The Credit Professional's Duty And Protection With Disclosing Corporate Fraud At The Public Company

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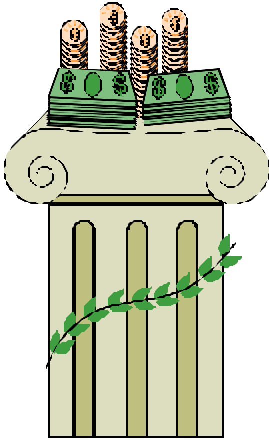

The Credit Research Foundation

An Occasional Paper

November 2002

Executive Summary

- The Sarbanes Oxley Act (SOA) requires more accurate financial disclosure and reporting from public companies. Under the "who-killed-the-company" investigation and prosecution, the Justice Department and SEC are pursuing corporate fraud charges against officers with zeal.
- Prosecutors are indicting middle management level employees allegedly enmeshed in the fraudulent reporting so as to assist in building corporate fraud cases against senior executives. For example, employees have been accused of making adjustments to WorldCom's financial ledgers to misstate its financial condition.
- SOA was adopted to combat the wave of fraudulent accounting and financial reporting scandals and corporate bankruptcies. It focuses on the conduct of corporate officers and public accounting firms and adequate disclosure in public company financial statements. All financial information must accurately present the company's financial conditions and results of operation for the period.

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Scott Blakeley, Esq.

Recent corporate fraud is estimated to have cost the economy $200 billion in lost investment, unpaid creditor financing, unpaid vendor credit and lost jobs. These extraordinary losses prompted the US Congress to overwhelmingly pass federal legislation under the name of The Sarbanes Oxley Act, in hopes of deterring corporate fraud. The Sarbanes Oxley Act (SOA) requires more accurate financial disclosure and reporting from public companies then ever before. SOA has earmarked over $700 million for the Securities and Exchange Commission to investigate and prosecute corporate fraud. Under the "who-killed-the-company" investigation and prosecution, the Justice Department and SEC are pursuing corporate fraud charges against officers with zeal.

Recently, several top executives of numerous large public companies have been charged criminally with corporate fraud. The SEC alleges that many of these top executives reaped millions by inflating their company's stock price through fraudulent accounting and reporting. As a result of these corporate frauds, creditors and investors have suffered losses in the billions.

Prosecutors are not only targeting senior executives who have reaped millions through their corporate misdeeds, but now are moving down the chain of command. Prosecutors are indicting middle management level employees allegedly enmeshed in the fraudulent reporting so as to assist in building corporate fraud cases against senior executives. These employees are being prosecuted, notwithstanding there is no evidence that the employees received financial gain in the scheme.

For example, two former WorldCom employees working in the accounting department pleaded guilty to criminal conspiracy and securities fraud charges based on a criminal complaint brought by the U.S. Attorney's Office for the Southern District of New York. WorldCom, the largest bankruptcy ever filed, was

forced to file for Chapter 11 after disclosing multi-billion dollar fraudulent accounting and reporting practices. The employees have been accused of making adjustments to WorldCom's financial ledgers to misstate its financial condition.

The employees contend that they had no choice in making the accounting adjustments, having been ordered by their superiors to make the changes. Indeed, there is evidence that the employees repeatedly objected to the accounting adjustments commanded by their bosses, and were assured that the adjustments would be fine. Free on bail, the employees are looking at 15 years in prison, but may receive reduced sentences given their cooperation with prosecutors.

After their plea bargain with the Justice Department, the employees now face civil fraud charges brought by the SEC under the federal Securities Act. WorldCom's former controller pleaded guilty to federal securities fraud charges and faces up to 10 years in jail. The controller also pled guilty to state securities fraud charges, and is facing up to five years in prison.

What lessons may the credit professional learn from these recent plea agreements with their own employer that is a public company? May a credit professional face comparable personal culpability concerning the accuracy of financial reporting provided by the credit professional to their superior?

A credit professional often has responsibility and accountability over managing and reporting on several significant assets and liabilities of the company valued often in the billions or hundreds of millions of dollars. Credit executives clearly have an influence over, or at least an intimate knowledge of several of their company's key financial statement components such as reserves, revenue recognition, A/R and inventory.

The aging and collectability of the accounts receivable may have a significant impact on a company's financial reporting to the public markets. A company's DSO is, at least on Wall Street, an important indicator of the condition of its accounts receivable, and therefore a gauge of asset quality. The "ingredients"

used in the DSO calculation by a credit executive may influence the results of its company's DSO which is an element of most 10K filings. Another important quality measurement of a company's accounts receivable can be the amount of bad debt and promotional allowance reserves booked - an item that the credit professional surely has control over.

The question then must be asked: in light of the SOA, what obligation does the credit executive have to protect their company from danger if they recognize unethical or now illegal (fraudulent) practices? Should they run the risk of being dragged into an investigation, or become a whistleblower.

What if, for example, the credit professional is pressured by superiors to change the processing of A/R to improve its financial reporting? In light of the SEC's and Justice Department's vigorous prosecution of fraudulent accounting and reporting, what does it mean to the credit professional? *How many credit executives have ever been ordered to hold off processing credit memos until the next quarter to improve the performance of the quarter just ending?*

Laws Used to Battle Corporate Fraud

The SOA was adopted to combat the wave of fraudulent accounting and financial reporting scandals and corporate bankruptcies. It focuses on the conduct of corporate officers and public accounting firms and adequate disclosure in public company financial statements. SOA imposes a number of duties and restrictions on officers and management of publicly traded companies. The CEO and CFO must sign a certification that the company's periodic reports, 10-Q and 10-K reports do not contain untrue statements. All financial information must accurately present the company's financial conditions and results of operation for the period.

SOA provides that the SEC enforces the legislation and has earmarked $766 million for SEC enforcement. The crime of financial fraud is added and the statute of limitations to bring such action is five years. Mail and wire fraud penalties are increased to 20 years.

Separate from SOA, there is the federal Securities Act that provides for civil and criminal penalties for corporate fraud. In addition, states have corporate fraud legislation that allows for state's to investigate and prosecute corporate fraud.

Whistleblower Protection

The SOA requires companies to set up procedures for anonymous, confidential reporting of fraud allegations. Employees can disclose their concerns of questionable accounting to regulators, law-enforcement officials or Congress with only a reasonable belief that a law has been violated. SOA provides whistle-blower protection to those who assist investigations being conducted by a federal regulatory or law enforcement agency.

Businesses that provide hotline services have seen their business explode as corporations respond to SOA. Also, companies have created their own hotlines to report questionable accounting in hopes that a complaining employee may stay in-house and not report to regulators.

Employees who have been fired, demoted or even threatened for reporting such allegations can file lawsuits. Not only lawsuits, but also criminal penalties are now authorized against someone who retaliates against an employee for reporting concerns regarding illegal conduct.

Complaints are required to be filed within 90 days of the alleged retaliation. The Occupational Safety and Health Administration will handle the complaints. The OSHA, which usually deals with complaints involving things such as asbestos or drinking water safety, will bring in outside experts for guidance to deal with the financial and accounting issues.

Prior to SOA, federal statutes only protected employees who report wrongdoing involving the government. Otherwise employees were forced to look to state laws for retaliation claims. But state laws vary widely and often do not offer a level of protection that would encourage "whistle-blowing."

Separate from SOA whistleblower protections, employees are retaliating by filing suit under the theory that they were fired because they would not participate in

corporate fraud. Some managers are striking back by suing their former companies saying they were fired after refusing to make changes to financial reporting that could be deemed fraudulent. For example, one former employee sued claiming he was fired after his recommendation that the company should write down millions in obsolete inventory. Executives supposedly refused the write down, as it would hurt the company's earnings.

Conclusion

The SOA, along with federal and state securities and fraud statutes, may force publicly traded companies to report their financial information more responsibly, emphasizing full disclosure. There are significant penalties for those who choose not to adequately disclose or who fraudulently disclose. Given the Justice Department and SEC's funding for, and vigor in, pursuing questionable corporate reporting, the credit professional must be especially mindful of the financial information being reported.

According to an article in the September 2002 *Journal of Accountancy* "A Perspective On Audit Malpractice Claims" by Sherry Anderson and Joseph Wolfe, most nonpublic audit claims arise from technical standards violations, failure to detect defalcations and failure to include appropriate disclosures on the face of the financial statements or in the footnotes. For example, of the 63% of nonpublic audit claims that arose from technical standards violations, almost half involved improper inventory valuation and more than one-third involved accounts receivable errors.

Too often the auditors accepted management representations about the collectability of a particular receivable or class of receivables without adequately examining past collection experience or the reasonableness of management representations in light of market and industry conditions. Expert review often revealed bad debt reserves were inadequate and the company failed to write off a significant portion of accounts receivable in prior periods. This failure resulted in material errors in past and current financial statements.

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Scott will be a featured speaker on this subject at the upcoming Credit Research Foundation Credit and Accounts Receivable Open Forum March 19, 20 & 21 2003 in North Dallas, Texas.

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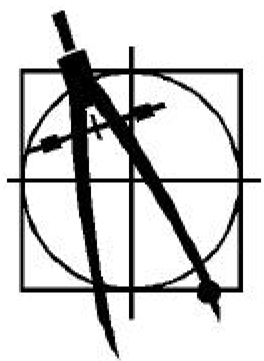
RESOURCES

Visit the Credit Research Foundation website for additional resources

http://www.crfonline.org



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