

Accounting Fraud Getting Increased Attention From The SEC And Class Action Counsel

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Accounting and financial disclosure issues are increasingly becoming the focus of litigation – both with the Securities and Exchange Commission (SEC) and the plaintiffs' class action bar – according to recent pronouncements from the SEC and a leading research firm that tracks securities class actions. Last week, the SEC announced two financial fraud cases against companies and their former executives, accusing them of various accounting failures that gave investors inaccurate views of company finances. These cases appear to be among the fruits of the SEC's Financial Reporting and Audit Task Force, created in 2013 to strengthen the SEC's efforts to identify securities law violations relating to the preparation of financial statements, issuer reporting and disclosure and audit failures. The Task Force's efforts have taken a noticeable upturn in FY2015 and thereafter. In one case, Logitech International agreed to pay a \$7.5 million penalty for fraudulently inflating its 2011 year-end results by, among other things, misstating its warranty accruals and failing to amortize certain intangibles. Two former finance department employees also agreed to pay \$75,000 in penalties for their roles in these misstatements. Simultaneously, the SEC filed a complaint in federal court against two other more senior former employees (the former CFO and the former acting controller) alleging that they understated the write-down of excess inventory by millions of dollars. In the other case, a battery manufacturer, along with its former CEO and chairman, its former CFO, and former CAO, agreed to pay penalties for the company's materially overstated revenues and assets for 2010 and 2011 related to the company's failure to write down investments and receivables related to one of its largest customers whose financial condition was deteriorating. In a press release announcing these two actions, Andrew Ceresney, director of the SEC's Enforcement Division, stated that these cases demonstrate that the agency is "intensely focused on whether companies and their officers evaluate judgmental accounting issues in good faith and based on GAAP." To underscore the agency's focus on accounting judgment, in the battery manufacturer case, the SEC also concluded that the PricewaterhouseCoopers LLP engagement partner who oversaw the audit of the manufacturer's financial statements violated professional auditing standards by failing to perform sufficient procedures and obtain sufficient competent evidential matter to test and support the company's determination that its assets were not impaired. For his part, the accountant agreed to be suspended from appearing before the SEC for at least two years. The agency's action against the outside auditor is consistent with a recent perceptible upward trend in actions against outside auditors (including against several other national accounting firms, along with several of their partners). Chair Mary Jo White this past December underscored this focus on auditors,

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both internal and external, along with those preparing financial statements, when she told the AICPA that they bore a heavy burden to ensure the strength of financial reporting. (In this vein, she pointed to, among other things, the agency's intent to pay "close attention" to the use of non-GAAP measures, which she called a potential "source of confusion" rather than illumination). Chair White has explained recently that the SEC's focus on financial reporting fraud is sustained and likely to expand. She noted to Congress, and others, that the agency "continue[d] to see instances of public companies and their senior executives manipulating their accounting to meet various expectations and projections." In fact, of the record number (807) of enforcement cases the SEC brought in FY2015, the number alleging financial disclosure violations (135 cases against 213 individuals and companies) was the largest since 2004, during the aftermath of Enron, Worldcom, Tyco and various other accounting-related scandals. These cases represented about 20 percent of the agency's total enforcement actions and were the SEC's biggest area of focus for the year. As a result, in testimony to both houses of Congress, she stated that the agency intended to continue to focus resources on financial reporting and issuer disclosure cases like these. Chair White has expressly sought Congressional approval for additional funds for the SEC's Enforcement Division to hire dozens of forensic accountants, information technology specialists, and trial attorneys, to continue the agency's efforts against financial and accounting fraud. She also noted that the risk of accounting fraud existed, and may be even greater, in the private company space. As more "unicorns" (companies with valuations over a billion dollars) remain private or ultimately go public, the agency is concerned that "the prestige associated with reaching a sky high valuation fast drives companies to try to appear more valuable than they actually are." Chair White reminded a group of Silicon Valley investors and executives in March that Exchange Act Section 10(b) and Rule 10b-5 applies to all companies, public or private, and cautioned that "the risk of distortion and inaccuracy is amplified because start-up companies, even quite mature ones, often have far less robust internal controls and governance procedures than most public companies. Vigilance by private companies about the accuracy of their financial results and other disclosures is thus especially critical." In the world of private litigation, a new report by [Cornerstone Research](#), concludes that securities class action filings with accounting allegations, the market capitalization losses associated with those cases, and accounting case settlements are all on the rise. According to Cornerstone, the market capitalization losses associated with the 71 securities class action filings alleging accounting fraud in 2015 more than doubled. The settlement value of cases alleging accounting improprieties in 2015 almost tripled the value of similar settlements in 2014, rising to \$2.6 billion. Other highlights from this analysis include:

- In 2015, 37 percent of accounting cases were filed in the Ninth Circuit (more than any other).
- The complaints filed alleging internal control weaknesses were the highest in 10 years.
- Accounting cases in 2015 had a median time lag of only eight days between the end of the alleged class period and the filing day of the complaint, the shortest in 10 years. Only 11 percent of accounting cases were filed more than six months after the end of the alleged class period.

- 86 percent of account case settlements alleged internal control weaknesses (the most in 10 years).
- For settlements in cases with alleged GAAP violations, settlement amounts were the highest for matters involving write-downs.
- Restatement cases made up 30 percent of the total number of accounting case filings in 2015.

Increased scrutiny by both the SEC and plaintiffs' class action counsel of accounting practices and judgmental decisions, coupled with the growing settlement value of these cases, strongly suggests that companies pay heightened attention to their exercise of accounting judgment. The quest to be the next "unicorn" or to meet analysts' expectations in this climate can have profoundly negative ramifications, both for the companies themselves and for the individual officers or gatekeepers involved in those decisions.