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Why Financial Statements Matter: Enforcement and Litigation Implications

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Public companies continue to face serious risks from accounting irregularities and misstatements that result in errors in financial statements. Accounting irregularities can lead to regulatory and even criminal investigations, as well as significant claims in civil litigation. Regulatory and criminal investigations and civil litigation often result in resolutions or settlements involving large financial penalties and other sanctions. Further, the underlying internal investigation and forensic analysis necessary to identify the root of the problem and correct it can itself be costly, a public relations nightmare, and a major distraction. This article examines different types of accounting-related fraud and applicable legal provisions that can be the basis of an enforcement action or civil litigation and describes how an accounting error leading to a restatement can come to light. The article concludes with a survey of some recent trends and cases.

ACCOUNTING FRAUD PROSECUTION: A RETURN TO THE "BREAD AND BUTTER" OF THE SEC?

In 2003, several years before the financial crisis, accounting fraud was the hot button issue, with cases like *Enron*, *Adelphia*, and *WorldCom* dominating the news. Over the course of the last decade, civil litigation and criminal

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prosecutions involving allegations of accounting fraud have steadily declined, with the Securities and Exchange Commission and other governmental agencies focusing their attentions on the subprime mortgage fallout, Ponzi schemes, and other cases related to the financial crisis.[1]

However, there are signs that the focus of regulators is returning to accounting fraud cases. When Mary Jo White was appointed as chairman of the SEC, there was much fanfare surrounding her background as a "tough prosecutor," and sure enough, she has indicated that under her leadership, the SEC will be "bold and unrelenting" in its efforts "to further strengthen [its] enforcement function."[2] The SEC's investment in resources that will provide it with the electronic means to detect accounting fraud exemplifies these efforts. In a December 2012 speech to the Financial Executives International Committee on Finance and Information Technology, Craig M. Lewis, chief economist and director, Division of Risk, Strategy, and Financial Innovation at the SEC talked about a new predictive accounting model that the SEC would be implementing in 2013. According to Lewis, this proactive risk modeling tool will help the SEC analyze corporate filings, identify firms that might be outlier firms, and "assess the degree to which registrants' financial statements appear anomalous." Experienced lawyers who have dealt with enforcement matters have expressed the view that these technological developments will aid the SEC's return to its "bread and butter" enforcement program focused on accounting issues, particularly as the crisis-era cases draw to a close.[3]

TYPES OF ACCOUNTING-RELATED FRAUD

There are many types of accounting-related fraud that have been the subject of enforcement actions and civil litigation, including:

- inappropriate revenue recognition;
- improper expense calculations;[4]
- earnings mismanagement;[5]
- reserve manipulation;[6]
- misappropriation;[7] and
- violations of the Foreign Corrupt Practices Act ("FCPA").

This article focuses on inappropriate revenue recognition, which, of late, is one of the more common types of accounting-related fraud involving financial statements, and the FCPA — particularly the so-called "books and records" provisions, which have been increasingly used by the SEC as a basis for enforcement actions, although we will briefly address accounting fraud in all of its different forms.

Generally, revenue is realizable and earned when all of the following conditions are met:

- persuasive evidence of an arrangement exists;
- delivery has occurred or services have been rendered;
- the seller's price to the buyer is fixed or determinable; and
- collectability is reasonably assured.[8]

Accelerating or otherwise manipulating revenue recognition on a financial statement provides a tempting way to appear to improve a company's outward financial performance. However, if the decision to do so is too aggressive and inconsistent with accepted accounting principles, it can, at a minimum, result in significant errors in a company's financial statements. And, to the extent that such a decision is made deliberately to mislead the public, it can result in an enforcement action, civil litigation, and even criminal charges.

Foreign Corrupt Practices Act (the "FCPA")

In general terms, the FCPA prohibits U.S. companies or other covered entities and individuals from bribing foreign officials to obtain government contracts or some other business advantage. The FCPA is composed of two sets of provisions. The accounting provisions (often referred to as the "books and records" provisions, although there are also provisions relating to internal controls), apply more broadly than to instances of bribery, and require companies to keep accurate books and records and to maintain a system of internal accounting controls.[9] The other set of provisions, the anti-bribery provisions, prohibits the bribery of foreign government officials. Both the

Department of Justice and the SEC have the authority to enforce the FCPA.

The accounting provisions apply only to "issuers," which include companies whose securities are listed in the United States (even if their principal place of business is located outside of the United States). The FCPA requires issuers to keep accurate books and records and to maintain a system of internal controls designed to ensure management's control over the company's assets. The accounting provisions are frequently used as a basis to investigate, prosecute, or sanction companies for bribery because bribes are invariably recorded inaccurately or in a false and fraudulent manner (e.g., a bribe is labeled a "commission" or "sales expense"). Issuers are responsible for the application of the accounting provisions to all of their controlled subsidiaries as well.

The aggressive enforcement of the FCPA shows no signs of slowing down. In 2010, the SEC's Enforcement Division created a specialized unit to focus exclusively on its enforcement of the FCPA. In recent years, there has been a substantial increase in the number of enforcement actions brought against companies and individuals and the size of the financial penalties imposed. Over the last decade, the dollar amounts of financial penalties resulting from FCPA actions have increased tenfold, with the number of enforcement actions increasing more than sixfold. While 2012 saw a reduction from 2010 and 2011 (a record year), it was still notable for the wide range of enforcement actions, including against major companies and individuals.

STATUTES THAT MAY BE IMPLICATED IN ACCOUNTING FRAUD CASES[10]

Section 17(a) of the Securities Act of 1933

Section 17 is the general anti-fraud provision of the Securities Act. It governs all sales of securities. Section 17(a) prohibits in the offer or sale of securities the use of any means of interstate commerce (1) to employ any device, scheme, or artifice to defraud, (2) to obtain money or property by means of material misstatements or omissions, or (3) to engage in any course of business that would operate as a fraud upon a purchaser. In keeping with the general scheme of the Securities Act of 1933 (the "Securities Act"), Section 17 protects only purchasers and operates only against sellers.

Section 17(a) is a key anti-fraud provision and could be used where a material misstatement or omission in a financial statement defrauds a purchaser of securities. This provision is commonly used by the SEC in accounting fraud enforcement actions.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10(b)-5

Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") prohibits the use of manipulative or deceptive devices in connection with the purchase or sale of any security.[11] Section 10(b) applies to all securities and to security-based swap agreements. Rule 10b-5, promulgated by the SEC pursuant to its rulemaking authority, prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security.[12]

In general, to prevail on a Rule 10b-5 claim, a plaintiff must prove that the defendant (1) made a false statement or omitted a material fact, (2) with scienter, (3) in connection with the purchase or sale of a security, (4) upon which the plaintiff justifiably relied, and (5) which proximately caused (6) the plaintiff's economic loss.[13] An accounting-related misstatement or omission, if material, can be the basis for a securities fraud claim under Section 10(b) and Rule 10b-5 where investors allege that they relied upon such statements in connection with the purchase or sale of a security and suffered losses as a result.

Books and Records and Internal Controls Provisions of the Exchange Act

Section 13(a) of the Exchange Act and related rules prohibit false statements or omissions as to any material fact in connection with any periodic report required to be filed with the SEC.[14] Likewise, as noted above, Section 13(b) requires issuers to (a) make and keep books and records that accurately and fairly reflect the transactions of the corporation and (b) devise and maintain an adequate system of internal accounting controls.[15] To the extent a company identifies an accounting fraud issue (and particularly if that issue ultimately requires a restatement of previously issued financial statements), such conduct will likely run afoul of both of these statutes.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 ("SOX") contains two provisions, Sections 302 and 906, that require certification by chief executive officers and chief financial officers regarding the accuracy of periodic reports and sufficiency of internal controls (these are often called "SOX certifications"). In significant part, these provisions were enacted in response to the accounting scandals of the early part of the last decade, such as Enron and Worldcom, where material misrepresentations in accounting statements led to the collapse of major companies (along with a collapse in the stock price of those companies).

As directed by Section 302(a) of SOX, the SEC has adopted rules imposing obligations relating to certification of SEC filings on both principal executive and financial officers and companies.[16] Among other things, these rules require CEOs and CFOs to certify that:

- they are responsible for establishing, maintaining and regularly evaluating the effectiveness of disclosure controls and procedures;
- they have made certain disclosures to the auditors and the audit committee of the board about the internal controls; and
- they have included information in the quarterly and annual reports about their evaluation and whether there have been significant changes in the internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

Also, there are related criminal provisions which make it a crime for the CEO or CFO to make a false statement in connection with the required certification. Again, these provisions would apply in the context of accounting fraud or misstatements in financial reports, to the extent that a CEO or CFO signed a SOX certification regarding the accuracy of financial statements and internal controls, knowing that financial statements are inaccurate in a material way.

IDENTIFICATION OF ACCOUNTING FRAUD AND INITIATION OF ENFORCEMENT INVESTIGATIONS

A company may identify misstatements or omissions on financial statements through its own control and accounting processes. However, there are also other internal and external sources that could lead a company to learn about a significant accounting issue, as discussed in greater detail below.

Section 10A of the Exchange Act

Under Section 10A of the Exchange Act, a company's outside auditor is obligated to investigate and report to management if it becomes aware of information indicating that an illegal act may have occurred, regardless of whether the improper act had a material effect on the financial statements of the company. The auditor must also determine whether the illegal conduct had an effect on the company's financial statements, and, in addition to informing management, must ensure that the audit committee of the board of directors or the entire board has been notified. The company must investigate the potential illegal act reported by the auditor and take necessary remedial actions to address it. If it does not, the auditor may be required to report that to the board of directors; the board, in turn, must make an immediate notification of the issue to the SEC.

Whistleblowers and the Bounty Program

Many accounting fraud issues come to light as a result of whistleblowers within a company or external parties with intimate knowledge of the business or accounting practices of a company. Now, with the implementation of the whistleblower bounty program (the "Bounty Program"), administered by the SEC Whistleblower Office, individuals have financial incentives to report potential accounting irregularities.[17] Any eligible whistleblower who voluntarily provides the SEC with original information is eligible to receive a bounty of ten to thirty percent of financial penalties or sanctions greater than $1 million imposed as a result of the core facts identified by the whistleblower. The information provided must be original information about a securities law violation and must lead to a successful enforcement action.

Eligible whistleblowers include employees, agents, customers, counterparties, and unrelated third parties (e.g., current and former spouses). Whistleblowers may remain anonymous if represented by an identified attorney. In addition, to be eligible, the whistleblower must voluntarily submit the original information before he or she receives a request, inquiry, or demand in connection with the enforcement investigation or action from any federal authority, regulatory authority, or state attorney general.

Whistleblowers are protected under the Dodd-Frank Act because retaliation is prohibited, regardless of whether the whistleblower's provision of information leads to successful action or whether the whistleblower meets all of the qualifications to be eligible for the award. Whistleblowers who are the victims of retaliation can file causes of action and are entitled to reinstatement, legal fees, and up to twice their back pay, plus interest.

In the first year of the Bounty Program, the SEC received a total of 3,001 tips.[18] The most common complaints received by the agency were, in fact, accounting related:

Selected Statistics for Whistleblower Program – Fiscal Year 2012		
Type of Complaint	Number Received	Percentage of Total
Disclosures and Financials	547	18.2%
Offering Fraud	465	15.5%
Manipulation	457	15.2%
FCPA	115	3.8%
All Tips	3,001	100%

Of the 3,001 tips, 2,507 originated within the United States and the balance came from 49 other countries. The top five states where tips originated were California (435), Florida (202), New York (246), Texas (159), New Jersey (102), and Washington (102).

There were 143 judgments and orders for enforcement actions issued during the year that have the potential to qualify for a whistleblower award. On August 21, 2012, the SEC made its first award under the Bounty Program in the amount of $50,500, which will increase if there is an increase in sanctions ordered in that particular case. On June 12, 2013, the SEC issued an order that awards three whistleblowers a total of 15 percent of the amount it collects from the sham hedge fund Locust Offshore Management LLC and its CEO for defrauding investors of $2.7 million.

SEC Sweep Investigations

On occasion, accounting and other regulatory issues are identified through an industry sweep, in which the SEC or other regulatory authority subpoenas multiple companies in the same business sector regarding a particular issue. The SEC and other agencies conducting a sweep might not have evidence of specific violations in the companies subject to an industry sweep. Rather, the catalyst may be, among other things, a news report, a tip from a whistleblower, or wrongdoing in a single company which draws the attention of the regulator to a possible issue that other companies might have as well (i.e., company A, which is in the same business as companies B, C, and D, reports an accounting irregularity, causing the SEC to check to make sure companies B, C, and D are not making the same error or engaged in the same misconduct).

In particular, the SEC and DOJ have utilized sweeps to investigate accounting fraud and violations of the FCPA. For example, the SEC recently launched a sweep investigation of the movie and film industry, asking whether movie studios made payments to Chinese officials for the opportunity to distribute and film movies in China. The SEC and DOJ also recently conducted a "sweep" of medical device and pharmaceutical companies.

RESTATEMENTS

Once a significant accounting issue is identified, the company may have to restate its financial statements. A restatement is a revision and publication of one or more of a public company's previous financial statements to address a material error in the previous statement. In addition to issuing the restatement, the company will also need to advise the SEC of the issue.

Materiality

Restatements are generally required for material errors. An error is material if a reasonable investor would regard the error as significantly changing the entire mix of facts upon which the investor would rely in making an investment decision.[19] Both the Financial Accounting Standards Board and the SEC, in Staff Accounting Bulletin No. 99, have provided guidance on materiality.[20] In general, both reject any bright-line rules or formulas with respect to a determination of materiality. Materiality typically has both a quantitative and a qualitative aspect. For example, a quantitatively small error could be material if it relates to a qualitatively important piece of information. A quantitatively large error, on the other hand, while perhaps more likely to be material, may also be immaterial if it is not relevant under all of the facts and circumstances.

Risk of Restatement and Collateral Consequences

A restatement can have many unintended consequences, such as default under agreements requiring timely delivery of financial statements contained in SEC filings, rating agencies' downgrades, loss of status as a well-known seasoned issuer, the inability to use Form S-8 and S-3 (brief form) registration statements, risk of a shareholder lawsuit, or federal/state regulatory and/or criminal enforcement interest.

Initial Disclosures

A company must disclose in an SEC filing under Item 4.02 of Form 8-K within four days of a determination that previously issued financial statements should no longer be relied upon because of an error. The trigger for the filing is a conclusion by the board of directors, a committee, or authorized officers that a restatement is required. The filing must include a brief description of the facts underlying the conclusion that a restatement is necessary to the extent known to the company at the time of the filing of the Form 8-K.

As noted, once this disclosure is made, it is likely to trigger investigations — by regulators, and depending on the nature of the restatement, by criminal authorities as well. The disclosure may also cause shareholders to sue, particularly if the price of the stock drops as a result of the restatement.

Restatement Statistics

The number of restatements has declined since 2007, when 1,213 restatements were filed. However, after three years of declining restatement filings, there was an increase in 2010 and again in 2011, with 803 and 820 filed, respectively. In 2012, there was a slight decline in the numbers, with 768 restatements filed. Nevertheless, the numbers of restatements are significant.

Selected Statistics re: Restatements by Year[21]		
Year	# Restatements Filed	# Unique Filers
2007	1213	1091
2008	922	827
2009	715	668
2010	803	765
2011	820	742
2012	768	713

ACCOUNTING-RELATED CLASS ACTIONS (2007-2012)

As noted above, in addition to enforcement investigations related to restatements and accounting issues, companies have to be concerned about shareholder class actions and derivative actions. Since 2007, the number of civil cases filed by plaintiffs relating to restatements had been on the decline. Many attributed the decline (and the decline in the number of restatements itself) to the implementation of the Sarbanes-Oxley Act of 2002 and the resulting improvements in corporate governance practices. Nevertheless, in 2011, there was an increase in the number of restatement-related case filings — possibly as a result of cases brought relating to the financial crisis. In 2011, there was a marked increase in the percentage and number of securities class action lawsuit filings involving accounting-related allegations, compared to the filings in 2010. There were 46 accounting-related cases in 2010 and that number increased to 70 in 2011, which represented an increase from 26 to 37 percent. Many of these accounting cases included allegations of internal control weaknesses.[22] In 2012, however, there were 35 accounting cases out of 152, which represents a percentage that is closer to that from 2010.

Selected Statistics re: Accounting-Related Case Filings[23]

Year	Total Securities Cases	# of Accounting-Related Cases	# of Restatement-Related Cases
2007	177	77	29
2008	223	93	22
2009	167	61	16
2010	176	46	12
2011	188	70	20
2012	152	35	20

Settlements

Accounting fraud class action lawsuits are particularly costly. Typically, accounting-related filings take longer to resolve and are less likely to result in dismissal or settlement. In addition, despite the fact that, in 2012, 30 percent of securities class action filings were accounting-related cases, accounting-related cases represented more than 90 percent of the 2012 total settlement value — reflecting the seriousness and costs of this type of misconduct.[24]

Noteworthy Trends and Developments

In accounting-related cases, members of audit committees were the defendants most frequently included in amended complaints.[25] Conversely, accounting firms are being sued less. Between 2007 and 2009, approximately 12 percent of securities class actions included an accounting firm as a codefendant. For the period covering 2010 through 2011, the percentage of cases with an accounting firm codefendant was roughly three percent.[26] In 2012, only two securities class actions included an accounting firm as a codefendant.

The Supreme Court's 2011 decision that a mutual fund investment adviser could not be held liable under Rule 10(b)-5 as a "maker" of an allegedly false statement in the fund's prospectus on the grounds that the fund, not the advisor, made the statement, may have contributed to this trend. As a result of this decision, plaintiffs are not able to sue parties that are not directly responsible for any misstatement, including auditors, who are therefore liable only for the statements in their audit opinion.[27]

SURVEY OF RECENT ACCOUNTING FRAUD CASES

Revenue Recognition

Securities and Exchange Commission v. TheStreet, Inc. On December 18, 2012, the SEC sued online financial-media company TheStreet, one of its former CFOs, and two executives of a former subsidiary (acquired in 2007), for accounting fraud. The SEC alleged that TheStreet misstated its financials in 2008 when it improperly reported revenue from fraudulent transactions. The former CFO is alleged to have ignored basic accounting rules in several transactions involving the subsidiary, a consumer promotion sweepstakes and contests business ("Promotions.com"). The SEC said that the CFO was responsible for the company prematurely recognizing revenue and using the percentage-of-completion method without meeting the regulatory requirements for doing so. Further, the SEC alleged that because Promotions.com's financial results were consolidated with those of TheStreet, the incidents of falsified and improperly recognized revenue led to "material misstatements" in the TheStreet's quarterly and annual reports for fiscal year 2008, leading to an overstatement of TheStreet's operating income (or understated operating loss) by about 152 percent, or $1.7 million, that year. The SEC also charged that after acquiring Promotions.com in 2007, TheStreet failed to implement a system of internal controls at the business unit, enabling the accounting fraud. The three executives paid penalties totaling approximately $400,000, and agreed to a bar from serving as an officer or director of a public company for 10 years.

Securities and Exchange Commission v. NutraCea. On January 13, 2011, the SEC filed a complaint against NutraCea, its former CEO, CFO, controller, and two of its former accounting personnel, alleging that NutraCea overstated product sales revenues by $2.6 million in its 2007 fiscal year by booking false sales and improperly recording $1.9 million in revenue from a bill and hold transaction. When NutraCea's outside auditors refused to allow the company to record $2.6 million in sales to one customer, the CEO attempted to subsequently convince the auditors that it should be recorded to other customers. The auditors refused. Instead, the CEO induced another customer to issue sham purchase orders and also arranged for that customer to receive a loan to make a down payment on the purchase. NutraCea and its executives settled the matter, variously agreeing to a payment of $150,000 in civil penalties plus reimbursement of bonuses, bars from serving as an officer or a director of a public company, and bars from appearing or practicing before the Commission as an accountant.

Securities and Exchange Commission v. Dell, Inc. The SEC charged Dell, Inc. (following Dell's restatement of earnings) with using fraudulent accounting practices to make it appear that the company was consistently meeting Wall Street earnings targets and reducing its operating expenses. Specifically, executives at Dell failed to inform investors that they used hidden payments, in the form of rebates, from Intel Corp to meet analysts' targets. The SEC's complaint further alleged that Dell's most senior former accounting personnel engaged in improper accounting by maintaining a series of "cookie jar" reserves that they used to cover shortfalls in operating results. On July 22, 2010, Dell agreed to pay a penalty of $100 million. Dell's current CEO and former CEO each paid penalties of $4 million. Other former company officers and employees also paid penalties as well. Dell agreed to enhance its disclosure processes, including the retention of an independent consultant to recommend improvements and enhance training regarding the disclosure requirements of the federal securities laws.

Securities and Exchange Commission v. Diebold, Inc. On June 2, 2010, again following a restatement of financial result, the SEC filed a complaint against Diebold, Inc. alleging that the company and several of its executives improperly inflated the company's earnings to meet earnings forecasts. The complaint alleged that from 2002 to 2007, the company employed a variety of improper accounting practices, including recognizing revenue subject to a side agreement and manipulating reserves. Diebold allegedly maintained "cookie jar" reserves to manage earnings, including a $4.5 million corporate excess inventory account. Diebold consented to a final judgment in which the company agreed to pay a $25 million civil penalty and was permanently enjoined from future violations of the securities laws.

Securities and Exchange Commission v. General Electric.[28] On August 4, 2009, after a four year investigation and several restatements, GE settled SEC fraud charges related to hedge accounting and revenue recognition. GE was charged with accelerating the recognition of revenue from its locomotive and aircraft spare parts business in an effort to enhance its financial results. GE was fined $50 million, and agreed to enhance its internal controls. The SEC uncovered the violations after conducting risk-based investigations at GE. According to GE, the company produced 2.9 million documents, and the internal review and SEC response cost $200 million in legal and accounting fees. The company also took disciplinary action against employees involved in the transactions, which included firing employees who engaged in intentional misconduct.

FCPA

There have been a number of FCPA-related actions brought under the "books and records" and internal controls provisions, involving both the SEC and the DOJ; a few of them are described below, but in general, there continues to be a steady stream of these types of cases:

Securities and Exchange Commission v. Oracle. On August 16, 2012, the SEC charged Oracle with violating the FCPA's books and records and internal control provisions (Section 13(b) of the Exchange Act) by failing to prevent a subsidiary from secretly setting aside money off the company's books to make unauthorized payments to phony vendors in India. According to the SEC complaint, Oracle India sold products/sources to Indian government and users through local distributors who had written agreements with Oracle India. Oracle India employees then inflated prices paid by the government and directed excess funds to be kept by distributors. Oracle India employees concealed the existence of the side fund from Oracle. The company's books and records allegedly did not properly account for the funds. The SEC reached a settlement with Oracle for a $2 million penalty.

Securities and Exchange Commission v. Eli Lilly and Company. On December 20, 2012, the SEC brought charges against Eli Lilly and Company under the FCPA's anti-bribery, books and records, and internal control provisions in connection with improper payments its subsidiaries allegedly made to foreign government officials to win business in Russia, Brazil, China, and Poland. The company agreed to pay more than $29 million to settle the charges.

Securities and Exchange Commission v. Allianz SE. On December 17, 2012, the SEC charged Allianz SE with violating the books and records and internal controls provisions of the FCPA for improper payments to government officials in Indonesia that resulted in $5.3 million in profits. Allianz agreed to pay more than $12.3 million to settle the SEC's charges.

Securities and Exchange Commission v. Tyco International. On September 24, 2012, the SEC charged the Swiss-based global manufacturer with violating the FCPA when subsidiaries arranged illicit payments to foreign officials in more than a dozen countries. Tyco agreed to pay $26 million to settle the SEC's charges and resolve a criminal matter with the DOJ.

Criminal Accounting Fraud

United States v. Collins, 07-cr-1170, U.S. District Court, SDNY. On November 16, 2012, Joseph Collins, a former partner at the Mayer Brown firm and outside attorney for Refco Inc., was found guilty of conspiracy to commit securities fraud, filing false statement with the SEC, and wire fraud, in a retrial after his 2009 fraud conviction was reversed in January 2012. Collins allegedly helped Refco CEO Phillip Bennett and other key executives defraud investors of $2.4 billion, by drafting fraudulent legal documents that allowed the company to cover up the fact that it was engaging in certain fraudulent round trip accounting transactions to transfer losses off of its books in order to improve its financial statements.

The underlying crisis began on October 10, 2005, when Refco announced

Bennett had transferred $430 million to a separate company he controlled, and had hid that information from the company's auditors and board. Between 2002 and 2005, Bennett had bought bad debts from Refco in order to prevent corporate write-offs, then paid for the bad loans with money borrowed by Refco. As a result, Refco had to restate its financial statements back to 2002.

On October 12, 2005, Bennett was arrested and charged with securities fraud. On October 17, 2005, Refco declared bankruptcy. Bennett and Tone Grant, the former president of Refco, received 16-year and 10-year sentences, respectively, after they were convicted in 2008.

CONCLUSION

The risks and costs associated with accounting irregularities remain significant for public companies. As the regulatory investigations and civil litigations resulting from the financial crisis come to an end and the SEC looks to redeploy its resources under the leadership of Mary Jo White, there will inevitably be an increased focus on accounting fraud by the SEC and others. Indeed, public companies can and should expect regulatory agencies and other enforcement agencies to take an aggressive approach to addressing accounting fraud. Thus, public companies should continue to be vigilant in their efforts to reduce or eliminate accounting irregularities and misstatements. Further, officers and directors should be knowledgeable about the legal provisions that can be the basis of an enforcement action or civil litigation and, if not already in place, must ensure that their companies have sound accounting policies and procedures, as well as robust internal controls over financial reporting to prevent accounting-related fraud.

NOTES

[1] Over the last several years, regulators and prosecutors have ramped up their pursuit of financial fraud, in significant part because of the financial crisis. For example, in the United States, the Department of Justice's Financial Fraud Enforcement Task Force, created in November 2009, has been aggressively investigating and prosecuting thousands of fraud cases. Additionally, Congress enacted the Fraud Enforcement and Recovery Act, authorizing expenditures of $245 million in each of 2010 and 2011,

which enabled various agencies, such as the Securities and Exchange Commission ("SEC"), to bolster its resources by hiring additional investigators and attorneys.

[2] http://blogs.law.harvard.edu/corpgov/2013/04/25/bold-enforcement-envisioned-following-the-confirmation-of-mary-jo-white-as-sec-chair.

[3] Jacob Frenkel, former SEC enforcement lawyer. http://online.wsj.com/article/SB10001424127887324125504578509241215284044.html.

[4] Improper Expense Calculations: Under general accounting principles, expenses should be recognized and recorded within the same period as the revenue generated or earned by the expenses being reported. Improper expense calculations occur when the costs that should be reported as expenses in the period in which they were incurred are instead capitalized as assets. Improper expense calculations include improper expense recognition, improper capitalization or deferral of expenses, improper use of reserves, understating bad debts/loans/losses, and other understatement of expenses.

[5] Earnings Mismanagement: The use of aggressive accounting techniques to manipulate the company's accounting practices and produce financial reports that may paint an overwhelmingly positive, but inaccurate picture of a company's business activities and financial position. The management of earnings can then lead to manipulation and misstatement taking management down the path from questionable ethical practices to blatant fraud.

[6] Reserves Manipulation: A tool used by management to meet profitability targets and avoid net losses, by increasing or decreasing earnings at will. Companies experiencing current positive operating performance may seek to defer earnings into future periods to reduce market expectations of future performance, and to establish reserves for use in covering future period expenses. Companies experiencing poor financial performance may decide to cover missed expectations, by describing the current year performance as a "fluke" and establish reserves through "non-recurring" expenses.

[7] Misappropriation: Also known as insider fraud, where third parties (director) or employees abuse their position to steal from the company through fraudulent activity. Typically, the assets stolen are cash or cash equivalents, such as credit notes or vouchers. However, the fraud can extend to include company data or intellectual property. Accounting misappropriation can also include false entries or entries into incorrect account and is often used to cover up fraud, embezzlement schemes, and skimming.

[8] SEC Staff Accounting Bulletin No. 104.

[9] *See* 15 U.S.C. § 78m (b) (codified in Section 13 of the Exchange Act).

[10] In addition to the specific statutes addressed in this section, there are more general anti-fraud statutes, such as wire fraud, 18 U.S.C. § 1343, or mail fraud, 18 U.S.C. § 1341, that can also be used in criminal cases to charge accounting fraud.

[11] *See* 15 U.S.C. § 78j(b).

[12] *See* 17 C.F.R. § 240.10b-5.

[13] *See, e.g., Dura Pharm. Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (finding that the false statement or omission must be "made in connection with the purchase or sale of securities…which [was] furthered through the defendant's use of the mails or a national securities exchange.").

[14] *See* 15 U.S.C. § 78m(a); *see also* Rule 12b-20 (17 C.F.R. 240.12b-20; "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.").

[15] *See* 15 U.S.C. § 78m(b).

[16] http://www.sec.gov/rules/final/33-8124.htm.

[17] This program was implemented in May 2011 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

[18] Annual Report on the Dodd-Frank Whistleblower Program: Fiscal Year 2012, available at: http://www.sec.gov/about/offices/owb/annual-report-2012.pdf.

[19] *See, e.g., Basic v. Levinson*, 485 U. S. 224, 231-32 (1988) (providing definition of materiality in connection with 10b-5 securities fraud).

[20] *See* Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information; SEC Staff Accounting Bulletin No. 99.

[21] Audit Analytics, 2011 Financial Restatements: An Eleven Year Comparison, (May 2012).

[22] *See* Cornerstone: Securities Class Action Filings (2012 Year in Review), pp. 5; Cornerstone: Accounting Class Action Filings and Settlements (2011 Review and Analysis), p. 1-2.

[23] *See id*.

[24] *See* Cornerstone: Accounting Class Action Settlements Continue to Represent a Large Share of Total Settlement Dollars, available at: http://www.cornerstone.com/accounting-class-action-settlements-continue-to-represent-a-large-share-of-total-settlement-dollars.

[25] Cornerstone: Accounting Class Action Filings and Settlements (2011 Review and Analysis), p. 10.

[26] *See* Comolli, Renzo, Miller, Ron, Montgomery, John, Starykh, Svetlana, Recent Trends in Securities Class Action Litigation: 2012 Mid-Year Review, National Economic Research Associates, Inc.

[27] *Janus Capital Group, Inc. v. First Deriv. Traders, Inc.*, 131 S. Ct. 2296 (U.S. June 13, 2011).

[28] *See* Marie Leone and Tim Reason, *GE Settles Accounting Fraud Charges*, available at: http://www/cfo.com/printable/article.cfm/14162632.