

Misstatement Amounts and Associated Penalties for Fraudulent Financial Reporting

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Abstract

This paper examines recent civil lawsuits brought by the Securities and Exchange Commission (SEC) for trends in legal action taken against companies and individuals engaged in fraudulent financial reporting. In many cases, corporate executives benefit from manipulating financial statements but seem to face little to no consequences when the fraud is uncovered. In this study, SEC fraud cases are followed from investigation to prosecution or settlement. The misstatement amounts are compared against the amount of any penalties and other legal consequences. Suggestions are then made for deterring fraudulent reporting in the future.

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1. Introduction

News outlets have reported numerous corporate fraud scandals focusing on large public firms. These firms misstated their financial reports and created a public perception of greater profitability and stability. The stockholders who invested in these companies lost billions of dollars once the fraud was detected and, in some cases, the companies collapsed. At the same time top executives often received generous compensation packages and other company benefits while masking financial problems through misstated Securities and Exchange Commission (SEC) filings. A study by the Committee of Sponsoring Organizations (COSO) in 2010 found that the instances of fraudulent reporting had grown from 294 to 347 cases in the last decade and the losses have become magnified while little accountability was demanded of executives who had profited from these actions (Beasley, Carcello, Hermanson, & Neal, 2010).

This paper will investigate these allegations. Specifically, this paper examines the most recent civil lawsuits brought by the Securities and Exchange Commission (SEC). Each case is followed from the fraud detection date through investigation and sentencing. The estimated misstatements are compared with the penalties and fines imposed in each case. Finally, suggestions are made to discourage fraudulent financial reporting.

Generally Accepted Accounting Principles (GAAP) have been established by the Financial Accounting Standards Board (FASB) in order to regulate accounting practices in the United States. Adherence to these principles is required by the SEC for publicly traded companies. GAAP enables users to objectively compare financial reports of companies. The SEC files actions against the companies known to be in non-compliance with GAAP as well as any related executives who perpetrated or had knowledge of fraudulent activity.

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The top managers and executives responsible for misleading investors may face legal penalties that are insufficient given the loss in firm value and executive gains. Some judges, such as U.S. District Judge Frederic Block in N.Y., find there is also a gap between “losses to investors and the financial punishment agreed to by the SEC with company executives” (Eaglesham, 2012). For example, Symmetry Medical Inc. overstated net income by approximately \$52.4 million over six years and paid its CFO a \$185,000 bonus, but the executive was ordered to pay only \$25,000 in civil penalties after reimbursing the company for the bonus (SEC Litigation Release No. 66268, 2012). Furthermore, a study conducted in 2006 found that for 585 firms facing SEC enforcement actions, regulatory fines totaling \$5.028 billion were imposed. This represents only 3.1% of the estimated \$161.3 billion aggregate loss in firm value (Karpoff, J., Lee, D., & Martin, G., 2006).

In addition to monetary penalties, the SEC may also bar executives from serving as an officer or director of a public company, as in the judgment against Thor Industries in May 2011. In this case the company’s Chief Financial Officer was ordered to pay a total of \$394,830 in penalties and interest and was permanently barred from serving as an officer or director of a public company for fraudulently reporting income (SEC Litigation Release No. 21966, 2011).

It stands to reason that upper-level management would gain the most from manipulating financial statements. Executive compensation packages are often tied to the stock price and to the performance of the company. Additionally, the pressure to meet performance standards may encourage managers to manipulate financial reports. For example, companies must report sufficient earnings to meet debt and other covenants or competitors and financial analysts may put external pressure on the executives to meet share price expectations (Albrecht, Albrecht, & Dolan, 2007). In fact, a study by the Committee of Sponsoring Organizations (COSO) in 2010

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revealed that the Chief Executive Officer (CEO) or Chief Financial Officer (CFO) was involved in 89 percent of fraud cases between 1997 and 2007 (Beasley, Carcello, Hermanson, & Neal, 2010). Similarly, the SEC found that financials were falsified to not only meet performance expectations but also to raise stock prices and improve the terms for debt and equity financing and that, as these measures improved, executives benefitted by receiving greater performance based compensation (Beasley et al., 2010).

While there seems to be much to gain from financial statement manipulation, it may be possible to deter fraud by imposing harsher penalties and making the potential gains appear less attractive. If the size of the penalties imposed by the SEC offset the gains of executives, then corporate officers will be less likely to misstate financial statements. Otherwise, they may be motivated to engage in fraudulent activity at least some of the time. In order for penalties to effectively reduce fraud, it is also important to ensure that adequate penalties are imposed in all cases of fraud detection so that executives can predict the consequences of their illegal actions (Sen, 2007).

This paper is an exploratory study of the penalties imposed on individuals engaged in fraudulent financial reporting from January 2010 to January 2012. The remainder of this paper is organized as follows: part two describes the Enron scandal, part three highlights important legislative changes, part four describes the SEC civil enforcement process, part five presents data from the SEC, and part six offers the conclusion and suggestions for improvement.

2. The Impact of Enron

The case of Enron Corporation is one of the most widely recognized fraud scandals in recent history. Enron overstated the value of its assets and also undervalued or omitted its

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liabilities. Revenues were inflated as a result of questionable accounting tactics, such as estimating and including future income from contracts in current period earnings (Healy & Palepu, 2003). Enron executives and managers were compensated heavily in stock options. These options were linked to short-term stock price, creating an incentive for Enron executives to continually inflate earnings, keeping both Wall Street expectations and stock prices high. Enron essentially bought the compliance of auditors at Arthur Andersen and hired accountants to exploit weaknesses in GAAP. Enron was being traded at 55 times its earnings in 2001 just before it collapsed (McLean, 2001). In November of 2001 Enron's stock price plummeted as it became evident there was little financial backing to its inflated earnings. The company's \$23 billion in liabilities could not be paid, leading Enron to file for Chapter 11 bankruptcy ("An Implosion on Wall Street", 2001).

It is estimated that shareholders in Enron lost close to \$74 billion when the stock price collapsed. They eventually recovered approximately \$7.2 billion of those losses in 2008, most of which were paid by banks engaged in fraudulent dealings with Enron (Hays, 2008). Most shareholders did not recoup even 10 percent of their losses, as lawyer fees were included in this settlement. CEO Kenneth Lay was faced with a possible 45 years in prison but died before sentencing. Former CEO Kenneth Rice was fined \$50,000 and sentenced to 27 months in prison (lessened for cooperating with authorities). Former CEO Jeffrey Skilling was sentenced to 24 years and fined \$45 million, while other executives were given lesser sentence terms (Porretto, 2007).

The penalties assigned to these fraudsters seem small relative to shareholder losses. For some, it may almost seem worth taking a risk in committing fraud. Most of the Enron executives were sentenced to less than 10 years in prison. Many of those involved were never prosecuted.

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The \$50,000 fine given to CEO Kenneth Rice seems insignificant given the losses of shareholders and employees who have forfeited pension plans and lost their jobs.

The collapse of Enron greatly undermined investor confidence. Other public companies found it difficult to raise capital and lost a combined \$7 trillion in stock market value in the years following the scandal (Iwata, 2006). This strong public response prompted Congress to pass legislation to strengthen the integrity of financial reporting.

3. Legislation in Response to Fraud

Improvements in fraud regulation have been needed for some time. The *Report on National Commission on Fraudulent Financial Reporting* issued by COSO in 1987 recommended the need for a “strengthened regulatory and legal environment” in response to fraudulent financial reporting. This would include more severe penalties, increased criminal prosecution, and an enhancement of SEC resources (Report of the National Commission, 1987). The Sarbanes-Oxley and Dodd-Frank Acts have been the most recent legislative actions affecting fraud regulation.

Sarbanes-Oxley Act of 2002

In response to the collapse of Enron and the exposure of other fraud scandals, the Sarbanes-Oxley Act (SOX) was passed by Congress in 2002. Provisions of SOX include requiring management to report on internal controls, requiring more financial disclosures, providing whistleblower protection, and imposing greater corporate accountability. The Sarbanes-Oxley Act also provides legal consequences for violating these provisions. Criminal penalties are issued by the U.S. Department of Justice and individual U.S. attorney’s offices. The following sections address potential penalties and other actions:

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Section 802. This section makes the destruction of records relating to an investigation by an agency of the United States a criminal offense. This is punishable by a fine or imprisonment of up to 20 years (Sarbanes-Oxley, 2002). Such a rule increases the likelihood that relevant records are kept by a company. This is important because the records provide important evidence of financial reporting deficiencies and misconduct. Keeping them will facilitate audit quality which may strengthen the reliability of financial reporting as well as investor confidence. (Final Rule: Retention of Records, 2003)

Section 906. The criminal penalties imposed for fraudulently certifying financial reports are addressed in Section 906. Corporate officers may be subject to fines of up to \$5 million and/or imprisonment of up to 20 years (Sarbanes-Oxley, 2002). This provision increases the risk associated with financial statement manipulation because the CEO and CFO are criminally liable for misstatements (Levin, Primis, & Urgenson, 2002).

Section 1105. The SEC is given the authority to prevent someone from serving as an officer or director if their conduct is in question (Sarbanes-Oxley, 2002). This order may be temporary or permanent, based on the SEC's discretion on whether the person is fit to serve. The SEC considers the likelihood of recurrence when making such a decision. Officers are barred from serving in order to prevent fraud perpetrators from "serving as fiduciaries to the public" and to protect investors (Carlson, 2009).

Evidence has shown that Sarbanes-Oxley has been effective in preventing fraud. Incidences of earnings management as well as class action lawsuits related to fraud fell after the implementation of the Act (Coates, 2007). Subsequent surveys show a rise in investor confidence (Coates, 2007).

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Dodd-Frank Act

In early 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed by Congress in response to the financial crisis of 2008. The crisis and subsequent recession were a result of banks providing too many sub-prime mortgages, the failure of Congress to regulate financial institutions, and failures of corporate governance at financial institutions (The Financial Crisis Inquiry Report, 2011). Although the Act was created to regulate financial institutions, the following provision regarding executive compensation also impact nonfinancial companies:

Section 954. This section implements a clawback requirement. Clawbacks are intended to limit the risk of financial manipulation by taking away monetary incentives associated with such misconduct (Earle, J. & Wilkerson, A., 2011). If a material misstatement is found in the financial reports, then any incentive-based compensation received by executives in the three years preceding a restatement must be repaid (in excess of what should have been paid if the financials had been correct) (Dodd-Frank, 2010).

Although the clawback requirement will not become effective until the first half of 2012, hundreds of companies have already implemented the provision voluntarily. Studies suggest that those firms implementing clawbacks have improved the quality of financial reporting and investor confidence by reducing the incentive to manipulate financial statements (Dehaan, Hodge, & Shevlin, 2011).

4. SEC Accounting and Auditing Enforcement Releases (AAER)

The SEC regulates publically traded companies and is concerned with promoting the disclosure of accurate information and protecting against fraud. It has authority to investigate

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individuals and companies for security law violations. The Division of Enforcement of the SEC is responsible for these investigations and may recommend the SEC bring civil actions before an administrative law judge. Additionally the Division may work with other law enforcement agencies on criminal cases (The Investor's Advocate, 2012).

An SEC investigation may be initiated in response to referrals from government agencies, examinations of report filings, and public complaints among other sources. During an investigation, public documents are examined, witnesses are asked questions, and auditor's work papers may be examined. If it is determined that a securities law has been violated, the investigation staff will make a recommendation for further proceedings (International Institute for Securities Market Development, 2005).

The SEC may pursue either civil or administrative actions against defendants. In civil proceedings, the SEC will file a complaint with the appropriate U.S. District court seeking an injunction (prohibiting further violations of SEC rules). These proceedings may also seek civil monetary penalties, disgorgement (return of fraudulent gains), or suspensions of corporate officers. The SEC currently can impose civil penalties of \$150,000 per violation for individuals (Adjustments to Civil Monetary Penalty Amounts, 2009). If administrative actions are taken, the case is then heard by an administrative law judge and an initial decision is issued. This decision may later be appealed, affirmed, or reversed by the SEC. Administrative sanctions may include cease-and-desist orders, censures, civil monetary penalties, and disgorgement (The Investor's Advocate, 2012).

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5. Data Description

This study examines the Accounting and Auditing Enforcement Releases provided in the litigation section of the SEC website. Each enforcement release states the defendants charged, provides a summary of the violations, and describes any court actions taken. A brief note of any criminal charges pending by the U.S. Attorney's Office may be stated near the end of the release. A more detailed SEC complaint is also often provided. Information was gathered for 39 companies charged with fraudulent financial reporting from January 2010 to January 2012. The amount of the fraudulent misstatements and executive penalty amounts to date were then compiled into a chart for comparison. The following ten companies provide a representative sample of the cases examined:

Company	Misstatement Amount	Executive Civil Penalties	AAER Release No.
Symmetry Medical	\$52.4 million	\$25,000	3358
Deerfield Capital	\$3.6 million	None	3237
DHB Industries	\$233 million	None	3247
Michael Baker	\$7.3 million	\$51,930	3279
Thor Industries	\$27 million	None	3280
Verint Systems	\$6.5 million	None	3117
Collins & Aikman	\$49 million	\$610,000	3127
Trident Microsystems	\$37 million	\$400,000	3154
Affiliated Computer Services	\$51 million	None	3182
Vitesse Semiconductor	\$ 245 million	None	3217

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All of the ten companies above reported multi-million dollar misstatements, yet in only four cases did executives face a civil penalty. In those instances the penalties were significantly lower than the misstatements and perhaps could be considered inconsequential, with the largest individual amount of \$400,000 being imposed on the CEO of Collins & Aikman.¹ Executives were barred from performing as a director or officer before the SEC permanently in the case against Thor Industries and only temporarily for Trident Microsystems. Two cases are still pending with respect to director or officer bars (DHB and Vitesse Semiconductor). Civil penalties and other administrative actions have been pending the outcome of criminal proceedings for DHB and Vitesse Semiconductor since February 2011 and December 2010, respectively.

6. Conclusion and Suggestions

The civil lawsuits presented in this paper are representative cases of the many fraudulent financial reporting schemes investigated by the SEC. Often the final judgments impose penalties that are seemingly disproportionate to the misstatement amounts. Symmetry Medical, for example, overstated revenues by approximately \$52.4 million over five years, yet the CFO faced civil penalties of only \$25,000 and reimbursement of bonuses of \$185,000.

In fact, in some instances the executives were repeat offenders, having faced SEC charges in the past. For example, David Brooks was able to serve as CEO of DHB following prior charges of insider trading in 1992. In this case, the SEC penalty previously imposed did not seem to effectively prevent Brooks from later committing fraud again.

¹ Note that the clawback provisions of Dodd-Frank have not yet gone into effect.

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It is suggested that the SEC impose harsher penalties on executives in order to sufficiently reflect the magnitude of the financial misstatements. SEC chairperson, Mary Schapiro, proposed calculating penalties as some multiple of the disgorgement amount and increasing penalties for repeat offenders (Kadziolka, 2011). This method of assignment would attempt to link penalty amounts to the profits made by an individual. Fraud may also be deterred if the time between investigation and prosecution is shortened. Research suggests that the immediacy of punishment is important in discouraging future behavior (Perry, Erev, & Haruvy, 2000). The effectiveness of civil penalties may be diminished if they are pending for two years or more, such as in the proceedings against Vitesse Semiconductor Corp. In summary, the consistent application of more aggressive penalties in a timely manner might deter other companies from falsely reporting financial information.

This exploratory study examines the misstatement amounts and individual penalties for fraudulently reporting companies. Further research is needed to compare shareholder losses to the penalty amounts. Suggestions for further research include examining civil lawsuits against companies for shareholder settlements, which could serve as a proxy for shareholder losses. An assessment could then be made on whether individual penalties are sufficient to compensate for shareholder losses and deter future fraudulent reporting.

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