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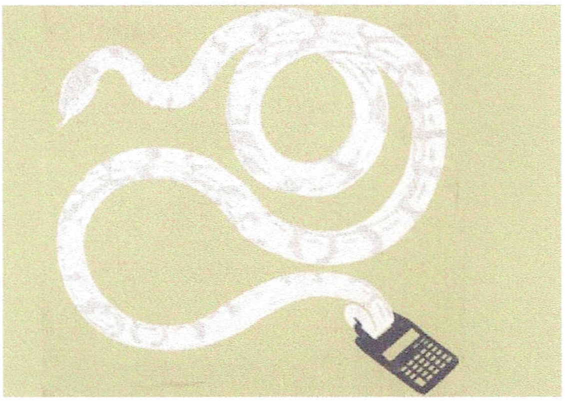
Is The SEC's Ponzi Crusade Enabling Companies To Cook The Books, Enron-Style?



Enron. Qwest. Adelphia.

Sunbeam. WorldCom. HealthSouth. A decade ago investors knew what those companies had in common: top executives who cooked the books. After their phony accounting was exposed, most went to jail–and hundreds of billions of dollars of shareholder wealth evaporated.

The Securities & Exchange Commission remains quite busy. In fiscal 2011 the agency brought a record 735 enforcement actions. But those looking to see the next Jeff Skilling or Richard Scrushy frog-marched in front of television cameras will be sorely disappointed. Only 89 of those actions targeted fraudulent or misleading accounting and disclosures by public companies, the fewest, by far, in a decade.

So what happened? Call it the Bernie Madoff effect. Embarrassed that it missed the Ponzi King's $65 billion scheme, the SEC reorganized its enforcement division, eliminating an accounting-fraud task force and adding new units to pursue crooked investment advisors and asset managers, market manipulations and violations of the Foreign Corrupt Practices Act. Since then Pfizer, Oracle, Aon, Johnson & Johnson and Tyson Foods have all paid fines to settle foreign-payoff charges.

That's all fine and good. But remember this: Foreign-payola charges (absent alleged accounting abuses) have minimal effect on a company's stock. Accounting fraud risks massive market disruption. Groupon, Zynga and Green Mountain Coffee Roasters are all down at least 75% in the past year, amid doubts about their accounting and prospects. And those examples don't even carry allegations of illegality.

Is a stretched SEC neglecting accounting fraud? In a statement to FORBES, SEC Enforcement Director Robert Khuzami argued that the task force was no longer needed because accounting expertise exists throughout the agency, and the number and severity of earnings restatements (a flag for possible accounting fraud) has declined dramatically since the mid-2000s. He added: "In a world of limited resources, we must prioritize our efforts. ... The reorganization helped to focus us on where the fraud is and not where the fraud isn't, while allowing us to remain fully capable of addressing cases of accounting and disclosure fraud."

Accounting experts agree that the Sarbanes-Oxley Act of 2002, Congress' response to Enron, has reduced abuses. But they worry the SEC is risking those gains. "The SEC enforcement of Sarbanes-Oxley has been minimal," says Jack Ciesielski, a CPA who sells accounting alerts to stock analysts. "Sarbanes-Oxley may have bought us some peace for our time, but without vigilance through long-term enforcement, it can't last."

Anyway, it's not like all numbers games have ceased. Public company CFOs, responding to a survey last year by Duke and Emory business profs, estimated that 18% of companies manipulate their earnings, by an average of 10%, in any given year–to influence stock prices, hit earnings benchmarks and secure executive bonuses. Most of this finagling goes undetected.

Sarbox aimed to limit accounting shenanigans by requiring companies to set up internal accounting controls and CEOs and CFOs to personally "certify" financial statements, risking civil and even criminal penalties if they knowingly signed off on bogus numbers.

In addition, public auditors were required to flag any "material weaknesses" in a company's internal controls, presumably providing an early warning to companies, investors and the SEC.

How's that working? A study by two University of Connecticut accounting professors found auditors have waved the weakness flag in advance of a small and declining share of earnings restatements–just 25% in 2008 and 14% in 2009, the last year studied. There was no auditor warning before Lehman Brothers' 2008 collapse, even though a bankruptcy examiner later concluded it used improper accounting gimmicks to dress up its balance sheet. And no warning before Citigroup lowballed its subprime mortgage exposure in 2007. (It paid a $75 million SEC fine.)

Instead, companies and auditors flag material weaknesses as they're restating earnings–that's what JPMorgan did in August when it revised first-quarter earnings to show $459 million more in losses from "the London Whale's" trading bets than it first reported.

Yet another Sarbox provision, absent vigorous SEC enforcement, may even be leading, perversely, to less disclosure of accounting problems. It provides that a year of performance-based pay can be "clawed back" from a CEO or CFO who signed off on earnings that have to be restated. Thus executives have a financial incentive to handle problems they discover quietly–either internally or with an "earnings revision" instead of a restatement. Last year revisions (as opposed to formal restatements) accounted for 57% of 727 earnings fixes, up from 33% of 1,384 fixes in 2005, Audit Analytics reports.

Never heard of a "revision"? Companies and auditors like it that way. With a formal restatement, a company must file a special form, 8-K, calling attention to its corrections. With a revision it can fix flawed accounting without filing an 8-K or formally restating old earnings, since the change supposedly isn't "material." With a revision executives' prior pay isn't at risk, auditors don't have to retract their approval of earlier statements, and there's usually little impact on the stock and so no investor lawsuits.

"The auditors are highly self-interested in accepting clients' desire not to restate, and the quality of financial reporting suffers," complains Salvatore J. Graziano, a partner at securities class action firm Bernstein Litowitz Berger & Grossmann. He says his firm has seen revisions used for "material writedowns to financial reserves, deferred tax assets or goodwill."

Egregious example: In 2010 Green Mountain, which sells Keurig brewers and K-Cups, said it had found an "immaterial accounting error" in the "inter-company markup in its K-Cup inventory balance" that would be fixed with a revision in one quarter. Its auditor, PricewaterhouseCoopers, signed off on that approach. Yet after the SEC raised questions the company ended up restating earnings from 2007 through the third quarter of fiscal 2010 to address that and other errors. PricewaterhouseCoopers, for its part, then flagged (retrospectively) material weaknesses in Green Mountain's internal controls but stated they'd been fixed. The SEC is still investigating.

A big unknown: whether insider tips flowing into the SEC since the Dodd-Frank Act authorized whistle-blower rewards will lead to more cases. Without insider help, accounting fraud is one of the "most challenging" securities violations to investigate, says Thomas A. Sporkin, a partner at Washington's Buckley Sandler who until June headed the SEC's Office of Market Intelligence, which screens tips.

A complaint one informant filed last year and shared with FORBES shows how whistle-blowers can cast arcane accounting decisions in a harsher light. Until he was let go he was a salesman at SuccessFactors, a maker of cloud-based human resources software, acquired by SAP for $3.4 billion this past February.

A perennial issue for enterprise software companies is when to recognize revenue from multiyear contracts. (It was at the root of the scandal that landed former Computer Associates CEO Sanjay Kumar in the federal pen.) Under GAAP companies can book current revenue only after services are delivered, even if they've been paid in advance. A 2009 SEC rule further limited their ability to manipulate revenue recognition on multiyear contracts. In the third quarter of 2010 Success?Factors said it had adopted that new rule and that it would boost 2010 revenue by $12.1 million. (Later, in its 2011 annual report, the company cited "material weaknesses" in the way it calculated that impact.) Meanwhile, at the end of 2009 SuccessFactors stopped reporting "backlog"–a non-GAAP metric it had used to show future fees from multiyear cloud subscriptions. When the SEC asked why backlog had disappeared, SuccessFactors responded that investors hadn't found it useful.

A pattern? The whistle-blower claims that salespeople improperly rewrote existing multiyear subscriptions as new contracts–which might have allowed the company to accelerate revenue while reducing the backlog number. SAP said it is cooperating with the SEC and that its own "thorough" investigation, conducted by an outside law firm, found "no merit" to the claims.

Given all this, how can you check for accounting risk in the stocks you own? Here are seven sure ways:

Scrutinize earnings revisions. Even though an 8-K filing isn't required, as it is with a restatement, you can usually find the details of any revision in a company's quarterly 10-Q or annual 10-K.

Read the SEC's mail. SEC letters questioning a company's financial statements, as well as the company's responses, can be found through an Edgar search on the SEC's site. The SEC does not make letters public for up to 20 business days after completing its review of a filing. But if it had a lot of questions, maybe you should, too.

Watch for changes in auditors. Notably 26% of firms accused by the SEC of fraudulent accounting between 1998 and 2007 changed their auditors just before or during their fraud–more than double the rate at which firms with clean accounting switched.

Track the shorts and the chatter. Short-sellers aren't always right about a stock, but some are good at sniffing out accounting problems. If a stock has a high or rising short interest, dig deeper at member sites such as ShortSqueeze and ValueForum or search for the pros' takes at Forbes.com and SeekingAlpha.

Look for anomalies in the financials. If revenue keeps rising while the workforce, facilities and backlog/bookings shrink, it could be a red flag for revenue manipulation. If revenue is going down but net income always hits targets, accounting tricks may be in play. Other tip-offs: earnings rising when cash flow isn't, an unexplained buildup in inventories and unusual swings in accruals.

Beware highfliers. Low-multiple companies cook the books, too, but young, hot companies face pressure to justify their lofty multiples and often have less-well-developed internal controls. Plus, it takes regulators time to issue new accounting guidance for new industries, like social media and cloud computing. That leaves open a window for the companies and their auditors to creatively interpret GAAP.

Watch for repeat offenders. Navistar's accounting problems led it to be delisted from the NYSE for 16 months during 2007 and 2008. Daniel Ustian, the CEO during that period, agreed with the SEC to pay back $1.3 million in incentive pay but continued running the company–until this past August, when it suffered a big loss and disclosed that the SEC was again questioning its accounting. He took a sudden retirement.