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Client Alert

Government Matters

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Messages for Public Companies from the SEC's Spate of September Enforcement Actions

Introduction

The United States Securities and Exchange Commission wrapped up its fiscal year on September 30, 2019 with a flurry of enforcement actions filed in the final weeks of the month. These cases will provide fodder for analysis for months to come, but for those who don't want to wait, this note discusses themes from eight notable public company accounting and disclosure settlements announced in September.

The eight September settlements, all of which were entered into on a neither admit nor deny basis, involved a range of improper accounting and disclosure violations that to varying degrees provided a misleading picture of the companies' business performance. In several of the settlements, for example, the SEC found or alleged that the companies inappropriately recorded accounting entries for the purpose of reporting results that met research analysts' consensus earnings estimates, and in others, the SEC found that companies had made misleading statements about other metrics important to investors.

Specifically, the SEC found or alleged that:

- A manufacturer of paint and other coating materials delayed or failed to record certain expense accruals and misclassified income as coming from continuing operations;[2]
- A bank holding company improperly classified and delayed taking appropriate charges for individually impaired loans;[3]
- A data services and measurement company manipulated monetary and non-monetary contracts and made false or misleading disclosures regarding customer counts and flagship product revenues;[4]
- A semiconductor component producer accelerated sales into current quarters "without disclosing the significant impact on revenues from its use of pull-ins" and without disclosing the impact on future sales expectations;[5]

- A Japanese automaker whose sponsored ADRs trade in the U.S. did not disclose over $140 million in compensation and retirement benefits given to its CEO;[6]
- A London-based automaker and its U.S. subsidiary inaccurately reported new vehicle sales;[7]
- A global pharmaceutical company did not properly disclose and record an accrual relating to a Department of Justice investigation and, in its Risk Factors, stated that certain risks "may" happen when they already had happened;[8] and
- A direct selling company inaccurately described its business model in China.[9]

Below, we discuss in more detail the facts and violations described in these cases, which resulted in combined penalties of $116,900,000 and provide a window into the SEC's current primary areas of focus when it comes to public company accounting and disclosure. These cases and the current activity we have observed in active enforcement investigations confirm that the SEC remains, and currently is, very focused on whether judgment calls made in financial reporting and disclosure items were inappropriately skewed toward demonstrating positive results, rather than providing a more accurate picture for investors.

IMPROPER ACCOUNTING TREATMENT

Expense Accruals. A basic tenet of generally accepted accounting principles (GAAP) is that companies must accrue for expenses as they are incurred. Because professional judgment is required in determining the amounts and timing for accruing expenses, companies often create procedures to guide employees in consistently applying factors and processes in determining the appropriate accruals in accordance with GAAP.

In one settlement, however, the SEC found that an officer of the company "track[ed] earnings and determin[ed] whether, and how, to record certain accounting entries, often late in the closing process, based on the entries' potential to move income from continuing operations positively or negatively in order to meet analysts' consensus expected earnings, or to narrow a gap." The SEC found that the company either made "intentionally erroneous accounting entries" or failed to make (or delayed making) necessary entries – and that this happened in a large number of expense accounts, including:

- **performance-based Restricted Stock Units expense**, where, "without a reasonable basis," the company "reduced an input to the performance factor methodology" so that its accrual would be smaller than required by GAAP;
- **self-insured healthcare claim expense,** where, after estimating its exposure, an officer of the company directed a subordinate not to make (until the following quarter) the accrual that was needed to record the estimated exposure;
- **severance expense,** where an officer of the company "without reasonable basis" directed that only a small portion of the company's contractual liability to a departing employee be recorded in the current quarter (and that the balance be recorded in a later period);
- **vacation pay expense,** where the company made a change in to its vacation pay policy in Q2 but delayed recording the increased expense associated with that change until Q4;
- **pension expenses** and **intangible asset amortization,** where the company discovered that it needed to correct certain entries but decided not to make those corrections until a subsequent quarter;
- **legal and property tax expenses**, where the company decided not to make the appropriate accruals in Q1 opting to instead improperly put those accrual off until the next quarter;
- **compensation plan pay-outs**, where the company improperly decided to delay a true-up of pay-outs that had been approved;

- **healthcare claims,** where the company "without a reasonable basis" and "contrary to GAAP" decided to release a portion of a reserve that had been set up in a prior period; and
- **inventory valuations,** where the company selectively conducted atypical off-cycle inventory re-evaluations in order to increase inventory valuations in two consecutive quarters (which, like the above expense adjustments, also led to increases in net income).

Income Adjustments. In the same settlement, the SEC found that, at the direction of the company's officer, the company made "intentionally erroneous accounting entries" to misclassify restructuring reserves and various reserves for discontinued operations as gains to income for continuing operations, which inappropriately increased "a non-GAAP measure that was a component of [the company's] reported EPS."

Impairment Charges. Another area of judgment the SEC has been reviewing relates to impairments, and one of the September settlements provides an example. The SEC found that a public bank holding company failed to identify and properly classify some loans and take appropriate charges for individually impaired loans as required by ASC 310-10-35. The SEC concluded that the bank failed to follow its own procedures in reviewing and assigning risk ratings to its loans and that the company "relied too heavily on borrowers' and guarantors' reputations, their historic business and banking relationship with [the bank], and their expected future prospects for more business, while overlooking indicators of financial distress." The SEC also found that there were failures in identifying and evaluating whether loan modifications constituted Troubled Debt Restructurings. According to the SEC's order, these failures collectively resulted in material understatements to the bank's allowance and provision for loan loss accounts.

Barter Transactions. Another settlement involved several barter transactions ("non-monetary transactions" or "NMTs") in which the company provided data sets to other companies in return for data sets from those companies. The SEC concluded that these NMTs had been accounted for improperly. In particular, the SEC found that "[the company's] conclusions that the NMTs had commercial substance and that the fair values of the data assets subject to the exchanges could be determined within reasonable limits [as required by ASC 845-10-30-3] were based on unsupported, false, or misleading statements or assumptions." As a result, the NMTs could not be accounted for by using fair value, and because the data transferred had no recorded or book value (because it could be duplicated easily), no revenue should have been recorded.

Linked Transactions. The SEC also found that this company accounted for certain transactions as though they were separate transactions when, in fact, they were linked. This resulted in the company improperly recognizing revenue.

Side Agreements. In addition, the SEC found that the company's CEO entered into side agreements allowing the CEO "to hide from internal accountants and the independent auditor future data delivery obligations, thereby permitting [the company] to recognize all revenue from the contracts in the quarter they were signed rather than having to defer some or all of the revenue to future quarters."

INADEQUATE DISCLOSURES.

Key Performance Metrics. The September settlements underscore a broader recent trend in which the SEC has charged companies for making false statements or omissions regarding key performance metrics to give an impression of better performance than the company actually achieved.

In one settlement, for example, the SEC found that the company's employees maintained a database of actual but reported vehicle sales that it referred to as the "cookie jar," which it dipped into to inflate vehicle sales numbers for months when the company wanted to report better results than it actually recorded. In at least two quarters, this resulted in the company falsely reporting year-over-year sales growth in two months when in fact, sales declined in those months when compared to the prior year. The SEC also found that the company paid dealers to report "fake sales" that were later "unwound."

Another settlement also addressed this issue, finding that the company and its CEO had manipulated two different performance metrics. One was a customer count number, for which the company altered the counting methodology over time to count individuals within advertising agencies rather than just the agencies, and to count customers at a lower revenue threshold over time. The other performance metric was a reported product sales number, for which the company altered its methodology to include more types of products within that reported tally. In both instances, the company changed its counting methodology without disclosing that the changes meant comparisons to prior periods were not "apples to apples."

Pull-In Sales. Earnings management, or the practice of companies manipulating their earnings in order to meet guidance or analysts' expectations, long has been a priority for the SEC's enforcement program, and, as noted above, the end of the fiscal year featured several cases in this area. In one case, the SEC found that the company had orchestrated a scheme to accelerate, or "pull-in", sales to current quarters that had been scheduled for future periods in order to close the gap between the company's publicly-issued targets and its actual results. The company offered various financial incentives to convince customers to agree to accept product earlier than expected, such as rebates, discounts, free product, and extended payment terms. While the transactions were compliant with GAAP, the SEC's order found that the company misled investors by failing to disclose the purpose, scope, or effect of the pull-in transactions. First, investors were left with the misleading impression that the company was meeting guidance through organic growth and normal customer demand for its products. Further, investors were unaware of the impact that the pull-in sales were having on revenue in future quarters.[10]

Loss Contingencies and Risk Factors Relating to Government Investigations. The SEC charged another company with (i) failing to properly disclose or accrue for contingent losses from a DOJ False Claims Act investigation, and (ii) making misleading risk factor disclosures.[11] The case is notable because it involves a scenario regularly faced by public companies – when to disclose and accrue for a loss arising from a non-public government investigation – and because it is the second such case that the Commission has brought in recent years.[12]

ASC 450 covers accounting for "contingencies" and requires issuers to *disclose* a material loss contingency if it is at least *reasonably possible* that it will occur, which is defined as a chance the loss will occur that is more than remote but less than likely. In addition, an issuer must *record an accrual* for a material loss contingency once the chance of the loss occurring becomes *probable* and the amount of the loss is *reasonably estimable*. Under the accounting literature, "probable" means "likely to occur," so the likelihood threshold for requiring a loss accrual ("probable") is a higher standard than the threshold for simply disclosing the loss contingency ("reasonably possible").

The SEC's complaint alleged that in November 2014, the company received a DOJ subpoena as part of a DOJ False Claims Act investigation into whether the company misclassified its products as generic and, therefore, overcharged the government for sales to Medicaid patients. The complaint alleges that the company argued over the ensuing months that DOJ should close its investigation, but DOJ rejected these arguments and requested that the company sign a tolling agreement. In October 2015, the company produced a damages analysis to DOJ that showed potential damages ranging from approximately $12-42 million, before trebling, for just one quarter of the multiple quarters at issue in the investigation. The SEC alleged that, as a result, the company knew or should have known by no later than the filing of its 10-Q for the third quarter of 2015 (on October 30, 2015) that the likelihood of a material loss relating to the DOJ investigation was at least reasonably possible, but improperly failed to disclose either the related loss contingency or an estimated range of loss.[13]

The complaint also alleged that in June 2016, after additional production and negotiations, the company produced to the DOJ a damages estimate of $114-260 million, before trebling, for one year of the period under investigation. In July 2016, DOJ provided its own damages estimates and threatened suit unless the company made a settlement offer, and then in early August rejected the company's $50 million offer and countered with a significantly higher amount. The complaint alleged that the company thus knew or should have known by the time it filed its second quarter 10-Q (on August 9, 2016) that a material loss resulting from the DOJ investigation was probable and that this loss was reasonably estimable, but the company improperly failed to accrue its best estimate of the loss (or, if it did not have a best estimate, the minimum amount of the loss within the estimated range of losses). The company did not disclose the DOJ investigation or potential loss contingency until October 7, 2016, when it announced that it had reached a $465 million settlement with DOJ.

In addition to the loss contingency disclosure violations, the SEC also alleged that the company's risk factors were misleading because they stated that there was a risk that the government *could* take the position that the company's product classification was incorrect when the company had been informed by the government that it *was* taking that position.

Executive Compensation. The SEC announced on September 23, 2019, that it had settled an action against a Japanese automaker, its former CEO, and a "representative director" (whom the SEC described as a human resources executive and the CEO's subordinate) relating to the accounting for, and disclosure of, compensation and retirement benefits paid (or to be paid) to the company's CEO. The Commission's order details how the CEO and representative director misled the company's CFO and other executives and how the CEO and representative director took various actions, including entering into "secret contracts" and executing "backdated letters" either to increase the CEO's compensation and retirement benefits or pay out those benefits in ways that would avoid disclosure. This misconduct caused the *disclosures* in the company's filings to materially understate the amount of CEO compensation and to misstate why the company's retirement allowances had increased – which in turn caused the financial statements to be materially false and misleading.

Business Structure. On September 27, 2019, the Commission also announced a settled action arising out of a company's misleading disclosures about the nature of its operations in China, which grew to account for approximately 20% of the company's worldwide sales by 2018. The company generally sells its products through multi-level marketing, which is considered a legal form of direct selling in the U.S. and other countries where the company operates, but which is prohibited in China. The Commission's order found that the company repeatedly said in its periodic filings that it employed a different business model in China due to this restriction, when in fact the business model it used in China was essentially the same multi-level marketing model that it used in other countries. The Commission's order found that these misstatements deprived investors of information to fully evaluate the risks associated with the company's China business.

The disclosures that were found to be inadequate differ in the five cases discussed above. But, of significance, in several of these cases, the inadequate disclosure does not appear to have resulted in the misstatement of any *numbers in* the financial statements. Together, these cases show that SEC is concerned not just about cases where the *numbers* in the financial statements proper might have been "managed," but also with cases where the *disclosures* do not fairly describe matters of interest to inventors.

Looking Ahead

In all of these cases, the SEC's concern was that, because of the illegal activities, investors received an inaccurate picture of each company's business. In some situations, the SEC concluded that the inaccurate picture occurred because the company wanted to create an appearance that the company had performed consistently with the “consensus expectations” of analysts who covered the company. In other situations, the SEC found that companies touted performance improvement or consistency using internally-generated metrics as if the same methodology had been consistently used to generate them, when that was not the case. In some cases, companies downplayed or avoided disclosing bad news.

These SEC settlements provide a window into what’s on the mind of SEC enforcement attorneys as they investigate tips, complaints, and statistical anomalies regarding accounting and disclosure issues, and are consistent with investigative trends we see in our own practice. These settlements also illustrate that even as the SEC’s current leadership prioritizes cyber, cryptocurrency, and frauds affecting retail investors, public company accounting and disclosure cases always will be a central part of the Enforcement Division’s program.

[1] Dixie Johnson, Alec Koch, Dick Walker, and Jim Gorsline are members of the Special Matters and Investigations team at King & Spalding. Ms. Johnson, based in Washington, D.C., also co-heads the firm's Securities Enforcement and Regulation practice and serves as Deputy Chair of the firm's Government Matters practice group, which houses the firm's ten government-facing practices. Mr. Koch, also based in Washington, D.C., previously served as Assistant Director in the SEC's Division of Enforcement. Mr. Walker, based in New York, previously served as Director of Enforcement and General Counsel of the SEC. Mr. Gorsline, based in Atlanta, GA, is a former CPA whose auditing and accounting experience complement his legal practice. The authors represented clients in connection with some of these matters.

[2] *See* In the Matter of PPG Industries, Inc., Accounting and Auditing Enforcement Release No. 4094 (September 26, 2019).

[3] *See* In the Matter of The Bancorp, Inc., Accounting and Auditing Enforcement Release No. 4081 (September 20, 2019).

[4] *See* In the Matter of Comscore, Inc., Accounting and Auditing Enforcement Release No. 4091 (September 24, 2019).

[5] *See* In the Matter of Marvell Technology Group, Ltd., Accounting and Auditing Enforcement Release No. 4076 (September 16, 2019).

[6] *See* In the Matter of Nissan Motor Co., Ltd., Accounting and Auditing Enforcement Release No. 4086 (September 23, 2019).

[7] *See* In the Matter of FCA US LLC and Fiat Chrysler Automobiles N.V., Accounting and Auditing Enforcement Release No. 4095 (September 27, 2019).

[8] *See* Securities and Exchange Commission v. Mylan N.V., No. 19-civ-2904 (D.D.C. filed September 27, 2019), Litigation Release No. 24621 (September 27, 2019); Accounting and Auditing Enforcement Release No. 4096 (September 27, 2019).

[9] *See* In the Matter of Herbalife Nutrition, Ltd., Securities Exchange Act of 1934 Release No. 87131 (September 27, 2019).

[10] Prior, similar SEC cases include *SEC v. Salix Pharmaceuticals, Ltd.*, No. 1:18-cv-08886 (S.D.N.Y. filed Sept. 28, 2018), and *In the Matter of Coca-Cola Co.*, Accounting and Auditing Enforcement Rel. No. 2232 (April 18, 2005).

[11] Unlike the other cases discussed in this article, the Mylan case involves allegations in federal court and an agreed-upon settlement without Mylan admitting or denying the SEC's allegations. As a result, these are not "findings" of the SEC, and instead are "allegations."

[12] See SEC Charges RPM International Inc. and its General Counsel for Disclosure and Accounting Failures (Sept. 9, 2016), available at https://www.sec.gov/litigation/litreleases/2016/lr23639.htm.

[13] In addition to disclosing a reasonably possible loss contingency, ASC 450-20-50-4 requires that such a disclosure include an estimate of the possible loss or range of loss, or a statement that such an estimate cannot be made.