When the SEC Alleges Corporate Accounting Fraud:
First Steps When Conducting an Investigation

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While there are many techniques to distort the financial condition of a publicly traded company, the most frequent types of improprieties involve revenue recognition, cost or expense recognition, accounting for reserves, and accounting related to business combinations.[1] Over the past five years, the rate of issuer financial statement and reporting-related enforcement actions by the SEC's Division of Enforcement has fluctuated. They were 29% of total enforcement actions in 2005, a percentage which decreased to 24% in 2006, increased to 33% in 2007, decreased to 23% in 2008, and decreased again to 22% in 2009.[2] Below we provide a brief overview of the most recent federal lawsuits brought by the SEC where companies or individuals were fined for conduct involving these errors,[3] and also identify key issues a lawyer should consider while charting the course of an investigation.

Revenue Recognition

Improper revenue recognition is the most common accounting error pursued by the SEC.[4] Revenue is considered realized and earned, and therefore properly recorded, when all

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[1] *See* PricewaterhouseCoopers LLP, 2009 Securities Litigation Study 30 (2009), *available at* http://10b5.pwc.com/PDF/NY-10-0559%20SEC%20LIT%20STUDY_V7%20PRINT.PDF.

[2] *See* SEC, Select SEC and Market Data 2005 - 2009, *available at* http://sec.gov/about.shtml. In addition to SEC civil enforcement actions, the government has increasingly initiated parallel criminal proceedings through the U.S. Department of Justice ("DOJ"). *See* David H. Kistenbroker et al., *Criminal and Civil Investigations: United States* v. *Stein and Related Issues*, 1574 PLI/CORP. 401, 405 (2006) (explaining that the Sarbanes-Oxley Act gave the SEC significantly more power to carry out its corporate oversight functions, and "the [DOJ] began ramping up its financial crimes prosecutions, often in tandem with those pursued by the SEC").

[3] Enforcement actions often address multiple forms of accounting errors. Here, we highlight only those relevant facts from the selected actions involving one of the specified errors.

[4] *See* Deloitte Forensic Ctr., Ten Things About Financial Statement Fraud: A Review of SEC Enforcement Releases, 2000-2008, 9 (2009), *available at* http://www.deloitte.com/assets/Dcom-

the following criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery of the product or service has occurred, (3) the fee or price to be received is fixed or determinable, and (4) the likelihood of collection and returns is reasonably assured.[5] Improper revenue recognition practices span a multitude of conduct, including: (1) reporting fictitious sales through the use of false sales documents, side agreements, and top-side adjustments by senior management;[6] (2) "holding the books open" by failing to recognize the calendar end of the reporting period to accelerate and recognize revenue to be earned in a future period to the current period;[7] (3) "channel stuffing" by using price discounts, extended payment terms or other concessions to induce customers into advance purchases of goods they have a right to return at a later date;[8] and (4) improperly valuating revenue by failing to take into account the true terms of sales, such as providing "package deals" to customers by selling goods at a premium while providing other concessions.[9]

Most recently, on August 4, 2009, the SEC filed a complaint against General Electric Company ("GE"), alleging four types of accounting improprieties, including prematurely recognizing over $370 million in revenue by selling locomotives to financial institutions in 2002 with the understanding that the financial institutions would later resell the

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UnitedStates/Local%20Assets/Documents/FAS_ForensicCenter_us_fas-us_dfc/us_dfc_ten_things_about_financial_statement_fraud_241109.pdf.

[5] *See* SEC Staff Accounting Bulletin No. 104, 17 C.F.R. Part 211 (2003), *available at* http://www.sec.gov/interps/account/sab104rev.pdf (2003) (originally issued in 1999).

[6] Overall, recording fictitious revenue is the most common type of revenue recognition fraud alleged by the SEC. *See* SEC, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002, 15 n.29 (2003), *available at* http://www.sec.gov/news/studies/sox704report.pdf [hereinafter *Report Pursuant to SOX*].

[7] *Report Pursuant to SOX*, *supra* note 6, at 7.

[8] *See In re Sunbeam Corp.*, Exchange Act Release No. 44305, at n.4 (May 15, 2001), *available at* http://www.sec.gov/litigation/admin/33-7976.htm (describing channel stuffing for the first time).

[9] *Report Pursuant to SOX*, *supra* note 6, at 12.

locomotives to GE's railroad customers in the first quarters of subsequent fiscal years.[10] The locomotives were stored at GE facilities and maintained by GE until they were delivered to the end users. GE was precluded from recognizing the associated revenue until delivery occurred, either physically or by the assumption of the risk of ownership. When questioned by staff accountants in GE's corporate accounting group, GE executives responded that the financial institutions were contractually responsible for the costs of storing and insuring the locomotives, but failed to reveal that side letters and verbal agreements negated those obligations.[11]

In *SEC* v. *United Rentals, Inc.*, the SEC filed a complaint against United Rentals Inc. ("URI") alleging numerous accounting violations, including that URI prematurely recognized revenue from six sale-leaseback transactions in order to meet earnings forecasts between 2000 and 2002.[12] URI sold used equipment to a financing company and leased it back for a short period, then arranged for an equipment manufacturer to sell the equipment at the end of the lease period, while guaranteeing the financing company against any losses incurred in the resale.[13] Because commitments related to the sales were not settled (*i.e.*, the guarantees), the sales price was not fixed and determinable. URI hid the true nature of the arrangements from its auditors by providing them with contracts that omitted the true terms of the deals.[14]

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[10] *SEC* v. *General Electric Co.*, No. 3:09-CV-01235(RNC), at 18-19 (D. Conn. Aug. 4, 2009), *available at* http://www.sec.gov/litigation/complaints/2009/comp21166.pdf.

[11] *Id.* at 20. GE agreed to pay $50 million to settle the SEC's charges. *See* Press Release, SEC, *GE Agrees to Pay $50 Million to Settle SEC's Charges* (Aug. 4, 2009), *available at* http://www.sec.gov/news/press/2009/2009-178.htm.

[12] *SEC* v. *United Rentals, Inc.*, No. 3:08-CV-01354 (CFD) (D. Conn. Sept. 8, 2008), *available at* http://www.sec.gov/litigation/complaints/2008/comp20706.pdf.

[13] *Id.* at 11.

[14] *Id.* at 17-18. URI agreed to pay $14 million to settle the SEC's charges. *See* Press Release, SEC, *United Rentals, Inc. to Pay $14 Million to Settle Financial Fraud Charges* (Sept. 8, 2008), *available at* http://www.sec.gov/news/press/2008/2008-190.htm.

In the SEC's June 21, 2007 complaint against the former CFO and Controller of Speechworks International, Inc. ("Speechworks"), the SEC alleged that, between 2001 and 2003, these executives caused Speechworks to overstate revenues by $2.9 million.[15] Speechworks created and sold software to an equipment manufacturer, which licensed and resold the software to third parties, paying Speechworks on a royalty basis. Through oral side agreements, the manufacturer agreed to prepay $2,000,000 in royalty payments to Speechworks, revenue which Speechworks recognized at the time the sales were made to the manufacturer, and prior to the software's shipment to third parties.[16] Speechworks also recognized as purported revenue a $900,000 payment from the manufacturer that was disguised as a royalty payment, but in fact was payment for Speechworks' agreement to amend the terms of a Speechworks stock warrant held by the manufacturer. The executives provided their auditors with falsified invoices and revenue reports, and also signed management representation letters stating that the company's financial statements complied with Generally Accepted Accounting Principles and that they were not aware of the existence of any side agreements.[17]

Although the initial wave of enforcement actions related to the massive accounting fraud at Cendant Corporation ("Cendant") began in June 2000, final judgment was not entered until December 29, 2009 against Cendant's former Chairman, Walter Forbes, for his

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[15] *SEC* v. *Forman*, No. 07-CV-11151, 2-3 (Mass. Dist. Ct. June 21, 2007), *available at* http://www.sec.gov/litigation/complaints/2007/comp20164.pdf.

[16] *Id.* at 2.

[17] *Id.* at 3. To settle the SEC's charges, the former CFO (Richard J. Westelman) agreed to pay $100,000 in penalties and to be permanently disbarred from serving as an officer or director of a public company. *See* Hiawatha Bray, *SEC, Ex-Speechworks Pair Settle Suit But 3d Official Says He'll Fight Charges of Accounting Violations*, BOSTON GLOBE, June 23, 2007, http://www.boston.com/business/markets/articles/2007/06/23/sec_ex_speechworks_pair_settle_suit/. The former Director of Finance (Arthur Haberman) agreed to pay $25,000 to settle the charges. *See id.*

role in the fraud.[18] Over a 12-year period beginning in 1985, Forbes and other executives at CUC International, which merged with Cendant in 1997, inflated operating income by more than $500 million. Finance reporting managers were directed to, among other things, manipulate membership sales revenues (including making up amounts necessary to fill revenue gaps to allow the company to meet analysts' estimates) and misuse liability accounts related to membership sales, at times reversing the accounts directly into operating income.[19] To perpetuate the fraud, membership sales transactions were kept off-books, and management created top-side adjustments on a spreadsheet from which the company's consolidated financial statements were prepared.[20]

Cost or Expense Recognition

Under the accrual method of accounting, an expense should be recorded during the accounting period it was "incurred" even if the company prepays the expense or does not pay for the expense until a later accounting period.[21] Improper expense recognition understates or defers expenses, and therefore overstates net income.[22]

On January 22, 2009, the SEC alleged that, through the practice of incurring "prepays," three former executives at subsidiaries of Cablevision System Corporation

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[18] *See* Press Release, SEC, *Former Cendant Corporation Chairman Walter A. Forbes Settles SEC Fraud Action* (Dec. 30, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21356.htm. The final judgment entered against Forbes enjoins him from violating federal securities laws and permanently bars him from serving as an officer or director of a public company. In the related DOJ criminal proceeding, Forbes was sentenced to 151 months in prison and ordered to pay $3.275 billion in restitution.

[19] *In re Cendant*, Exchange Act Release No. 42933 (June 14, 2000), *available at* http://www.sec.gov/litigation/admin/34-42933.htm.

[20] *See id.*

[21] *Report Pursuant to SOX*, *supra* note 6, at 14.

[22] *See id.*

("Cablevision") caused Cablevision to prematurely recognize $31 million in expenses that should have been recognized in future periods.[23] From 1999 through 2003, the executives directed their subordinates to have vendors misdate invoices for services that had not been rendered, so the invoices could be identified as expenses in the period in which the executives preferred them to be recognized. They also directed their subordinates to avoid having their internal accounting departments pay vendors directly, and to instead receive the checks themselves so they could hold the checks for delivery to the vendors at a later date.[24]

In *SEC* v. *Galbo*, two former executives of the drugstore chain CVS were sued by the SEC in July 2007 alleging that they caused the company to hide $18.1 million in losses related to its stuffed animal inventory.[25] In 2000, CVS valued the inventory on its books for $32 million, although internal projections valued the toys at only at $13.9 million (later liquidated for $12 million).[26] Instead of writing down the value of the inventory to market value, CVS entered into a transaction with a barter company to exchange the plush toys for credits with a face value of $42.5 million, while CVS kept physical possession of the toys.[27] Through multiple journal entries, CVS booked the credits at their face value, though the true value of the credits to CVS was less than $42.5 million because CVS could not use them at a one-to-one ratio for other

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[23] *SEC* v. *McEnroe*, No. 09-CV-0249 (E.D.N.Y. Jan. 22, 2009), *available at* http://www.sec.gov/litigation/complaints/2009/comp20862.pdf.

[24] *Id.* at 4. A cease-and-desist order was issued against Cablevision and no fine was imposed, although the former executives were ordered to pay penalties totaling $60,000. *See* Press Release, SEC, *SEC Files Settled Enforcement Action against Three Former Managers at Cablevision Systems Corporation in Connection with Improper Recognition of Expenses* (Jan. 22, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr20862.htm.

[25] *SEC* v. *Galbo*, No. 07-CV-245S (R.I. Dist. Ct. July 2, 2007), *available at* http://www.sec.gov/litigation/complaints/2007/comp20175.pdf.

[26] *Id.*

[27] *Id.* at 2.

goods and services. Although auditors questioned one of the executives about the transaction, he failed to disclose its real value. Both executives' compensation was dependent on CVS' financial results, one of whom received a discretionary bonus as a result of the transaction.[28]

Accounting for Reserves

A subcategory of expense recognition includes accounting for reserves. Companies set reserves to cover the estimated costs of expenses, such as taxes, litigation, debts and acquisitions.[29] If a company intentionally overestimates reserves, this can give a false appearance of increased earnings. Once the costs are incurred, the excess amount in the reserve can be reversed to boost earnings.[30]

On April 28, 2009, the SEC filed a complaint against executives of American Home Mortgage Investment Corporation ("AHM"), formerly one of the nation's largest mortgage companies.[31] The complaint alleged that the CEO, CFO and Controller understated AHM's first quarter 2007 loan losses on more than $240 million in loans that were spiraling into default, and which AHM made without income verification.[32] The executives deliberately lowballed their analysis of the rate of loss on the loans, purposefully understating reserves by more than $100 million, and hid the scheme by providing AHM's external auditor with

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[28] *Id.* at 9. A cease-and-desist order was issued against CVS and the two executives were ordered to pay $38,000 in fines. *See In Re CVS Corp.*, Exchange Act Release No. 55982 (June 29, 2007), *available at* http://sec.gov/litigation/admin/2007/33-8815.pdf.

[29] *Report Pursuant to SOX*, *supra* note 6, at 16-17.

[30] *See id.*

[31] *SEC* v. *Strauss*, No. 09 Civ. 4150 (S.D.N.Y. Apr. 28, 2009), *available at* http://www.sec.gov/litigation/complaints/2009/comp21014.pdf.

[32] *Id.* at 8.

misleading analyses they had prepared.[33] The company is currently liquidating pursuant to a Chapter 11 Plan.[34]

In February 2006, the SEC alleged that in December 2000 and March 2001 American International Group, Inc. ("AIG") entered into two sham reinsurance transactions with General Re Corp ("Gen Re") designed to falsely boost AIG's loss reserves by $500 million.[35] The transactions, which were devoid of risk transfer, were designed to have a roundtrip effect, requiring Gen Re to pay AIG $500 million in reinsurance premiums to insure a risk valued at $500 million. Contracts governing the transactions did not contain the true terms of the arrangements, which were memorialized in separate side deals and which included a payment from AIG to Gen Re to enter into the transactions (memorialized in a separate transaction to conceal the payment). Executives also wrote emails and letters to make it appear as if Gen Re, rather than AIG, initiated the transactions, which AIG recorded as insurance, as opposed to a deposit.[36]

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[33] The CEO (Michael Strauss) agreed to pay $2.45 million to settle the charges and is barred from serving as an officer or director of a public company for five years. *See* Press Release, SEC, *SEC Charges Former American Home Mortgage Executives for Misleading Investors About Company's Financial Condition: Former CEO Agrees to Pay $2.45 Million to Settle Fraud Charges* (Apr. 28, 2009), *available at* http://www.sec.gov/news/press/2009/2009-92.htm. The former Controller of AHM (Robert Bernstein) was ordered to pay a $125,000 penalty and was suspended from appearing or practicing before the SEC as an accountant for three years. *See In Re Bernstein*, Exchange Act Release No. 61113 (Dec. 4, 2009), *available at* http://www.sec.gov/litigation/admin/2009/34-61113.pdf. The litigation against the former CFO (Stephan Hozie) is still ongoing.

[34] *Strauss*, No. 09 Civ. 4150 at 3.

[35] *SEC* v. *Am. Int'l Group*, No. 06-CV-1000 (S.D.N.Y Feb. 9, 2006), *available at* http://www.sec.gov/litigation/complaints/comp19560.pdf.

[36] *Id.* at 11. Under a settlement with the SEC, AIG paid $800 million to investors injured by the alleged fraud. *See* Press Release, SEC, *AIG to Pay $800 Million to Settle Securities Fraud Charges by SEC* (Feb. 9, 2006), *available at* http://www.sec.gov/news/press/2006-19.htm. On January 20, 2010, the SEC filed an action against Gen Re arising from the transactions for manipulation of AIG's financial statements. Gen Re agreed to pay $12.2 million to settle the SEC's charges, $19.5 million to the U.S. Postal Inspection Service Consumer Fraud Fund to settle a related criminal investigation by the DOJ, and also

Accounting Relating to Business Combinations

Improper accounting in connection with business combinations involves the improper valuation of assets, improper use of merger reserves, and failure to disclose the liabilities associated with a business combination.[37]

In the SEC's May 23, 2007 complaint against BISYS Group Inc. ("BISYS"), the SEC alleged that, from July 2000 through December 2003, former BISYS officers and employees engaged in a variety of improper accounting practices, including improperly booking income earned by 12 acquired companies before the acquisitions were completed, as demonstrated in reports provided to management, including due diligence reports and preliminary analyses of BISYS' financial results.[38] This practice resulted in BISYS improperly recognizing over $7 million in revenue for the 2001, 2002, and 2003 fiscal periods.[39]

The Internal Investigation

Against this backdrop, a review of the SEC's recent enforcement actions makes clear that while accounting fraud occurs through different practices, similar conduct or incentives are present in perpetuating a variety of accounting irregularities. When confronted by auditors,

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agreed to pay $60.5 million through a civil class action settlement to AIG's injured shareholders. *See* Press Release, SEC, *SEC Charges General Re Corporation for Role in AIG and Prudential Accounting Frauds* (Jan. 20, 2010), *available at* http://www.sec.gov/news/press/2010/2010-10.htm.

[37] *Report Pursuant to SOX*, *supra* note 6, at 19.

[38] *SEC* v. *BISYS Group, Inc.*, No. 07-CV-4010 (S.D.N.Y. May 23, 2007), *available at* http://www.sec.gov/litigation/complaints/2007/comp20125.pdf

[39] *Id.* at 7. BISYS agreed to settle the charges and pay disgorgement and prejudgment interest totaling approximately $25 million. *See* Press Release, SEC, *BISYS to Pay $25 Million to Settle Financial Reporting and Related Charges by SEC* (May 23, 2007), *available at* http://www.sec.gov/news/press/2007/2007-100.htm. Cendant should also be highlighted here because the accounting fraud also included the overstatement of merger and purchase reserves. Among other improprieties, financial managers regularly established reserves based on figures with no financial basis and then later reversed the reserves directly into operating expense and revenue accounts. *See In re Cendant*, Exchange Act Release No. 42933 (June 14, 2000), *available at* http://www.sec.gov/litigation/admin/34-42933.htm.

company personnel use phony documentation or purposefully fail to disclose facts necessary to identify appropriate accounting treatment. Executives and senior management often direct subordinates to engage in conduct with little or no justifiable explanation. An individual's compensation and bonus payments may be directly tied to the company's financial performance or increased as a reward for improper conduct. Moreover, pulling off the fraud typically requires the input of many levels of staff. While it is tempting to begin an investigation by first gathering the applicable accounting policies and procedures and then speaking with the company's executives, gathering certain key facts at the outset of the investigation can streamline the remainder of your inquiry.

Team up with auditors – external and internal. These individuals may provide useful information about areas in on which they think the investigation should be focused, raise questions and concerns about the company's internal controls and reporting functions, past transactions, management representation letters, and compensation arrangements, and provide insight into how executive and senior management interact with personnel responsible for managing the company's financial records on a day-to-day basis.

Identify long-standing employees working on the front lines of accounting-based departments. Conducting initial interviews of these employees will help you determine how the company's policies and procedures are effected in practice and how those practices have changed over time. They can also tell you whether there are shorthand terms or phrases for the company's accounting practices. Asking whether the company has prematurely recognized revenue may not get the same answer as asking whether the company uses a "35-day-month" might yield. Such catchphrases are often open and notorious jokes.

Assess whether formal training programs exist to provide employees with an understanding of how their work impacts the company's financial statements. Sit in on training sessions to determine whether training deviates from internal policies. If there are no formal programs, this can be a source of frustration to employees, who commonly create "cheat-sheets" or other documents designed to show how written policies and procedures work in practice.

Contact vendors and suppliers involved in questionable transactions. You may find that the versions of the relevant transaction documents you received differ from those maintained by the parties with whom your client does business. Typically, vendor and supplier contracts allow a right of access to relevant records. A comparison of the "same document" may show that contracts maintained in your client's files vary from those in the vendor's files in their terms and dates of execution or effectiveness, or hidden side letters may appear.[40] Although it is tempting to avoid involving third parties, the SEC likely will issue a voluntary request or subpoena to obtain those records.

Speak with in-house counsel responsible for writing/reviewing relevant documentation. They can provide you with their understanding of the transaction(s) at issue and may be aware of irregularities in the documentation.

Review logs of compliance hotline calls. If they contain references to the conduct at issue in your investigation, promptly find out how the issue was resolved. Also inquire as to the existence of any relevant OSHA whistleblower suits.

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[40] Imaging computers of relevant employees has become a prevalent investigatory practice over the past five years, and with good reason. In addition to instituting a document hold, computer imaging ensures access to e-mail and other internal documents that may not be present in hard copy form due to routine destruction policies. Moreover, with the widespread dissemination of e-mail and archiving features, e-mail and other documents which otherwise may be considered "lost" or destroyed by one employee may exist on another's computer.

Remain up to date with changes in the enforcement landscape. Generally, companies and executives settle enforcement actions by agreeing to payment of a fine and the imposition of other sanctions, but are not required to admit wrongdoing or reveal extensive details of the alleged misconduct. In an April 1, 2010 interview, the SEC's enforcement director said that the SEC is deciding whether to provide a more detailed public record to provide more transparency into the facts underlying the SEC's claims.[41] Such a shift in policy could have a significant impact on a client's willingness to settle charges if detailed findings are publicized, and the ease with which shareholders can file class-action lawsuits.[42] This potential shift in SEC settlement policy is certain to gain more attention in the near future.

[41] Zachary A. Goldfarb, *SEC May Require More Details of Wrongdoing to Be Disclosed in Settlements*, WASHINGTON POST, Apr. 1, 2010, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/03/31/AR2010033103674.html?hpid=topnews.

[42] During discovery, private litigants typically request the privileged documents a company produces to the SEC during the course of an investigation. In the Southern District of New York, in *Police & Fire Ret. Sys.* v. *SafeNet, Inc.*, the selective waiver doctrine was recently addressed by Judge Crotty in deciding a motion to compel production of interview memoranda and a final report summarizing the results of the internal investigation. Judge Crotty denied the class action plaintiffs' motion to compel production of these materials on the grounds that (1) SafeNet produced these materials to the SEC (and DOJ) pursuant to confidentiality agreements containing a non-waiver provision preserving SafeNet's privilege claims in third-party litigation and (2) plaintiffs failed to show a "pressing need for the privileged materials." *Police & Fire Ret. Sys.* v. *SafeNet, Inc.*, 06 Civ. 5797(PAC), 2010 U.S. Dist. LEXIS 23196 (S.D.N.Y. Mar. 12, 2010).