepticism as to their appropriateness. That critique appears to resonate with the SEC staff, as David Woodcock, Task Force Chairman, has stated that he is troubled by the spike in the number of companies making minor revisions in financial statements. "In 2012, 64.7% of restating filers issued revision restatements, up sharply from 48.1% in 2009", and double the level in 2005, the first full year that companies had to file notices about them.¹² The SEC staff can be expected to scrutinize such revisions.

8 Sarah Frier, *IBM Defends Cloud-Computing Accounting Amid SEC Probe*, Bloomberg.com, (July 31, 2013), <http://www.bloomberg.com/news/2013-07-31/ibm-says-sec-investigating-its-cloud-computing-revenue-figures.html>.

9 Emily Chasan, *SEC Seeks More Goodwill Disclosure*, Wall St. J., Dec. 4, 2012, <http://blogs.wsj.com/cfo/2012/12/04/sec-seeks-more-goodwill-disclosure/>.

10 Lewis, *supra* note 5.

11 Francine McKenna, *Where Should SEC Start a Fraud Crackdown? Maybe Look at Fake Restatements*, Forbes, June 18, 2013, <http://www.forbes.com/sites/francinemckenna/2013/06/18/where-should-sec-start-a-fraud-crack-down-may-be-look-at-fake-restatements/>.

12 Kathleen Hoffelder, *Restatements by Accelerated Filers Shoot Up*, CFO.com, March 13, 2013, http://www3.cfo.com/article/2013/3/auditing_pcaob-audit-analytics-accelerated-filers-

- **Negligent Errors:** If the SEC’s enforcement response to the global financial crisis is a guide, we can expect that the agency may pursue accounting enforcement actions against companies and individuals where it takes issue with reported results, even where there is no evidence of intentional misconduct. A review of the SEC’s list of financial crisis enforcement actions on its website indicates that, in nearly half of those cases, the SEC charged defendants — both companies and their officers and directors — with engaging in negligent conduct (*i.e.*, non-scienter fraud).¹³ A similar pattern of pursuing negligence-based claims in the accounting area would substantially increase the risk to public companies and their personnel. Similarly, even in circumstances where a company’s financial statements are compliant with GAAP, the SEC may aggressively scrutinize the adequacy of a company’s disclosures.

Steps Companies Should Take Now to Prepare for Additional SEC Scrutiny of Their Financial Results

Although it is difficult to prepare fully for the intense scrutiny of an SEC enforcement investigation, there are some steps that companies can take in advance to minimize the risk of enhanced SEC scrutiny of their financials, or at least be prepared to address any questions the SEC may raise.

- **Assess the Adequacy of Documentation of Accounting Policies and Judgments:** Because the application of accounting policies and, in particular, the recording of judgmental accruals, asset impairments, and other accounting judgments all may be subject to hindsight examination in an enforcement investigation, it is advisable to review existing policies to make sure they are clear and that the company practice complies with the written policies. To the extent company practice diverges from the written policies, the company should make sure the issue is addressed and the policies are revised or the practices are adjusted, as appropriate under GAAP. The company should document consultations with independent auditors in addressing these issues. Similarly, companies should maintain contemporaneous documentation that supports the exercise of judgment with regard to particular accruals, including the factual information considered in reaching the judgments. Conversely, even informal, internal communications captured in email or otherwise, which may be read to suggest that consideration of the earnings impact of such judgments affected the decision makers, can be subject to scrutiny and criticism in an investigation and should be avoided.
- **Be Prepared for Potential Information Requests From the SEC:** The data mining and other novel techniques the SEC plans to employ seem likely to yield significant false positives, where companies become subject to enforcement inquiries out of the blue. In a hopeful sign, statements by the SEC staff suggest that they recognize that risk. Companies should be prepared to engage with the Enforcement staff and respond quickly to such inquiries with substantial information addressing the SEC’s issues. There is a high level of mortality among preliminary inquiries by the SEC, and substantial information that satisfies the staff’s “official curiosity” regarding the issues at hand may help bring a matter to an early close, avoiding the disruption and distractions of an external investigation. Nonetheless, the decisions about how best to present information to the staff to encourage the favorable resolution of an informal inquiry are delicate ones. Companies often trip up unwittingly when they fail to take the preliminary inquiry seriously, which can lead to the matter being transformed into a formal investigation.

¹³ SEC Enforcement Actions, <http://www.sec.gov/spotlight/enf-actions-fc.shtml> (last visited Sept. 23, 2013).

- **Review MD&A Disclosures to Ensure They Are Clear, Accurate and Complete and That They Communicate Risks Associated with Accounting Models and Judgments:** Given the SEC’s use of new word-searching software to analyze the MD&A section of periodic reports, companies need to continue to pay close attention to the language used in their reports. In addition to ensuring that the language accurately reflects their financial and operational conditions, companies should avoid vague language that could be viewed as an attempt to mask negative results or trends. Moreover, disclosure of the particular judgments required to account for a business decision could lessen the risk of an enforcement challenge.
- **Review Disclosure Committee Process to Ensure Its Design and Operation Is Effective:** In light of the SEC rules requiring reporting companies to maintain “disclosure controls and procedures,” company management and the audit committee should play a significant role including ensuring that the company’s disclosure controls and procedures are properly implemented. Documentation of compliance, with substantive and procedural obligations on the identification of significant deficiencies and material weaknesses in controls, should be complete.
- **Reassess Compliance Reporting and Investigation Processes to Encourage Internal Reporting of Misconduct:** Companies should reassess their internal reporting procedures to ensure they encourage internal reporting and communication, bolster procedures for the intake and investigation of internal complaints, and enhance anti-retaliation efforts to reduce perceived barriers to internal reporting and litigation risks. Responses to internal reports, including internal investigations as appropriate, should take account of the reporting deadlines under the SEC whistleblower rules. This is particularly important given the significant financial incentives for whistleblowers to report issues to the SEC.
- **Continue to Cultivate a Culture of Compliance:** Companies should continue to ensure that directors and employees are fully informed of the rules and regulations that may impact actions taken by them and the company. Any new or revised rules or guidance would be among the key matters to be communicated. It also may be helpful to conduct periodic training sessions on most important rules and regulations. We believe this recommendation is particularly important because the approach to compliance taken by a company could impact how an action by the SEC proceeds. For instance, in a recent SEC action brought based on Regulation FD¹⁴ only the executive who selectively disclosed the material non-public information was charged. The company, which was cited by the SEC for its cooperation with the investigation and culture of compliance, was not charged.

14 Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges Former Vice President of Investor Relations With Violating Fair Disclosure Rules, Rel. No. 2013-174 (Sept. 6, 2013).