# Update: SEC's Financial Reporting and Audit Task Force

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On February 11, Margaret McGuire, Vice Chair of the US Securities and Exchange Commission's (SEC) Financial Reporting and Audit Task Force (Task Force), participated in a DC Bar panel discussion to review the objectives, administration and early initiatives of the Task Force since its formation was announced by the SEC last July.[1] Below is a summary of some of the key points that emerged from McGuire's comments.

**The SEC's Objective in Creating the Task Force**

McGuire explained that the Task Force's goal is to catch financial reporting fraud at an earlier stage than in the past. McGuire noted that the number of financial reporting enforcement actions had dropped, as had the number of pure restatements, but suggested that this trend may reflect the SEC's failure to discover latent instances of fraud, as opposed to fewer instances of fraud. McGuire also acknowledged an increased focus on these issues by companies, audit committees and accounting firms.

**The Task Force's Organization**

The Task Force has 12 members—split between lawyers and accountants—who were selected after a well-subscribed application and vetting process. The members are detailed to the Task Force for the duration of its one-year mandate (which is subject to renewal). Each lawyer has accounting experience. One accountant is from the Office of the Chief Accountant (OCA); the others are from regional offices. Together, the current members have a combined 125 years of enforcement experience investigating financial reporting fraud.

The Goals and Initiatives of the Task Force

In contrast to the former SEC accounting fraud task force, which was created in the wake of the Enron accounting scandal to handle volume and conduct investigations on the back end, this Task Force will take a more novel approach and seek to generate and refer cases on the front end. McGuire highlighted five different goals of the Task Force:

1. ***To develop a deep understanding of financial fraud***. The Task Force intends to be proactive and explore the origins of financial reporting fraud and the susceptibility of particular areas and industries. Accounting issues are often identified a number of ways, whether within the agency or outside the agency (*e.g.*, whistleblowers, fellow regulators, the media, or class action suits), but often a combination of sources informs the identification of an issue to the Task Force.

   Although it will rely on tried-and-true methods, the Task Force's key initiative will focus on analyzing and exploring trends and patterns of conduct. In discussing areas of focus, McGuire listed, among others, revenue recognition, off-balance-sheet transactions, and multiple revisions of financial statements over a number of years by the same business segment. The Task Force also employs industry-specific initiatives to help it understand issues or metrics that occur in some industries more than others (*e.g.*, one Task Force member may review one industry so expertise is applied most efficiently). In addition, the Task Force fully expects to liaise with the Division of Corporation Finance in connection with issuer review and perform some of the traditional tasks of the OCA, but it will ultimately act in different spheres and approach its work in a more holistic fashion.

2. ***To develop state-of-the-art methodologies to identify financial fraud***. The SEC expects to continue developing and employing several methodologies, such as the Accounting Quality Model (AQM) developed by the SEC's Division of Economic and Risk Analysis, to identify issues and matters earlier than before. The subject of much discussion, AQM is a quantitative computer model with two components: (1) text analytics and (2) data analytics. The agency intends to use the model in a number of different applications, but McGuire reassured the audience that it would not be used by the Task Force to generate a list of disclosure anomalies that would shift the burden of explanation to companies or subject them as a matter of course to having the SEC's Enforcement Division open an informal inquiry. Human judgment remains a key component of any Enforcement investigation, and there would have to be a myriad of data sources suggesting a potential issue before the Task Force would act in a space in which it is not presently acting.

3. ***To share information and resources within the agency***. Financial reporting fraud may be part of any Enforcement investigation, and the Task Force seeks to draw on the tremendous amount of experience within the Enforcement Division. It also will provide guidance on best practices on financial reporting fraud issues to Enforcement staff.

4. ***To collaborate beyond the agency with other fellow regulators***. McGuire noted the close and successful working relationship with the Public Company Accounting Oversight Board.

5. ***To engage the public, academia and whistleblowers to inform the Task Force's work***. McGuire said the Task Force welcomes all "good ideas." She cited several studies concerning the probability of financial reporting fraud—including correlations between

propensity to commit this type of fraud and economic prosperity; the number of the CEO's speeding tickets; and the size of the CEO's yacht or house—to (1) illustrate the broad scope of available research to aid the Task Force's work; and (2) support the idea that, as long as human beings run corporations, there is always the chance of lax internal controls and fraud.

**Investigations by the Task Force**

In light of resource constraints presented by a 12-member staff, the Task Force's mission is to identify matters and issues early, conduct enough of an investigation or inquiry to develop a viable enforcement theory, and then refer the matter to front-line Enforcement staff. Once the Task Force refers a matter to Enforcement, it maintains only an advisory and resource role.

McGuire listed four possible outcomes of a Task Force investigation: (1) determination of no further action; (2) determination that continued monitoring is warranted; (3) incubation while the Task Force requests the voluntary production of documents, and then referral to front-line staff after forming a legal theory; and (4) quick referral to front-line staff. Noting that some matters will be quick and others may take years to develop, McGuire likened the process to the current assessment and allocation of resources for evaluating Tips, Complaints, and Referrals. The Task Force generally does not open formal investigative files; rather, it may start the process by opening informal inquiries to assess whether to institute an investigation. McGuire said the Task Force welcomes proactive education from companies that may be the subject of its formal or informal attention.

McGuire said that, thus far, Enforcement staff have been eager to take referred Task Force matters. In terms of success, McGuire said that benefits, if measured by the number of enforcement actions filed, likely would not be seen for a number of years, but within the agency, there have already been many benefits. McGuire would not speculate about how the agency's revised admit/deny policy would apply to financial reporting fraud cases other than to say it would not be ruled out. She also would not be surprised to see more accounting fraud cases brought in administrative actions.

While it is too early to predict the outcome of the SEC's efforts in this area, one thing should be crystal clear to registrants and their advisors: the SEC staff is taking meaningful steps to refocus its efforts to uncover potential financial reporting violations.

## *Authors*

## William R. McLucas

PARTNER

william.mclucas@wilmerhale.com

+1 202 663 6622

## Meredith B. Cross

PARTNER

meredith.cross@wilmerhale.com

## Daniel F. Schubert

PARTNER

daniel.schubert@wilmerhale.com

+1 212 295 6467