WHISTLEBLOWING FOR ACCOUNTING FRAUD: RACING THE SEC'S ROBOCOP

By
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In recent years SEC cases alleging fraudulent accounting practices have been in decline (only 11% of enforcement cases in 2012). FCPA and insider trading cases are more exciting, and generate more media attention, while financial fraud can be more timew-consuming, difficult to detect and to prove. Nevertheless, when I was in the trial unit at the SEC, I enjoyed litigating these cases as they often involved complex facts, phony accounting entries, earnings management schemes, and a sort of cat-and-mouse game played against people we always thought were really bad guys taking advantage of gullible investors. We especially enjoyed catching high-level managers like CFO's, Controllers, and complicit legal or auditing gatekeepers. The SEC staff seemed to stumble into these cases in random ways, through tips, newspaper stories, and referrals from other agencies.

Fortunately, financial fraud is back in vogue at the SEC. The new Director, former prosecutor Mary Jo White, has announced that these cases will get renewed attention. Last July, the SEC announced new programs to discover accounting fraud through the creation of a new "Financial Reporting and Audit Task Force" and a "Microcap Fraud Task Force." Most interesting perhaps will be the impact of the work of a new "Center for Risk and Quantitative Analysis" (CRQA or "RiskFin"), headed up by former Vanderbilt University Economist Craig M. Lewis.

RiskFin is, according to Mr. Lewis, "developing cutting-edge ways to integrate data analysis into risk monitoring." This SEC geek squad will mine data tagged by the new XBRL reporting system to pick out financial reports that "appear anomalous" and will automatically flag them for review by an examiner. The SEC has come a long way from the days when enforcement lawyers in DC and New York would race to get the day's Wall Street Journal to hunt for potential investigation targets and claim the case first by getting to their computer at dawn to log in a MUI ("matter under investigation").

The computer models at RiskFin will, within a day of the filing of a 10K or other report, use the new XBRL tags to identify firms that have made unusual accounting choices relative to their peer group. As Mr. Lewis described it recently to the Merrill Disclosure Solutions Blog:

If a firm was having a down year and felt that the actual numbers were lower than its peer group, it may seek ways to try and boost income, maybe by not recording as much bad debt expense….A manager may simply say: "Well, it's a bad year; let's take something out of the accrual bank." To do this, one would then say: "These credits look solid to us; we don't think we're going to lose that much." In a good year, you look at the exact same set of accounts and you say: "You know something? A lot of these credits are likely to be unable to pay us, so we want to take a little more bad debt expense." This allows you to make a deposit to the accrual bank.

Mr. Lewis noted that looking at peer group firms is logical: "If you are an oil and gas producer, there are a lot of accounting rules about how oil and gas producers have to book income, account for reserves, etc. If you are a software manufacturer, those same rules would not apply to you, so you would not want to compare a software manufacturer against an oil and gas company." The new SEC system, informally being called the SEC's Robocop, is, as Lewis described it: "[A] fully automated system that effectively takes a firm's filing the day it comes in, processes it, and then keeps it in the database so that somebody who is interested in a report on that company would be able to do so within 24 hours of the filing being posted on EDGAR."

RoboCop (officially know as the Accounting Quality Model" AQM) can model and determine how much of the total reported accruals are "discretionary." As two astute observers recently wrote: "RoboCop's objective—to identify earnings management--is not a novel one; rather, it is the model's proficiency that should worry filers… [Robocop can classify] discretionary accruals as either risk indicators or risk inducers. Risk indicators are factors that are directly associated with earnings management while risk inducers indicate situations where strong incentives for earnings management exist. Based on a comparison with the filings of companies in the filer's industry group, [RoboCop] produces a score for each filing, assessing the likelihood that fraudulent activities are occurring." *Corporate Filers Beware: New "RoboCop" Is On Patrol,* Jay Carney and Francesca Harker, BakerHostetler, *Forbes.Com* , August 9, 2013.

Director Lewis, for example, cites as a potential "risk indicator" an "accounting policy that results in relatively high book earnings, even though the firms simultaneously select alternative tax treatments that minimize taxable income…[a]nother accounting policy risk indicator might be a high proportion of transactions structured as 'off balance sheet.'"

RoboCop will also be able to look for other potential fraud indicators such as frequent auditor changes or disagreements with auditors, and will be able to analyze the MD&A sections of annual reports to look for word and phrasing choices that are tip offs to fraud, based on similar language in past filings by known fraudsters. Lewis noted in a recent speech that "fraudsters have tended to talk a lot about things that don't really matter much and they under-report all the risks that other firms that aren't having these same issues talk quite a bit about." It is pretty scary to think that a computer at the SEC can figure all this out in a few seconds, without even taking a lunch break over at the Union Station food court.

Which brings me back to whistleblowing, a favorite subject as I represent whistleblowers and continually think I should be getting more clients (what lawyer doesn't?) given what I believe is the massive amount of accounting fraud still out there, undiscovered. If RoboCop works as planned, the SEC will be uncovering all that fraud first, although my experience with government programs is that they few work out as brilliantly as predicted. "The SEC has also said it plans to use the risk scores as a means of corroborating (or invalidating) the approximately 30,000 tips, complaints, and referrals submissions if estimates will be received each year through its Electronic Data Collections Systems or completed [whistleblower] forms TCR." *Carney and Harker*, id.

These observers also suggest that the SEC will use the RoboCop scores to weed out whistleblower complaints: "With the SEC's new whistleblower program in place, illegitimate tips from individuals seeking a payday are sure to increase dramatically. A low score from RoboCop will make tipsters' claims less likely to be investigated." While I tend to think the SEC will not turn away a good tip simply because the company's "score" suggests lack of fraud, I am concerned that the staff will tend to rely too much on the tireless RoboCop to target investigations that may catch some offenders while still missing many others.

Rather, I suggest that would be whistleblowers become their own, less mechanized, RoboCops, and utilize the tools the SEC is using to evaluate their own company, and perhaps others in the same industry, for the same red flags the SEC's in-house robotic wizard is supposed to uncover almost instantaneously. If you are familiar with your firm's accounting policies, its books and records, and the manner in which it books accruals, for example, or makes top-side entries each quarter, you may be able on your own to sniff out earnings management or similar forms of accounting fraud. Read your company's MD&A disclosure. Contrast it with what you know to be the true facts. Compare it to your peer companies. You may also be an in-house accountant or internal or external auditor, compliance officer, in house counsel, and know the truth, or be on terms familiar enough with one of the above to ask the right questions. Certain (usually junior) members of the external audit team often know where the bodies are buried and given a conscience and a few beers may be willing to unburden themselves.

While there are complicated rules for when such insiders can become whistleblowers, the bottom line is that the SEC rules, under the right circumstances, allow almost anyone inside or outside a company to become a whistleblower. The challenge is to get the facts, find the documents, and be sure to make your internal report first (if you choose to do so) and then your submission to the SEC, in accord with its procedures.[1]

The encouraging news is that the SEC is once again back in the business of pursuing accounting fraud, and has geared up with new teams of lawyers, accountants, and the omni-vigilant super staffer RoboCop to ferret out the fraudsters. Happily as well, the whistleblower who beats RoboCop to the evidence will presumably receive the lion's share of the award, because as good as it is, it will never occur to RoboCop to apply for a piece of the pie.

[1] I have tried to explain these rules and offer guidance in prior articles. See, e.g. Daniel J. Hurson, *"The 'New Rules' For Becoming A Successful SEC Whistleblower",* Mondaq News Service, August 2013"; Daniel J. Hurson, "*When Can the Independent Auditor Become An SEC Whistleblower?", M*ondaq News Service, Nov. 20, 2012.