

## Accounting Fraud: Down, But Not Out

*Law360, New York (September 11, 2015, 10:38 AM ET) --*

Accounting fraud is one of the most costly types of fraud, not just in dollars lost by investors or companies, but also in the way it erodes confidence in the capital markets. The last major accounting fraud scandal played out in the early 2000s. In the interim, we've had two historic pieces of legislation enacted, in part, to decrease the likelihood of another widespread accounting fraud scandal. And we've seen a sharp decline in the number of financial restatements, private securities class actions and accounting-related U.S. Securities and Exchange Commission enforcement actions.

Have the legislative fixes worked? Is there really less accounting fraud today? This article will take a brief look at why we might have seen a diminished amount of accounting fraud and then consider why celebrating its decline might be premature.



David Woodcock

### Why We Might See Less Accounting Fraud Today

#### 1. Sarbanes-Oxley Worked

There is good evidence that Sarbanes-Oxley Act of 2002 has improved financial reporting quality by improving the audit profession, audit committees, internal controls and corporate and individual accountability.[1] There are also a smaller number of potentially high-risk companies because post-SOX, many went private or "dark." [2] Audit quality has improved, in part because of the Public Company Accounting Oversight Board. There have been far fewer restatements post-SOX, and they arise more often from unintentional errors, more likely come from noncore accounts, more likely have no impact on earnings, and elicit a lower average negative market reaction.[3]

In addition, audit committees are far more engaged. They are more attentive to potential whistleblowers, internal controls and the auditor relationship. SOX's requirement that CEOs and chief financial officers provide certifications regarding their company's financial statements and internal controls, along with the clawback risk in the event of a restatement, also may incentivize management. The recently proposed Dodd Frank clawback provision, which expands the scope of clawbacks, could further increase those incentives.[4]

#### 2. Internal Controls Have Improved

Whether due to SOX, market pressure or regulatory scrutiny, there is evidence that internal controls at public companies have improved. Internal controls are one of the fundamental drivers of earnings quality.[5] Numerous studies show that firms with internal control weaknesses have accruals that are less consistent with cash flows, more auditor resignations, more restatements and SEC enforcement actions, less precise management forecasts, and CFOs with weaker qualifications.[6]

Better empowered and engaged audit committees, CEO/CFO certifications and improved auditing quality have helped improve internal controls. In addition, there is “significant evidence” that Section 404 reports — in which a company reports on the scope, adequacy and effectiveness of its internal control structure — “prompt companies to make managerial and governance improvements.”[7] Researchers have documented a negative market reaction for material weakness disclosures, suggesting that investors value those disclosures.[8] Audit Analytics, an audit and accounting intelligence service and researcher, recently concluded that the relatively low number of restatements “is the positive effect of Sarbanes-Oxley section 404 and internal controls ... Everything gets better after [Section] 404.”[9] Finally, a recent survey of corporate leaders suggests that Section 404 has causally improved accounting quality and internal controls.[10]

### ***3. Many Eyes Are On the Lookout for Fraud***

The quest to find companies engaging in earnings management is far more sophisticated than it was even a few years ago, and this should make it more difficult to conceal accounting fraud.

*Academics:* There are now thousands of academic research papers on earnings management and accounting fraud, on the motivations, financial impacts and detection methods, among other things. They apply methods or concepts like Benford’s Law, quadrophobia, Beneish M-Scores, F-Scores, and cash flow variances, and they draw correlations between CEO/CFO driving records and propensity for ostentatious lifestyles. Their work is being used by regulators and analysts to detect accounting fraud earlier.

*Analysts and Short Sellers:* In addition to the institutional and private fund analysts, there are now several intelligence firms focused on detecting accounting fraud and earnings management. Whether they’re using quantitative analytics, fundamental analysis, or some combination, their work is contributing to the earlier detection of accounting fraud. And although short sellers are frequently wrong and regulators and others should subject their work to close scrutiny before acting on it, some believe they “help keep the market honest,”[11] thereby exposing fraud earlier.

*Regulators:* Most of the SEC’s enforcement effort to combat accounting fraud is begun in response to restatements, self-reports, press accounts, etc. But in recent years, the agency has ramped up efforts to be more proactive in detecting accounting fraud. The SEC created the Fraud Task Force over two years ago, and the Division of Economic and Risk Analysis and the agency as a whole have increased their focus on accounting fraud.[12] The task force has now evolved into the “Financial Reporting and Audit Group,” signifying a long-term interest by the agency’s leadership.[13]

There is some evidence these beefed-up regulatory efforts, and more particularly, greater divisionwide focus on this area, may be having an effect. In 2014, for example, the SEC brought 46 percent more financial reporting fraud cases than it did the year before. From 2013 to 2014, there was a 47 percent increase in class actions alleging accounting violations, and more than one in four of those cases referred to an SEC inquiry or action (the highest level since this correlation began to be tracked in 2010).[14]

#### **4. Whistleblowers Make Potential Violators Think Twice**

It's fair to say the Dodd-Frank-created whistleblower program has been a success for the SEC. The volume and quality of tips the commission receives has gone up every year in the four years of the program. In 2014, the SEC received over 3,600 tips,[15] and the largest number of self-categorized tips alleged violations relating to corporate disclosures and financial statements: 630 or around 17 percent of all whistleblower complaints. For whistleblowers, the financial incentives are significant. The SEC has paid over \$50 million in whistleblower bounties in the few years the program has been in operation.[16]

Not all whistleblower tips are useful, but there are instances where whistleblowers provide information the SEC is unlikely to obtain any other way. Whistleblower tips often include detailed analysis, key documents, and an insider's view of the fraud that proves integral to building a case. This means that corporate insiders are incentivized to nip a problem in the bud rather than allowing it to grow into a larger problem that might be reported to the SEC.

#### **5. Other Possible Reasons**

It is possible that the tone at the top and compliance culture improvements so often called for by companies, regulators, auditors, consumer groups and corporate attorneys have actually taken hold.[17] Moreover, the increase in corporate penalties could be deterring management from taking the risk of large-scale accounting fraud. Some recent prosecutions in this area may have the effect of reinforcing the message that the costs outweigh the benefits.[18]

#### **Why Accounting Fraud Hasn't Gone Away**

Despite these improvements in controls, detection and incentives, it is unlikely accounting fraud is on the brink of eradication.

##### **1. People are Imperfect**

Human nature has not changed in the last 20 years. The "fraud triangle," developed over 50 years ago, posits that when people are faced with certain pressures, have opportunities and can form rationalizations for misconduct, you have the necessary ingredients for accounting fraud.[19]

The pressures that might lead someone to commit accounting fraud include: desires to increase personal wealth or obtain promotions; efforts to maintain or elevate social status; attempts to escape from the penalties of poor performance; the desire to obtain a higher stock price or to meet the expectations of investors; or desires to postpone dealing with financial difficulties.[20] The rationalizations often used to excuse misconduct may include the notion that the conduct was within the bounds of an accounting gray area or was only going to be continued for a short time. The perpetrator might also rationalize that the fraud was necessary for deserved, but withheld, personal bonuses, was a short-term fix needed to protect jobs or the company, or was nothing different from what many other companies were already doing.[21]

The opportunities for accounting fraud are always present at the highest levels of the company, where many accounting frauds originate. This is largely because management almost always has the ability to override even effective internal controls.[22] The opportunities for accounting fraud are only enhanced by the persistent difficulty of its detection, despite the advances described above. In a recent survey of

several hundred CFOs, many cautioned that earnings management is difficult to unravel from the outside.[23] One CFO stated that “the chances an analyst would spot an occasional instance of earnings management are low, and only persistent abusers have a high chance of being detected.”[24] These revealing comments are supported by other studies,[25] one of which concluded: “there may be a persistent residual level of inappropriate conduct that cannot be eradicated.”[26] If these surveys and studies are believed, there may be a lot of at least minor accounting fraud in our economy today.

## ***2. Short-Termism Hasn't Gone Away***

Related to the discussion of human nature is the problem of “short-termism,” or the excessive focus on short-term results over long-term value.[27] Think of the focus on quarterly earnings. Former SEC Chairman Arthur Levitt decried the “runaway problem” of short-termism and earnings management back in 1998. Since then, we’ve had two massive financial crises (both caused in part by short-termism),[28] two historic regulatory responses, and an endless amount of ink spilled on the need to move away from the temptations of short-term thinking.

Surveys of financial executives demonstrate that the threat of short-termism is alive and well. One survey of several hundred financial executives, for instance, confirmed that many would take an action that is “value-decreasing for their firms to beat earnings expectations.”[29] Furthermore, “[o]ver 80% of financial executives said they would decrease discretionary spending, such as advertising expenses, maintenance expenses, and research and development expenses, to meet earnings targets.”[30] And “[o]ver 50% of financial executives said that they would ‘delay starting a new project even if this entailed a small sacrifice in value to meet earnings expectations or to smooth earnings.’”[31] In another survey of business leaders, researchers found that only 49 percent of respondents at larger companies, and 35 percent of smaller companies, would be willing to miss earnings of up to 5 percent in the current period in order to pursue an investment that would boost profits by 10 percent over the next three years.[32]

Interestingly, not only does the market seem to fail to penalize short-termism,[33] the trading practices and decisions of so-called “transient” institutional traders — those with a short-term time horizon reflected by high-portfolio turnover and high-momentum trading — probably even lead to earnings management.[34] As SEC Commissioner Dan Gallagher recently suggested: “if individual and institutional investors are focused on the short term, it’s no surprise that companies are in turn managing themselves for the short term.”[35]

## ***3. SOX May Have Helped, But It Isn't Perfect***

SOX was focused on improving audit committees, auditing and internal control disclosures, not directly on preventing fraud. Improvement in the three areas will at best minimize the opportunities for committing fraud, but the possibility of management override and collusion are inherent limitations of internal controls.[36]

SOX also may get credit for reducing the number of restatements, but it is unclear whether the reduced number of restatements is entirely positive. As noted in a recent article, managers are increasingly using earnings revisions, rather than Item 4.04 restatements, in order to handle errors quietly and therefore avoid clawbacks on executive bonuses and shareholder lawsuits.[37] In theory, frequent revisions could raise questions about the internal controls surrounding the accounts revised.

The increase in revisions coincides with companies’ seeming hesitation to disclose material weaknesses

in internal controls, perhaps to avoid negative market reactions that might follow. The SEC has expressed concern for several years that it is “surprisingly rare to see management identify a material weakness in the absence of a material misstatement.”[38] The PCAOB has also noted this issue in the audit context.[39] This raises the concern that companies and their auditors are not adequately assessing and testing internal controls.[40] And on overall audit quality, the PCAOB continues to find deficiencies in the auditing of accounting estimates in areas such as revenue, allowances for loan losses, inventory reserves and fair-value measurements.[41]

Another possible reason to question the effectiveness of SOX is the 2008 financial crisis. Although designed to address accounting and auditing scandals, SOX does apply to internal controls across all industries, and the failure of internal controls played an undeniable role in the crisis.[42]

#### ***4. The Current Environment May Not Be Right for Large-Scale Accounting Fraud to Thrive, But That Doesn't Mean It Won't Return***

The pressures to commit accounting fraud may not be as strong today. A manager’s decision “to commit accounting fraud is related to macroeconomic conditions.”[43] More specifically, “managers start committing accounting fraud during periods of strong macroeconomic performance, as measured by gross domestic product, and in the two years leading up to an economic peak.”[44] And fewer managers tend to begin “committing accounting fraud in the two years following an economic trough.”[45] A related pressure that drives earnings management is the desire to keep up with your competitors in the earnings race (“keeping up with the Joneses”).[46] But if everyone in the market is facing tough economic conditions, then that pressure is less powerful.

Without getting into a detailed analysis of recent economic growth or the stock market’s performance, it is clear that the years since the 18-month long recession that kicked off in December 2008 would likely not be considered “strong macroeconomic performance,” and thus, we should not expect as much accounting fraud as we’ve seen in periods where there is strong performance.

However, these effects may not last forever. As the Ethics Resource Center put it in their 2009 National Business Ethics Survey, we “see an important connection between workplace ethics and the larger economic and business cycle: when times are tough, ethics improve. When business thrives and regulatory intervention remains at status quo, ethics erode.”[47] Although this pattern may have been broken in the 2011 survey,[48] the ERC opined that the “soft recovery” post-recession “may have taken a toll on workers’ confidence and tempered risktaking on the job.”[49] The key question is what will happen when robust economic growth returns and executives and companies face greater pressures to perform or keep up with peers.

#### **What Can We Say With Some Confidence About the Future of Accounting Fraud**

The only thing that can be stated with certainty is that accounting fraud is unlikely ever to disappear completely. While conditions may not be prime right now, there is no guarantee that improved economic conditions or decreased regulatory focus could not pave the way for more widespread accounting fraud. And we can be pretty sure the next crisis won’t look exactly like the last. Regardless of the overall trends, however, we know that companies with strong ethical and compliance cultures experience less fraud and discover it more quickly. So the best approach for those who want to avoid problems is to build and nurture an ethical and compliance culture that minimizes the pressures and opportunities that might tempt otherwise good people to engage in misconduct.

—By David Woodcock, Jones Day

*David Woodcock is a partner in Jones Day's securities litigation and enforcement group in Dallas. He is a former chairman of the SEC Enforcement Division's Financial Reporting and Auditing Task Force and director of the SEC's Fort Worth, Texas, regional office.*

*The author would like to thank Peter Romatowski and Joan McKown, partners in Jones Day's Washington, D.C., office, and Tyson Lies and Katie Wall, associates in the firm's Dallas office, for their assistance on this article.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

[1] Suraj Srinivasan, and John C. Coates IV, SOX After Ten Years: A Multidisciplinary Review 31 (Sept. 2014), [http://dash.harvard.edu/bitstream/handle/1/12175242/Srinivasan\\_Suraj\\_J2\\_SOX%20After%20Ten%20Years%20-%20A%20Multidisciplinary%20Review.pdf?sequence=1](http://dash.harvard.edu/bitstream/handle/1/12175242/Srinivasan_Suraj_J2_SOX%20After%20Ten%20Years%20-%20A%20Multidisciplinary%20Review.pdf?sequence=1); Adam Hartung, Benefits Of SOX And Dodd- Frank, Forbes Online (Aug. 16, 2015), available at <http://www.forbes.com/sites/adamhartung/2015/08/16/regulations-work-benefits-of-sox-and-dodd-frank/>.

[2] Srinivasan & Coates, *supra*, at 16-20.

[3] Srinivasan & Coates, *supra*, at 33 (citing numerous studies).

[4] SEC Proposes Dodd-Frank Act Clawback Rules, Jones Day (July 2015), available at <http://www.jonesday.com/sec-proposes-dodd-frank-act-clawback-rules-07-09-2015/>.

[5] See, e.g., Jeffrey Doyle, Weili Ge, & Sarah McVay, Determinants of Weaknesses in Internal Control over Financial Reporting and the Implications for Earnings Quality, 44 J. Acct. & Econ. 193 (2007); Dain C. Donelson, Matthew Ege, and John M. Mcinnis, Internal Control Weaknesses and Financial Reporting Fraud 7 (May 2014), <http://ssrn.com/abstract=2449287> or <http://dx.doi.org/10.2139/ssrn.2449287>.

[6] Srinivasan & Coates, *supra*, at 34.

[7] *Id.* at 60.

[8] *Id.* at 13.

[9] Maxwell Murphy, The Big Number, The Wall Street Journal CFO Journal Blog (Apr. 20, 2015), <http://www.wsj.com/articles/the-big-number-1429577020>.

[10] Cindy R. Alexander, Scott W. Bauguess, Gennaro Bernile, Yoon-Ho, Alex Lee, & Jennifer Marietta-Westberg, Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective, at 56 J. Acct. & Econ. 267, 268 (Aug. 2013); Srinivasan & Coates, *supra*, at at 34.

[11] James Surowiecki, In Praise of Shortsellers, The New Yorker (Mar. 23, 2015), available at <http://www.newyorker.com/magazine/2015/03/23/in-praise-of-short-sellers>; see Cory A. Cassell,

Michael S. Drake & Stephanie J. Rasmussen, Short Interest as a Signal of Audit Risk, 28 *Contemp. Acct. Res.* 1278 (Apr. 2011).

[12] Peter J. Henning, The S.E.C. Is 'Bringin' Sexy Back' to Accounting Investigations, *New York Times Dealbook* (June 3, 2013); Andrew Ceresney, Co-Director, Div. of Enforcement, Financial Reporting and Accounting Fraud, American Law Institute Continuing Legal Education (Sept. 19, 2013).

[13] Stephanie Russell-Kraft, SEC's "RoboCop" Drags Agency Into 21st Century, *Law360* (Aug. 21, 2015), <http://www.law360.com/articles/693679/sec-s-robocop-drags-agency-into-21st-century>.

[14] Cornerstone Research, *Accounting Class Action Filings and Settlements: 2014 Review and Analysis 1* (2015).

[15] Mary Jo White, Chair, Sec. & Exch. Comm'n, The SEC as the Whistleblower's Advocate (Apr. 30, 2015).

[16] *Id.*

[17] Ethics Resource Center, *2013 National Business Ethics Survey 14-17* (2013), available at <http://www.ethics.org/downloads/2013NBESFinalWeb.pdf>.

[18] Press Release, Dep't of Justice, Former Arthrocare Executives Sentenced for Orchestrating \$750 Million Securities Fraud Scheme, U.S. Department of Justice (Aug. 29, 2014), <http://www.justice.gov/opa/pr/former-arthrocare-executives-sentenced-orchestrating-750-million-securities-fraud-scheme>.

[19] Joseph T. Wells, *Principles of Fraud Examination* 20 (2d Ed. 2008).

[20] *Id.* at 300-01.

[21] *Id.*

[22] Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 72 *Fed. Reg.* 35,324 (June 27, 2007) (codified at 17 C.F.R. pt. 241).

[23] Ilia Dichev, John Graham, and Shiva Rajgopal, Earnings Quality: Evidence from the Field 40-41 (Oct. 10, 2012).

[24] *Id.* at 40.

[25] Ernst & Young, *13th Global Fraud Survey, Overcoming Compliance Fatigue: Reinforcing the Commitment to Ethical Growth*, 13th Global Fraud Survey 7 (2015); I.J. Alexander Dyck, Adair Morse, & Luigi Zingales, How Pervasive is Corporate Fraud? 4 (Rotman School of Mgmt., Working Paper No. 2222608, 2013) (finding that the probability of a company engaging in a fraud in any given year is 14.5%).

[26] Ernst & Young, *supra*, at 1.

[27] Lynne L. Dallas, Short-Termism, the Financial Crisis, and Corporate Governance, 37 J. Corp. Law 265 (2012).

[28] *Id.* at 268 n.7 (noting that it is generally accepted that short-termism contributed to both the most recent financial crisis well as the accounting scandals of the early 2000s).

[29] *Id.* at 280.

[30] *Id.*

[31] *Id.*

[32] Jonathan Bailey & Jonathan Saul Godsall, Focusing Capital on the Long-Term, Short Termism: Insights from Business Leaders 6 (Dec. 26, 2013).

[33] Dallas, *supra*, at 280-81.

[34] *Id.* at 302-06, 362.

[35] Daniel M. Gallagher, Commissioner, Sec. & Exch. Comm'n, Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College n.50 (June 23, 2015).

[36] Donelson at 7.

[37] Christine E. L. Tan and Susan M. Young, An Analysis of "Little r" Restatements, 29 Acct. Horizons 668 (Sept. 2015).

[38] Brian T. Croteau, Dep. Chief Accountant, Office of the Chief Accountant, Remarks Before the 2013 AICPA National Conference on Current SEC and PCAOB Developments — Audit Policy and Current Auditing and Internal Control Matters (Dec. 9, 2013).

[39] PCAOB, Audit Committee Dialogue (May 2015), <http://pcaobus.org/sites/digitalpublications/audit-committee-dialogue> (noting that 83% of the restatements announced during 2013 and 2014 by companies required to report on ICFR had no material weakness reported in the ICFR opinion preceding the announcement); see Srinivasan & Coates, *supra*, at 14.

[40] Croteau, *supra*.

[41] PCAOB, Audit Committee Dialogue, *supra*.

[42] See, e.g., Press Release, Sec. & Exch. Comm'n, JPMorgan Chase Agrees to Pay \$200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965> (citing firm's failure to establish and maintain internal controls); Press Release, Sec. & Exch. Comm'n, SEC Charges Bank of America With Securities Laws Violations in Connection With Regulatory Capital Overstatements (Sept. 29, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543065483> (same).

[43] Robert H. Davidson, Accounting Fraud: Booms, Busts, and Incentives to Perform 4-5 (Jan. 26, 2011).

[44] Id. at 5.

[45] Id.

[46] Wells, *supra*, at 300-01.

[47] Ethics Resource Center, 2009 National Business Ethics Survey 2 (2009), <http://ethics.org/files/u5/nbes-final.pdf>.

[48] Id. at 11.

[49] Id. at 15-16.

---

All Content © 2003-2015, Portfolio Media, Inc.