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Helping boards ID warning signs of toxic corporate culture

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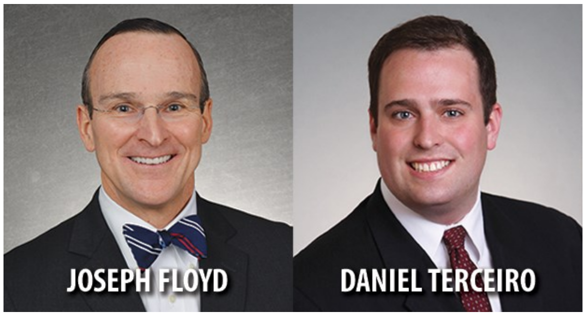

Boards of directors bear enormous responsibilities for the tone at the top and corporate culture of the companies they are entrusted to oversee. This fiduciary duty is evident in the selection of senior management and when assessing the overall ethical climate for the enterprise.

The recent settlement by the U.S. Securities and Exchange Commission with former accounting and finance personnel at Bankrate, related to an alleged financial reporting fraud, provides an excellent example of the perils of an adverse corporate culture as well as the warning signs for potential problems.

Bankrate is an online publisher of financial information and operates several websites, primarily focusing on personal finance. According to the SEC, the former Bankrate employees intentionally manipulated the company's revenue and expenses in order to improve financial results for the second quarter of 2012.

Below is a brief overview of the fraud alleged by the SEC at Bankrate and specific examples of internal Bankrate communications indicative of corporate culture problems.
Also provided below are proposed questions to ask and factors to consider when assessing corporate culture. Legal counsel advising boards of public registrants may find these considerations useful in guiding their clients to avoid similar problems resulting from corporate culture issues.

Background

In August, the SEC reached settlements with the former CFO and director of accounting for Bankrate for alleged violations of federal securities laws. The settlements included fines and suspensions from appearing or practicing before the SEC under Rule 102(e) of the SEC's Rules of Practice.

Per the SEC, Bankrate's former CFO directed others in the organization to record fraudulent revenue without any justification or support, for the sole purpose of meeting analyst expectations.

When Bankrate's external auditor sought supporting documentation regarding some of the additional revenue, the VP of finance responded with what the SEC characterized as a "misleading, generic explanation," a message that both the CFO and director of accounting reviewed and approved.

Emails among these individuals provide details regarding the alleged auditor deception and, of particular concern, an environment in which numerous people had knowledge of the improper behavior.

During this same quarter, according to the SEC, the CFO instructed one of the division accountants to reduce an accrued expense account for the sole purpose of fabricating an earnings number. The CFO had been using the accrual account as a "cushion" or "cookie-jar" account that could be arbitrarily manipulated as needed.

The company also improperly capitalized accounting expenses as "deal costs" rather than expensing them as required under GAAP.

The inflated financial results emanating from these improper accounting entries caused Bankrate to materially overstate its adjusted EBITDA and adjusted EPS for the second quarter of 2012.

Per the SEC, within the two weeks following the Q2 2012 earnings release, the CFO sold Bankrate stock at an artificially inflated price. The company ultimately corrected its Q2 2012 financials as part of a broader restatement in June 2015.

Bankrate, as a corporation, reached a settlement with the SEC related to the accounting fraud charges and paid a $15 million civil penalty. Bankrate also faced significant restatement costs, loss of shareholder value and confidence, and a class action lawsuit.

Needless to say, the consequences and distractions resulting from financial frauds can be detrimental to a public registrant.

Corporate culture problem

Notably, in Section 9A of its Form 10-K Annual Report for fiscal year 2014, Bankrate admitted it had a culture problem.

Specifically, the company stated that it "did not maintain an effective control environment, which is the foundation for the discipline and structure necessary for effective internal control over financial reporting, as evidenced by: (i) the failure to maintain a corporate culture that sufficiently instilled, prioritized, and supported an adequate enterprise-wide attitude of control consciousness, established or supported sufficient focus on compliance with appropriate accounting policies and procedures, or implemented adequately designed and effective operating controls over accounting in accordance with GAAP … ."

With hindsight, Bankrate disclosed its corporate culture problems, which raises the question: Could the warning signs have been identified earlier?

Corporate culture generally refers to the shared values, attitudes, standards and beliefs that characterize members of an organization and define its nature. While this may sound somewhat abstract, people's common conduct and activities are often indicative of the type of culture that exists in a company. Just as certain traits and actions can signal ethical and proper behaviors, there are indicia that signify potential culture problems.

Based simply on the internal communications highlighted in the SEC release, there were several warning signs of a problematic corporate culture at Bankrate prior to the discovery of the fraud. These warning signs included:

- excessive use of offensive language in emails and other internal communications;
- hostility, pressure and threats regarding employees;
- widespread knowledge of unethical behavior; and
- multiple instances of lack of integrity.

Select examples of the internal email discussions include the following:

Upon learning of the CFO's demands that the company book unsupported revenue, the director of accounting sent the following email to the VP of finance:

"F[***] me — seriously … You better make sure that the revenue/margin analytics are thoroughly explained so that we avoid questions on this sh[**]. Doesn't [he] realize that all this does is put us in a hole to start [the third quarter of 2012] since it will be reversed when the 'estimate' is trued up? So in Q3 are we going to record even more when the numbers suck? I know you get it but I'm not sure [he] is thinking ahead for what it means."

When the CFO learned that individuals refused to record unsupported revenue, he sent an email to other Bankrate personnel saying that he was "going to rip [the division CEO's] f[***]ing head off" and fire the division accountants if they "f[***] up the accounting."

Bankrate maintained multiple internal spreadsheets with "cushion" accounts and used them to alter financial results. The VP of finance dubbed these accounts "Ed's Cushion."

In 2011, the CFO asked the VP of finance to "review the final Balance sheet and cushion anal[ysis] … I may want to tune our numbers."

According to the SEC, the CFO did eventually use the "cushion" accounts to alter the financial results.

In 2012, the CFO directed the VP of finance to manipulate financial results and "book like $150 in rev to EBITDA in May … [p]lus reverse $75k in accruals."

He also added: "keep it under the radar."

When directing the VP of finance to record certain accounting expenses improperly as deal costs, the CFO sent an email instructing the VP of finance to "Charge ALL [auditor] BILLS TO ACCRUED DEAL COST — I DON'T CARE IF THEY COMPLAIN, WE CAN SAY IT WAS A MISTAKE."

The VP of finance forwarded that to the director of accounting and said it was "[a]nother [CFO's name] special."

The director of accounting wrote an email to the VP of finance indicating that he had spoken to the CFO, saying: "he said there may be some additional good guy adjustments coming and I f[***]ing knew that he was going to do something like this … We need to be very careful how this gets reflected to be able to have some basis for the estimate to show [the auditor] if they happen to figure it out."

Of significant concern, per the SEC release and complaint, the improper conduct at Bankrate involved at least nine people in accounting, finance and other areas throughout its various divisions.

Identifying the warning signs

As noted above, corporate culture can seem abstract, which can make it difficult to quantify, measure and assess. Considering the events that took place at Bankrate, as well as best practices, the following examples of questions, observations and considerations will assist boards of directors in assessing the corporate culture of their organizations:

- Consider employee turnover statistics by level and division, as well as information gathered from exit interviews.
- Ensure that financial rewards are tied to ethical behavior and compliance, not just financial performance.
- Tour the company facilities and meet with non-executive employees to assess general attitudes.
- Inquire as to hiring practices, including the characteristics sought in prospective employees.
- Be cognizant of employee stress levels and understand the importance placed on work-life balance within the company.
- Determine whether the company recognizes employees for their participation in community involvement activities.
- Discuss employee recognition programs and the attributes that are rewarded.
- Review employee evaluations to determine if constructive feedback and/or criticism are commonplace.
- Evaluate bonus structures and ensure that they are realistic and do not apply excessive pressure to meet sales, revenue or earnings targets.
- Consistent with the "broken windows" theory, inquire as to how the company handles small lapses in compliance and ethics.
- Monitor management's internal messages for tone and employee treatment.
- Evaluate social media reviews, notably Vault and other public forums for commentary.
- Discuss the company's team-building exercises and social events and how these impact company culture.

Closing

Boards of directors bear a direct oversight responsibility for their company's culture and management's tone at the top. Legal counsel and other advisors for boards can play a key role in helping guide how a board fulfills its fiduciary and oversight responsibilities to shareholders, including the monitoring of corporate culture.

No board wants to find itself dealing with the problems encountered at Bankrate.

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