5 Things Whistleblowers Should Know About Reporting Accounting Fraud to the SEC

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Accounting fraud hasn’t gone away – at all. While crypto scams and frauds have taken the spotlight recently, companies are still using accounting tricks to “cook the books” on a widespread scale. A new study titled How pervasive is corporate fraud? estimates that in an average year 41% of publicly traded companies misrepresent their financial reports and only one-third of corporate frauds actually come to light. Those statistics, while shocking, could actually increase in the current economy.

A Business Insider article titled Investors beware — the Great Fraud Reckoning is upon us reports that with “financial conditions tightening, the market is primed to put pressure on corporate balance sheets, tempting executives to cheat to meet Wall Street’s expectations.” Under pressure to “beat the street” or at least meet analysts’ consensus earnings estimates, corporate executives could resort to accounting fraud to distort mediocre results or hide dire financial conditions.

Warren Buffett has observed that “A rising tide floats all boats… only when the tide goes out do you discover who’s been swimming naked.” With the cost of borrowing increasing and a decline in the stock market, we are likely to discover accounting scandals that were concealed when interest rates were low and meme stocks were going “to the moon” without the financial performance to justify soaring valuations.

Whistleblowers will play a vital role in exposing and halting accounting frauds by reporting violations to the U.S. Securities and Exchange Commission (SEC). Disclosing fraud is risky and consequently many workers ignore the fraud or remain silent. The SEC Whistleblower Program provides strong incentives to report accounting fraud and important protections for whistleblowers.

1. Whistleblowers Can Anonymously Report Accounting Fraud to the SEC and Earn Awards

Under the SEC Whistleblower Program, the SEC is required to issue awards to eligible whistleblowers who provide original information about violations of the federal securities laws, including accounting violations and fraud, that leads to enforcement actions with total monetary
sanctions in excess of $1 million. In exchange for the valuable information, a whistleblower may receive an award of between 10% and 30% of the total monetary sanctions collected in the successful action.

If represented by an attorney, a whistleblower may submit a tip anonymously to the SEC. In certain circumstances, a whistleblower may remain anonymous, even to the SEC, until an award determination. However, even at the time of a reward, a whistleblower’s identity is not made available to the public. And the SEC is committed to protecting whistleblower’s identity to the fullest extent possible.

Since the inception of the SEC Whistleblower Program, the SEC has issued more than $1 billion in awards to whistleblowers. The largest SEC whistleblower awards to date are $114 million, $110 million, and $50 million.

2. Most Employees, Including Officers and Directors, Can Be Eligible for Awards

Generally, individuals who are integral to a company’s compliance are not eligible for awards, unless an exception applies (see below). These individuals include employees whose principal duties involve compliance or internal audit responsibilities, employees of public accounting firms, and the officers, directors, trustees, and partners of the relevant entity.

Three exceptions in the SEC Whistleblower Program’s rules allow these individuals to report to the SEC and receive awards if:

- They reasonably believe the disclosure is necessary to prevent conduct likely to cause substantial injury to the financial interest or property of the entity or investors;

- They reasonably believe the entity is engaging in conduct that will impede an investigation of the misconduct; or

- At least 120 days have passed either since they properly disclosed the information internally, or since they obtained the information under circumstances indicating that the entity’s officers (e.g., the entity’s audit committee, chief compliance officer, or their supervisor) already knew of the information.

The May 2011 SEC release (Release No. 34-64545) adopting the rules governing the SEC Whistleblower Program explains the rationale for limitations on the ability of particular categories of individuals to receive awards and the exceptions listed in the rules:

As a general matter, these individuals occupy sensitive roles that can enable them to identify and stop possible violations of the securities law, and their diligence in doing so can be an important factor that companies or other entities achieve compliance. Thus, we believe it is a more efficient and cost-effective use of the Investor Protection Fund to provide further incentive to these individuals to fulfill those responsibilities rather than allowing them to use knowledge of possible wrongdoing to obtain an award by reporting to the Commission. That said, we have recognized certain exceptions to the exclusions that, in our view, reflect situations where the benefit of paying an award—in terms of reducing the harm to the entity and investors, and in preserving our enforcement capacity—justifies the cost associated with a claim on the Investor Protection Fund.
3. Whistleblowers Should Know the SEC Whistleblower Program’s Rules Before Filing a Tip

When determining the amount of an award, the SEC considers various factors that may increase or decrease an award percentage of between 10% and 30% of the monetary sanctions collected in a successful enforcement action. Whistleblowers should consider these rules prior to filing a tip with the SEC to maximize their awards (among many other reasons, as detailed in the article 5 Tips for SEC Whistleblower to Get SEC Whistleblower Awards).

For example, the SEC may increase the amount of an award based on:

- The significance of the tip to the success of an enforcement action.
- The extent of the assistance that you and your legal representative provided in the SEC action or related action.
- The SEC’s law-enforcement interest in deterring the specific violation.
- Whether, and the extent to which, you participated in your company’s internal compliance and reporting systems.

Conversely, the SEC may reduce the amount of an award based on these considerations:

- If you participated in, or were culpable for, the securities-law violation you reported.
- If you unreasonably delayed reporting the violation to the SEC.
- If you interfered with your company’s internal compliance and reporting systems.

4. Accounting Fraud Enforcement Actions Often Lead to Significant Penalties

Eligible whistleblowers may receive awards of between 10% and 30% of the monetary sanctions collected in successful enforcement actions. SEC enforcement actions against accounting violations and improper disclosures can lead to significant penalties which, in turn, can lead to significant whistleblower awards. Indeed, over the past several years, some of the SEC’s largest enforcement actions were brought against companies engaged in accounting schemes and disclosure violations:

- On July 30, 2020, Bausch Health (formerly Valeant Pharmaceuticals) agreed to pay a $45 million penalty to settle charges of improper revenue recognition and misleading disclosures in SEC filings and earnings presentations.

- On December 9, 2020, General Electric agreed to a $200 million penalty to settle charges for disclosure failures in its power and insurance businesses.

- On December 16, 2020, Luckin Coffee Inc. agreed to pay a $180 million penalty to settle
charges of defrauding investors by materially misstating the company’s revenue, expenses, and net operating loss in an effort to falsely appear to achieve rapid growth and increased profitability and to meet the company’s earnings estimates.

- On September 3, 2021, The Kraft Heinz Company agreed to a $62 million penalty to settle charges that it engaging in a long-running expense management scheme that resulted in the restatement of several years of financial reporting.

5. A Wide Range of Accounting Violations Can Lead to SEC Whistleblower Awards

Former SEC Chair Mary Jo White emphasized that “comprehensive, accurate, and reliable financial reporting is the bedrock upon which our markets are based, and is essential to ensuring public confidence in them.” The SEC has taken significant enforcement actions to combat a wide range of financial frauds and issuer disclosure violations.

Improper Revenue Recognition

According to a Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002, during the five years preceding the enactment of SOX, the “SEC brought the greatest number of actions [involving issuer financial-report violations] in the area of improper revenue recognition: 126 of the 227 enforcement matters involved such conduct, including the fraudulent reporting of fictitious sales, improper timing of revenue recognition, and improper valuation of revenue.” The same remains true today. The following enforcement actions are examples of improper revenue recognition schemes that could qualify for an SEC whistleblower award.

- **SEC v. Gathright, et al.**

  The SEC charged SMF Energy and its officers with accounting fraud for inflating revenues through a fraudulent billing scheme. According to the SEC’s complaint, the billing scheme “increased the amount of gallons of fuel invoiced beyond what was actually delivered to customers,” which resulted in false and misleading disclosures in the company’s SEC filings. The billing scheme circumvented SMF Energy’s internal accounting controls and led to, among other things, materially overstated revenues, profit margins, shareholders’ equity, and net income in its SEC filings.

- **SEC v. MedQuist, Inc.**

  The SEC charged MedQuist with accounting fraud when it secretly inflated customer bills by increasing the number of lines of medical test that it purportedly transcribed. According to the SEC’s complaint, the “scheme was able to continue for several years because the unit of measure upon which bills to many customers were based . . . could not be verified by customers. Knowing that its customers were unable to verify line counts on bills, [MedQuist] . . . manipulate[d] line counts on customer bills to reach specific revenue and margin targets.”

- **In re L3 Technologies, Inc.**
The SEC charged L3 Technologies (L3) for failing to maintain accurate books and records and failing to maintain adequate internal controls when the company improperly recorded $17.9 million in revenue from a contract by creating invoices associated with unresolved claims that were not delivered when the revenue was recorded. According to the SEC’s order, employees “immediately reported concerns regarding potential violations of L3’s accounting policies and internal accounting controls to L3’s internal ethics department,” but the subsequent ethics review failed to uncover the misconduct due, in part, to “a failure by ethics investigators to adequately understand the billing process.”

- **SEC v. Putnam, et al.**

The SEC charged Anicom Inc. and its directors with violating federal securities laws after the company falsely reported millions of dollars of nonexistent sales to inflate net income by more than $20 million. According to the SEC’s complaint, Anicom included in its financial statements millions of dollars in sales to a fictitious customer, SCL Integration.

- **SEC v. Tangoe Inc., et al.**

Tangoe, Inc. paid $1.5 million to settle charges that it reported revenue prematurely for work that had not been performed and for transactions that did not produce any revenue at all. According to the complaint, the violations included: “1) counting customers’ prepayments for future services as current revenue; 2) improperly recording a loan from a business partner as revenue; 3) recording revenue in the wrong reporting periods; 4) prematurely recording revenue from contingent fee arrangements; 5) recording revenue from customers who were unlikely to pay; 6) violating the accounting rules for bad debt reserves; and 7) prematurely counting revenue from long-term contracts with ongoing obligations.”

**Inadequate Internal Accounting Controls**

- **In re Monsanto Company, et al.**

On February 9, 2016, the SEC announced that Monsanto agreed to pay an $80 million penalty for inadequate internal accounting controls. According to the SEC’s order, the company failed to properly account for millions of dollars in rebates offered to retailers and distributors of Roundup after generic competition had undercut its prices and caused the company to lose significant share in the market. Monsanto booked substantial amounts of revenue from sales incentivized by the rebate program, but failed to recognize all of the related program costs at the same time.

**Improper Accounting of Expenses**

- **SEC v. Penn West Petroleum, et al.**

Penn West, a Canadian-based oil and gas company agreed to pay $8.5 million in civil penalties for fraudulently moving hundreds of millions of dollars in expenses from operating expense accounts to capital expenditure accounts. This accounting fraud artificially reduced the company’s operating
costs by as much as 20 percent in certain periods. The object of the scheme was to deceive investors about a key publicly reported metric concerning the cost of oil extraction and processing needed to sell a barrel of oil.

As alleged in the SEC’s complaint, Defendants engaged in three principal types of improper accounting practices in furtherance of their scheme:

- Defendants improperly moved certain expenses that had been recorded in Penn West’s operating expense accounts to its capital expenditure accounts, a reclassification practice known internally at Penn West as “reclass to capital.” This had the effect of moving the expenses from the company’s income statement, where they appeared as expenses, to the company’s balance sheet, where they appeared as assets, thus lowering the company’s reported operating expenses and making it appear that Penn West was investing capital in support of increased production.

- Defendants improperly moved certain operating expenses to Penn West’s royalty account, a line item on the company’s income statement intended to show money expended paying royalties to the owners of land on which Penn West drilled. This practice was referred to internally as “reclass to royalty.”

- Defendants improperly took excess operating expense amounts that had been accrued in prior accounting periods, but not expended, which should have been written off, and instead reduced those accruals in subsequent periods to reduce Penn West’s operating expenses and make them appear more consistent over the course of the year. This practice was referred to internally as “accrual softening.”

**Channel-Stuffing**

- **SEC v. Asti**

On April 27, 2015, the SEC obtained a $131 million judgment against Symbol Technologies Inc. for fraudulent revenue-recognition practices, including quarter-end “stuffing” of Symbol’s distribution channel to help meet revenue and earnings targets imposed by its CEO.

- **SEC v. Bristol-Myers Squibb Company**

On August 4, 2004, Bristol-Myers Squibb agreed to pay a $150 million fine for selling excessive amounts of pharmaceutical products to its wholesalers ahead of demand in order to falsely inflate earnings. The channel-stuffing resulted in the company improperly recognizing revenue from $1.5 billion in sales to its two largest wholesalers. In addition, the SEC filed charges against two former Bristol-Myers officers for the fraudulent earnings management scheme.

For additional information, see our article on how to report channel stuffing and earn an SEC whistleblower award.

**Fraudulent Management Estimates and “Cookie Jar” Reserves**
In re Computer Sciences Corporation, et al.

On June 5, 2015, Computer Sciences Corporation agreed to pay $190 million to settle charges that the company engaged in a wide-range accounting-and-disclosure fraud that materially overstated its earnings and concealed from investors significant problems with its largest contract. According to the SEC’s order, the company’s former Finance Director prepared a fraudulent accounting model in which he included made-up assumptions to avoid reporting a negative hit to the company’s earnings. The company also overstated its earnings by using “cookie jar” reserves and by failing to record expenses as required.

Improper Post-Closing Entries

In re Weatherford International, et al.

On September 27, 2016, Weatherford International agreed to pay a $140 million penalty to settle charges that it inflated its earnings by using deceptive income-tax accounting. According to the SEC’s order, Weatherford fraudulently lowered its year-end provision for income taxes each year so the company could better align its earnings results with its earlier-announced projections and analysts’ expectations. The company lowered its year-end provision for income taxes by making numerous post-closing adjustments to fill gaps and meet its previously disclosed effective tax rate.

Improper Asset Valuations

In re Miller Energy Resources Inc., et al.

On August 6, 2015, Miller Energy Resources Inc. was charged with inflating values of oil and gas properties, resulting in misstated financial statements. According to the SEC’s order, the company overstated the properties’ value by more than $400 million as a result of the CFO’s relying on a reserve report that did not reflect fair value of the assets. In addition, the CFO double-counted $110 million of fixed assets already included in the reserve report.

Misleading Non-GAAP Financial Measures

SEC v. SafeNet, Inc., at al.

The SEC issued new guidance on its interpretation of the rules and regulations on the use of non-GAAP financial measures. In a previous enforcement action, the SEC fined a company more than $1 million for misleading non-GAAP financial measures.

We have been privileged to successfully represent accounting fraud whistleblowers at the SEC. While most of the sanctions in the enforcement actions that stemmed from our client’s disclosures consist of disgorgement and penalties, these enforcement actions also held individuals accountable by imposing penalties on the masterminds on the culpable individuals and barring them participating in the financial reporting of public companies or suspending them from appearing before the SEC as an accountant for a certain period of time. By helping the SEC hold individuals accountable for
accounting fraud, our courageous whistleblower clients help the SEC deter senior executives and final reporting professionals from engaging in accounting fraud.

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Source URL: https://www.natlawreview.com/article/5-things-whistleblowers-should-know-about-reporting-accounting-fraud-to-sec