
Baruch College

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Today's Topics

- Case Metrics
- Enforcement Focus Areas
- Enforcement Process
- Accounting Investigations

Distribution of Cases Across Core Enforcement Areas

CORE ENFORCEMENT PROGRAM AREA	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Financial Disclosure	29%	28%	29%	24%	33%	23%	22%
Investment Advisers	11%	14%	16%	16%	12%	13%	12%
Broker-Dealers	20%	22%	15%	13%	14%	9%	16%
Securities Offerings	16%	15%	9%	11%	10%	18%	21%
Insider Trading	7%	7%	8%	8%	7%	9%	6%
Market Manipulation	5%	6%	7%	5%	5%	8%	6%
Delinquent Filings	-	-	-	16%	8%	16%	14%
Other	12%	8%	16%	7%	11%	4%	3%
Total	100%	100%	100%	100%	100%	100%	100%

Per the U.S. SEC 2007, 2008 and 2009 Performance and Accountability Reports

Anatomy of a Typical SEC Investigation

- SEC commences an investigation
- Evidence Gathering and Analyses
- Well Notice Issued
- Settlement Discussions
- Commission Approves Enforcement Action
- SEC Files Complaint
- Litigation, if action not settled at time of filing

Recent Accounting Matters

- *SEC v. Collins & Aikman Corporation, et al Settlement* (4/19/2010)
- *Safenet* (11/12/09) (first action involving Reg G, involving non-financial measures)
- *New Century* (12/7/09)
- *SEC v. GE* (8/4/09)
- *SEC v. Maynard L. Jenkins* (CEO of CSK Auto)—
Section 304 claw back \$4 million; not charged with violations (7/23/09)
- *Countrywide Executives* (6/4/09)
- *American Home Mortgage* (4/28/09)
- *Halliburton and KBR FCPA* (2/11/09)

Triggers for SEC Enforcement Interest

- Regulatory referrals
 - ✓ SEC Divisions and Offices
 - ✓ Other regulatory agencies
- Issuer Self Reporting
- Informants/Whistleblowers
- Restatements
- News/Analyst/media reports
- Officer resignations
- Outlier industry performance

New enforcement Initiatives

- Restructuring
 - Streamlined management
 - Office of Market Intelligence—tips/complaints/referrals
- New units
 - Asset Management (hedge funds and private equity)
 - Market Abuse (insider trading and market manipulation)
 - Structured and New Products (complex derivatives)
 - FCPA
 - Municipal Securities
- Cooperation
 - Cooperation agreements
 - Deferred Prosecution agreements
 - Non-prosecution agreements

Accounting Fraud Areas of Focus

Conduct of individuals (especially gatekeepers)

- CEO's, CFO's and Controllers
- Audit Committees
- Auditors
- Lawyers
- Counterparty aiders and abettors

The Slippery Slope of a Financial Fraud:

- Starts with “making the numbers”
- Then, “Managing the Numbers”
- Ends with “making up the numbers”

Fraud Risk Factors

What are Company Pressures/Attitudes/Incentives Relating to Fraud?

- Undue emphasis on non-GAAP metrics
- Compensation linked to financial metrics
- Aggressive accounting policies
- Aggressive earnings or revenue forecasts?
- Too much emphasis on achieving quarterly results or Wall Street expectations?
- Undue emphasis on increasing or maintaining the stock price?
- Lack of Transparency regarding disclosures
- Appearance that transaction may lack economic substance

SEC Objective - Accounting Investigations

- Determine whether the company's financial statements were **materially misstated** and/or whether the company's footnote and/or MD&A disclosures contained **materially false or misleading statements** (or omitted material facts)
- Determine who was responsible for any errors:
 - Issuer (employees, officers and/or directors)
 - Auditors (firm and/or partners)
 - Other third parties (e.g., customers or suppliers)
- Determine why the misstatement occurred (i.e., intent)
- Prosecute violations of federal securities laws

Approach to Investigation

- Understand the relevant business transactions
- Understand how the company accounted for these transactions
- Evaluate compliance with GAAP
- Evaluate financial statement footnotes and disclosures
- Evaluate compliance with GAAS (if material error)

Evidence Gathering

There is always a paper trail!

- Invoices
- Contracts
- Accounting Records (journal entries, G/L entries)
- Email and Correspondence
- Audit Working Papers

Documents may tell you:

- When a transaction was recorded
- Who knew about a transaction
- Who approved the accounting or disclosure
- Who interacted with outside auditors

Federal Securities Laws

➤ Fraud Violations

- Section 17(a) of the 33 Act—fraud in connection with the offer or sale of a security;
- Section 10(b) of the 34 Act and Rule 10b-5—fraud in connection with the purchase or sale of a security;
- Fraud Violations require proof of Materiality and Intent

➤ SEC Reporting Violations—Section 13(a) of the 34 Act

- 12b-20 (additional disclosure catch-all)
- 13a-1 (annual reports)
- 13a-13 (quarterly reports)

➤ Books & Records Violations—Section 13(b)(2)(A) and Rules:

- 13b2-1 (cannot falsify books and records)
- 13b2-2 (officers or directors cannot mislead accountants)

➤ Internal Controls Violations—Section 13(b)(2)(B) & 13(b)(5)

Materiality

- Materiality is a legal and an accounting concept.
- Legal:
 - substantial likelihood that a reasonable investor would consider it important in making an investment decision.
 - substantial likelihood that the fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available
- See SEC Staff Accounting Bulletin No. 99
 - Quantitative materiality—magnitude based
 - % of Net Income/Earnings or other relevant financial statement line-item
 - Qualitative materiality—misstatement may be small, but important:
 - Issuer met or exceeded earnings expectations
 - Avoided a loss
 - Avoided defaulting on debt covenants
 - Impacts management representations to auditors

Fraudulent Intent--Scienter

Intentional or Reckless Conduct

- Intentional

- Evidence showing a person knew the financial statements were materially misstated.
 - Person falsified or altered accounting records (e.g., booked fictitious revenue or backdated a transaction);
 - Evidence of intent to evade known accounting rules
 - Omitted or misrepresented material facts to deceive investors

- Recklessness;

- Conduct that is highly unreasonable and constitutes an extreme departure from the standards of ordinary care;
- Established from facts and circumstances and **Red Flags**;
 - Quarter-end adjustments that enable company to hit performance targets
 - Rumors about side agreements or contingencies on sales contracts;
 - Disclosure that lacks transparency
 - Excessive related party transactions
 - Transactions with questionable business purpose

Rule 102(e)

- “Improper professional conduct”
- Definition includes three types of actionable conduct :
 - Intentional, knowing or reckless
 - Single instance of highly unreasonable conduct
 - Multiple instances of unreasonable conduct
- Assessment of independent auditors if material misstatements:
 - GAAP—What was auditor role in the accounting errors; were they misled?
 - GAAS—Was the audit deficient, and if so, how so?
- Crucial—What facts and circumstances did the auditors know about :
 - What audit procedures were done?
 - What representations did the company make to the auditors?
 - What did third parties tell the auditors?
 - How did the auditors handle issues that were discovered?

Recent 102(e) matters

- E&Y Bally Total Fitness
 - \$2 billion restatement
 - Alleged not only that E&Y was aware of Bally's fraudulent and improper accounting and disclosure practices, but that E&Y subsequently implemented a scheme to cover up prior improper accounting and deficient audits
- In the Matter of Andrew Sims, CPA
 - Involved a violation of the auditor independence rules by an auditor seeking employment with his audit client.
 - Over a period of months, an audit partner at Mazars LLP, engaged in employment discussions with his audit client to become the chief accounting officer of a U.S. back-office organization owned by the audit client that was to become responsible for the financial reporting of the audit client's US operations

Recent 102(e) matters

- Michael J. Moore, CPA (Moore) and Moore & Associates (M&A)
 - Federal court injunction & Rule 102(e) suspension
 - Alleged that the audits failed to meet numerous PCAOB Standards and were so deficient that they amounted to no audits at all
 - The complaint alleged, among other things, that Moore and M&A issued audit reports for more than 300 clients who consist of primarily shell or developmental stage companies with public stock quoted on the OTCBB or the Pink Sheets
 - The complaint further alleged that the audit opinions were often the product of high school graduates hired with little or no education or experience in accounting or auditing



U.S. SECURITIES AND EXCHANGE COMMISSION

"We are the investor's advocate."

William O. Douglas
SEC Chairman, 1937-1939