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SEC accounting fraud enforcement: Back to the future

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While the number of accounting fraud related cases during the past year are below historical averages, taking a look at the type of cases is somewhat reminiscent of past years, and I believe indicative of what we might expect in the future. After a slow start in 2020, a common consequence of a change in presidential administrations, and the changes to the work environment resulting from the pandemic, the U.S. Securities and Exchange Commission ("SEC") subsequently brought a flurry of cases during the summer and into the fall. A steady stream of cases have continued to be filed.

Revenue recognition features prominently

At least seven cases were brought by the SEC during the past 12 months that cite issues with how public companies recognised, or disclosed, revenue and revenue generating practices. Several of these highlight practices that were commonplace in the early part of this century. U.S. generally accepted accounting principles (GAAP) requires that revenue only be recognised when there is persuasive evidence that an arrangement exists, there is a fixed or determinable fee, services have been performed, and collectability is reasonably assured. The SEC cases highlight some incorrect practices ranging from the simple, to somewhat complex schemes.

'Bill-and-hold' schemes featured in a couple of enforcement actions. While bill-and-hold sales arrangements are permissible, the SEC has set forth seven criteria that must be met in order to appropriately recognise such sales: (i) the risks of ownership have passed to the buyer; (ii) the buyer has committed in writing to buy the goods; (iii) the buyer has requested that the seller hold the goods, and has a business reason for doing so; (iv) there is a scheduled delivery date for the goods that is reasonable; (v) there are no remaining obligations that the seller must complete; (vi) the goods cannot be used to fill orders from other customers, and so have been segregated; and (vii) the goods must be complete. The enforcement actions brought did not meet such criteria. A U.S. provider of LED lighting and lighting controls recorded anticipated future sales as current bill-and-hold transactions at quarter ends to make up for revenue shortfalls. Although no arrangement had been agreed to with the customer for the company to 'hold' the purchased equipment, management backdated documents that were provided to the external auditors to 'support' the recognition of revenue. In a similar scheme, an energy, transportation and industrial equipment manufacturer also inappropriately recognised revenue through the use of improper bill-and-hold arrangements, the recording of sales not completed to the customer's specifications, or for which the customer had not yet agreed to accept, commonly referred to as 'pull in' sales.

Two enforcement actions highlighted the complexity of some revenue recognition fraud schemes:

A U.S. server technology company was changed with an elaborate approach to maximising revenue at the end of each quarter, through the creation of numerous schemes to prematurely recognise revenue. The company allegedly engaged in the recognition of revenue prior to delivery of goods, sending goods prior to the customer's requested delivery date, changing shipping terms to recognise revenue on shipment as opposed to delivery, and holding bill of lading for overseas customers thereby preventing customers from taking possession of the goods. While this ensured payment for the goods, revenue should not have been recognised upon shipment.

A manufacturer of cranes, when facing a decline in business during 2016, entered into a contract with a customer that, despite having no revenue, cash flows or operations, would purchase a number of cranes and lease them to third parties. To fund the purchase, the registrant arranged for financing with a third party, that it concealed through the creation of a purported financing subsidiary to hide the fact that the Company was making the financing payments for the customer, and guaranteeing the debt. The finance payments were paid through false invoices management created.

Two other enforcement actions were brought against registrants for a failure to accurately disclose certain revenue generating practices. Of note, the two cases did not allege that the company failed to comply with GAAP – merely that the companies failed to disclose material information about their revenue management practices that rendered statements made misleading. In both instances, the SEC alleged that the companies engaged in pull-in transactions, whereby the companies accelerated or 'pulled forward' existing orders that customers had requested be shipped in future quarters. The companies requested customers to accept shipment of certain product in the current quarter that they had already ordered for delivery in the next quarter. Such requests were often made with sales incentives including extended payment terms and discounts. The SEC alleged that investors should have been informed of such practices, incentives and the potential impact that pulling forward sales would have on future periods.

Earnings management: The EPS initiative

In September 2020, the SEC brought two actions against companies that emanated from the SEC's Earnings per Share (EPS) initiative. Observers speculated that the initiative was started on the back of academic research papers that noted various statistical anomalies in disclosed EPS figures across public companies. The two companies charged by the SEC, allegedly departed from their stated internal policies and practices in order to maintain various allowances or accruals at certain levels that would increase the reported EPS to closely align with or exceed analyst consensus expectations. The practices came to light when the companies were ultimately required to rectify their accounting estimates resulting in a marked failure to make EPS expectations.

Non-GAAP disclosures

Many companies include in their public filings non-GAAP metrics or indicators commonly used by analysts to assess company performance. The SEC, in public statements, has been outspoken about the need for companies to provide accurate and consistent non-GAAP KPIs/metrics. During the past year, two companies were charged with false and misleading disclosures.

A provider of broker dealer services calculated post tax distributable earnings (Post Tax DE), a non-GAAP metric. The SEC alleged that the company took the benefit of a tax deduction without reducing Pre-DE income by the amount of the expense that was the basis for the deduction. In a similar action, a pharmaceutical company allegedly mis-reported its "same store organic growth" and "cash EPS" metrics.

Boards of Directors of companies, their audit committees, and internal audit play a vital role in identifying such frauds. Much of the conduct referenced above was driven by management's pressure to meet analysts consensus expectations. Corporate gatekeepers should be aware of those metrics (revenue, EPS, non-GAAP metrics) against which the performance of the company is judged, the motivations that this creates for the management team, and the potential schemes that could be deployed to manipulate such performance numbers.

Neil Keenan is a Partner at FRA based in the firm's Washington, DC office. Prior to joining FRA, Neil was a Partner at PwC in their Washington DC, and Los Angeles, CA offices. Neil has a variety of experiences across accounting disciplines. He is a specialist in accounting fraud having completed numerous accounting investigations, served as a specialist for PwC when fraud was alleged at audit clients and acted an external and internal auditor. He also specialises in anti-corruption investigations and compliance, and asset misappropriation and embezzlement. Beyond investigations, Neil brings broad experience that includes claims processing, M&A financial and compliance due diligence, corporate finance, corporate valuations, and business recovery and restructurings.