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SEC Enforcement Trends: Minor Accounting and Disclosure Infractions Attracting Major Scrutiny



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During the final months of Chair Mary Jo White's leadership of the Securities and Exchange Commission (the "Commission" or "SEC") (October 2016 through January 2017), the SEC settled a series of enforcement cases involving mostly minor accounting and disclosure issues. These settlements, described more fully below, illustrate an SEC enforcement trend that has been developing over the last several years that has led to an uptick in actions involving negligent or non-scienter accounting, internal controls, and/or books and records violations—in addition to the more common accounting fraud charges. As described, below the negligence cases often involve the SEC evaluating subjective decision processes employed by a company in complex matters of accounting, where the staff seems willing to second guess management and substitute its judgment, likely often with hindsight. These cases serve as a strong reminder that the SEC's enforcement division remains focused on pursuing public company cases. And it is also possible that these easier to prove, negligence cases will find more favor with the incoming enforcement staff. Whether this trend will continue during the Trump administration is unclear, but companies should nevertheless exercise great care and regularly evaluate their accounting and disclosure controls and realize that these cases will at least be used by auditors as they follow through with their audit processes.

I. Financial Reporting Processes.

On Nov. 7, 2016, PowerSecure International ("PowerSecure"), an energy management firm, agreed to settle the SEC's claims related to PowerSecure's process for determining and reporting operating segment financial performance. Pursuant to ASC 280, a company is required to determine its operating segments "based on the way management organizes its business components to make operating decisions and assess performance." The SEC alleged that instead of disclosing financial information in the management discussion and analysis sections of its periodic filings about seven smaller operating segments, PowerSecure improperly aggregated and disclosed the financial results of these seven smaller operating segments as one reporting segment for 2012 to Q1 2014, as three reporting segments for Q2 2014 to Q4 2014, and as four reporting segments for 2015. In its Form 10-K for year-end 2015, PowerSecure disclosed that its

segment reporting was incorrect from 2012 through 2014 and revised that prior year information accordingly, consistent with its 2015 reportable segments.

PowerSecure's prior practice was allegedly inconsistent with "how the company was structured" and how the CEO regularly reviewed operating results and assessed performance, which the SEC alleged occurred on "a more disaggregated level than the consolidated [segment]." The SEC further alleged that "PowerSecure did not have a segment reporting policy, and there was limited documentation of its segment reporting requirements." The SEC claimed that PowerSecure's segment disclosure was not in accordance with generally accepted accounting principles (GAAP), that PowerSecure tested goodwill impairment at a higher level in the organization than appropriate, and that PowerSecure lacked sufficient internal accounting controls. As a result of these deficiencies, the SEC charged PowerSecure with non-scienter-based violations of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, and 12b-20 thereunder and Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. Without admitting or denying the allegations, PowerSecure settled the SEC's claims by agreeing to pay a \$470,000 civil monetary penalty.

On Jan. 18, 2017, General Motors ("GM") agreed to settle the SEC's claims related to GM's process for identifying and evaluating loss contingencies. Starting in 2014, GM recalled approximately 30 million cars worldwide related to a defective ignition switch that could cause the engine to shut off during driving and prevent the vehicle's airbags from deploying. The SEC alleged that certain GM personnel understood that the ignition switch represented a potential safety issue in the spring of 2012, but the GM's Warranty Group, which was responsible for the accounting treatment of possible losses related to potential recalls, didn't learn about the likely recall until November 2013. Once the Warranty Group finally learned of the likely recall, it determined to accrue approximately \$41 million for the estimated costs of the recall, but the SEC alleged that GM's consideration of a loss contingency related to the ignition switch was too late. Specifically, the SEC alleged that prior to November 2013, GM should have considered whether a loss was "reasonably possible" and whether disclosure was required under ASC 450, rather than waiting until November 2013—when a recall was probable and the costs of the recall were estimable. The SEC alleged that this episode illustrated GM's lack of adequate internal accounting controls, and GM settled the SEC's claims by agreeing to pay a \$1 million civil penalty. Notably, GM announced the SEC investigation in April 2014, but it then took nearly three years to reach a settlement on these facts, during which the company likely endured substantial legal fees and costs, as well as the overhang caused by the existence of an SEC investigation.

Both settlements here are noteworthy due to the lack of allegations of intentional misconduct. The SEC didn't allege why GM's Warranty Group wasn't told about a potential recall, nor did the SEC ascribe ill-intent to PowerSecure's determination that it had at most four reporting segments, rather than seven. Moreover, neither of these settlements involved allegations that the improper conduct changed the amount of any reported financials. The SEC only alleged that GM should have *considered* a disclosure earlier, not that its subsequent \$41 million loss contingency should have been *recorded* earlier. Similarly, the SEC only alleged that PowerSecure tested its goodwill impairment at a higher level than was appropriate, not that the magnitude of any goodwill impairment was improper.

II. Subsequent Accounting Adjustments.

On Oct. 20, 2016, FMC Technologies ("FMC") agreed to settle the SEC's claims relating to improper accounting adjustments and internal controls failures. In January 2013, a business unit-level accounting team decided to change the method for accruing paid time off (PTO) liability from annually to ratably each month, contravening GAAP and FMC's accounting policies that required annual accruals because employees accrued PTO annually. The accounting team then reversed the 2013 annual PTO accrual by almost \$800,000, which led to an overstatement of the applicable segment's profits and enabled the segment to meet its internal target. In Q2 2013, the accounting team decided to eliminate the PTO accrual altogether, which was not in compliance with GAAP. The SEC alleged that FMC further violated GAAP by failing to conduct measurements of currency fluctuations that were required by ASC 830 in connection with an inter-company loan between two of FMC's subsidiaries. Although the failure to remeasure didn't require FMC to amend prior filings, it led to an \$8.1 million out-of-period adjustment in

September 2014. FMC settled the SEC's claims of inaccurate books and records and inadequate internal controls by agreeing to pay a \$2.5 million penalty.

On Jan. 19, 2017, HomeStreet Inc. agreed to settle the SEC's claims that it conducted improper hedge accounting. The SEC alleged that from 2006 to 2008, HomeStreet originated approximately 20 fixed-rate commercial loans and then made interest rate swaps to hedge the exposure. Pursuant to ASC 815, HomeStreet "designate[d] the loans and the swaps in fair value hedging relationships, which can reduce income statement volatility." However, ASC 815 also requires that companies "periodically assess the hedging relationship and must discontinue the use of hedge accounting if the effectiveness ratio falls outside a certain range." The SEC alleged that HomeStreet's Treasurer instructed and oversaw a process in which Treasury employees from 2011 to 2014 provided adjusted inputs and test results regarding HomeStreet's hedge effectiveness testing to HomeStreet's accounting department, and as a result, HomeStreet had inaccurate accounting entries. This process allegedly violated both GAAP and the company's internal accounting policies, and the SEC alleged that HomeStreet didn't have proper books and records and internal accounting controls. HomeStreet settled the SEC's claims by agreeing to pay a penalty of \$500,000. In addition, HomeStreet's Treasurer agreed to settle the SEC's claims that he caused HomeStreet's violations.

These two settlements—neither of which required a restatement of financials—involved unsupported accounting adjustments to initially correct accounting treatment, but the fines imposed on each company varied significantly. This variance might be tied to the potential impact of the accounting errors to the financial statements, as FMC was fined \$2.5 million for two accounting errors that led to an overstatement of profits by \$800,000 and an additional \$8.1 million unrealized foreign currency loss, whereas HomeStreet made 64 improper adjustments to its loan fair value calculations that management later determined did not materially impact any reporting period. These cases also illustrate that companies must exercise caution in changing accounting methodologies, even years after an event was initially recorded.

III. Non-GAAP Accounting Measures.

The SEC has also begun cracking down on the improper use of non-GAAP accounting measures that could be misleading to investors. On Sept. 8, 2016, the Commission charged the former Chief Financial Officer and Chief Accounting Officer of American Realty Capital Properties ("ARCP"), a large publicly traded real estate investment trust now known as VEREIT, Inc., with overstating ARCP's financial performance by manipulating the calculation of ARCP's adjusted funds from operations ("AFFO"), a non-GAAP metric that is viewed by analysts and investors as a key indicator of a REIT's performance. After warnings from ARCP accounting personnel that the company had used an incorrect method to calculate AFFO in its first quarter 2014 10-Q filing, ARCP's CFO and CAO allegedly falsified the company's presentation to investors shortly before filing its second quarter results in an effort to conceal the first quarter overstatement. The SEC charged the two former executives with fraud under Section 10(b) and Rule 10b-5, as well as aiding and abetting violations of Exchange Act Section 13(a) and Rules 12b-20, 13a-11, and 13a-13.

On Jan. 18, 2017, New York-based marketing company MDC Partners agreed to settle claims by the SEC that it failed to disclose certain perks offered to its former CEO and also used misleading non-GAAP measures. The latter involved a metric called "organic revenue growth," which excluded acquisitions and foreign exchange impacts from the company's revenue growth calculation. The SEC alleged that during the second quarter of 2012 through year end 2013, MDC included a third, undisclosed reconciling item in its calculation of organic revenue growth, which overstated that metric. MDC also allegedly violated the "prominence" requirement, which requires that GAAP measures be given equal or greater prominence than non-GAAP measures in a company's financials. MDC agreed to settle the charges for a \$1.5 million civil penalty.

The use of non-GAAP accounting has become increasingly common in recent years. The ARCP and MDC cases are an indication that the SEC's enforcement staff is viewing these disclosures with greater scrutiny. The ARCP case alone might be dismissed as an outlier, given that it involved a rather extreme set of facts involving the alleged manipulation of a company's financials by two senior executives the day before an investor presentation; however, the SEC's action against MDC

suggest that non-GAAP accounting measures confirm that ARCP was not a one-off enforcement action. While the undisclosed perks to MDC's CEO made the company a particularly attractive target, much of the SEC's cease-and-desist order focused on MDC's use of non-GAAP accounting metrics in its financial disclosures. The fact that the SEC based its charges in part on non-compliance with the prominence requirement is particularly noteworthy, as that requirement affords the SEC a considerable amount of prosecutorial discretion (in determining the relative prominence of GAAP and non-GAAP metrics) and can be problematic for companies like real estate investment trusts that tend to rely heavily on non-GAAP metrics to measure financial performance.

IV. Revenue Recognition.

On Oct. 17, 2016, Lime Energy Co. ("Lime") agreed to settle the SEC's claims that it improperly recognized millions of dollars in revenue from 2010 to 2012 using increasingly aggressive (and improper) accounting tactics. The SEC alleged that in 2010, Lime's utilities division recognized revenue using the "percentage of completion" method, such that as costs incurred on a project increased, so did revenue. But the utilities division's internal accounting controls allegedly allowed journal entries to be entered for project costs based on a personal assurance that documentation for the costs existed, rather than actually requiring documentary support. Thus, in 2010, Lime allegedly booked revenue for certain projects where it had no documentation of its costs, even though Lime had not received appropriate documentation of its own expenses to justify that it had earned revenue. From there, Lime allegedly booked millions in revenue after the close of the year end for 2011. And in 2011 and 2012, Lime's management allegedly directed the recognition of revenue for projects that didn't exist. Lime eventually determined that it had overstated its revenue from 2010 to 2011 by approximately \$40 million, and Lime restated its financials for 2008–2011 and Q1 2012. The SEC alleged that Lime violated the anti-fraud, books and records, and internal controls provisions of federal securities laws, and Lime settled the charges by agreeing to pay a \$1 million civil penalty. Four members of Lime's management also reached settlements with the SEC relating to their roles in the improper revenue recognition scheme.

On Jan. 11, 2017, L3 Technologies Inc. ("L3") agreed to settle the SEC's claims that it improperly recognized revenue relating to a government contract with the U.S. Army. From 2010 to 2013, L3 performed \$50 million in work for the U.S. Army, but by the end of 2013, the U.S. Army had not yet validated that the work had been completed and L3 had not yet billed the U.S. Army for the work. Nevertheless, in December 2013, an L3 finance official directed L3 to generate 69 invoices for its work, without delivering the invoices to the U.S. Army. One of the requirements for revenue recognition under ASC 605 is that collectability must be reasonably assured, but since the U.S. Army had not reviewed or agreed to pay the invoices, any recognition of revenue relating to these invoices would have been inappropriate. Yet L3 recognized \$17.9 million in revenue, which allowed several L3 employees to "barely satisfy the target required in order to qualify for management incentive bonuses." An internal investigation conducted by outside advisers six months later detected both this improperly recognized revenue and other accounting errors made from 2011 to 2014. The aggregate result was that L3 had overstated its pre-tax income by \$169 million, and was forced to restate its financials for 2011 through 2014. The SEC alleged that L3 didn't have proper books and records and internal accounting controls, and L3 agreed to pay a \$1.6 million penalty to settle the charges.

Notably, both companies agreed to settle their investigations for civil penalties under \$2 million, even though the magnitude of each company's accounting errors was more than ten times the amount of the penalty. Both companies' accounting errors also involved direction from senior management, but only Lime involved allegations of fraud. One explanation for this discrepancy might be that Lime involved several instances of improper conduct over three years by four members of a business unit's senior management, whereas L3 involved a single improper act one member of a business unit's senior management. In addition, Lime sold \$2.55 million in common stock to one of its board members based on Lime's allegedly false financial statements, whereas L3 did not involve any sales of securities.

V. Implications.

These cases demonstrate that the SEC is willing to bring enforcement actions where the ultimate penalty is fairly small and the conduct at issue only involves negligence, often related to events that are immaterial to a company's reported financials. This trend is consistent with the range of initiatives announced by former SEC Director of Enforcement Robert Khuzami in 2010, "designed to increase [the SEC's] ability to identify hidden or emerging threats to the markets, and act quickly to halt misconduct and minimize investor harm." Since that date, the SEC has aggressively pursued matters that were historically considered to be lesser infractions, culminating in this string of accounting actions that were settled shortly before the change in administrations.

An important component of this trend is that the improper conduct need not be intentional. For example, neither of the financial reporting cases (PowerSecure and GM) or the accounting adjustment cases (FMC and Home Street) involved allegations that management was intentionally manipulating the company's financials. Nonetheless, the SEC pursued actions against all of these companies. While the civil penalties were comparatively small, a protracted enforcement action will often result in significant legal and expert fees. In addition, reputational harm and the uncertainty that can exist in the market during the pendency of an SEC inquiry can far outweigh the monetary penalties that the SEC might pursue.

As a result, companies should periodically reassess their financial reporting processes to minimize risk and the potential for future enforcement actions. Ensuring that all key stakeholders within the company have input in and ownership of the company's reporting process can often ensure that changes or shifts within the business are caught early and their disclosure implications fairly considered. It is also important to maintain transparency with external auditors regarding the effectiveness of internal controls and to regularly identify areas that might need improvement or reinforcement. Detailed record-keeping of these communications involving thoughtful discussions by qualified personnel will often influence the course of an investigation.

It is difficult to anticipate how this trend will evolve—or whether it will continue at all—under the Trump administration. However, enforcement trends generally do not change overnight, and it is best practice for companies to regularly review their internal controls and reporting processes to put themselves in a strong position to deflect any form of heightened scrutiny that may come down the line.

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