Insights

U.S.: A CAUTION ON EARNINGS MANAGEMENT

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In September 1998, U.S. SEC Chairman Arthur Levitt gave a speech called, “The Numbers Game” in which he expressed his “fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting.” He stated that, “Managing may be giving way to manipulation; Integrity may be losing out to illusion.” He talked about “hold[ing] the line on good practices,” and not “operat[ing] in the gray area between legitimacy and outright fraud.” Chairman Levitt identified five areas subject to particular abuse:

- “big bath” restructuring charges
- creative acquisition accounting
- “cookie jar reserves”
- “immaterial” misapplications of accounting principles
- premature recognition of revenue

A few years later, widespread apprehension about earnings management and numerous accounting scandals sparked passage of the Sarbanes-Oxley Act of 2002 (“SOX”). SOX was passed with the stated purpose of protecting investors by improving the accuracy and reliability of corporate disclosures. It requires that issuers and audit firms adhere to much stricter rules, including the requirement that auditors report to independent audit committees and that annual reports include an internal control report, complete with auditor attestation, wherein management assesses the company’s financial reporting controls.

Today, the SEC continues to have an active docket of earnings management cases. These have seemingly focused on two areas – accelerating revenue through measures that encourage customers to take product early, and using expenses either to improve current results (through delay or under-accrual) or to create “cookie jar reserves” (by over-accruing) to help in future lean quarters. In a late 2019 case, the SEC charged Marvell Technology Group, Ltd. with fraud and reporting violations, asserting that it was incentivizing customers to accelerate product purchases so it could meet publicly-released revenue guidance.[1] The Commission alleged that Marvell used undisclosed

"pull ins" of sales to its current quarter to improve its current results and failed to disclose that those "pull ins" were masking a trend of declining customer demand and deteriorating financial results.

There is no doubt that intentional efforts to hide deteriorating performance, or accounting "gimmicks" that enable companies to meet analysts' expectations when they otherwise would not, should be prosecuted by the SEC. But the reality is that the line between legitimate management of one's business and illegal earnings management is not always clear. Companies generally push their sales people to sell as much as they possibly can as soon as they can. The "hockey stick" effect, in which prices drop at the end of a quarter so that companies and salespeople can meet targets, is very common. Similarly, the dividing line between an accrual that was optimistic but reasonable, and one that was so optimistic as to be evidence of earnings management, can be an uncertain one. Moreover, it can be hard to distinguish between an increase in reserves during good times that reflects legitimate concern that sales returns will also increase, as opposed to the creation of cookie-jar reserves.

In the first two quarters of 2020, companies face unprecedented challenges. It is likely that many companies will miss earnings projections made before the arrival of and economic devastation caused by the coronavirus pandemic. There may be a temptation to assume that earnings shortfalls attributed to COVID-19 will be less likely to cause stock price disruption than they otherwise might, and to increase accruals and reserves more generously than it might have otherwise been thought necessary during more normal times. Unfortunately, crystal balls do not work as well as 20/20 hindsight, so an increase in reserves because of a legitimate fear of the impact of the pandemic on future results may look like the creation of a cookie jar reserve. Conversely, the failure to acknowledge the risks of COVID-19 on one's future business could result in under-reserving, which could be equally suspect.

The SEC is clearly making an effort to assist companies by articulating its disclosure expectations during this difficult time. The Division of Corporation Finance urged issuers to disclose the risks and effects of COVID-19 on their businesses, and provided a long list of questions to consider when assessing those risks and effects. Division of Corporation Finance, Coronavirus (COVID-19): CF Disclosure Guidance: Topic No. 9 (March 25, 2020). It has also reminded companies to take advantage of the safe harbor when providing forward looking information with projections of the pandemic's longer-term impact. *Id*. In addition, the Office of the Chief Accountant has offered to assist market participants with challenging financial disclosure issues, noting in its April 3 release that, "OCA has consistently not objected to well-reasoned judgments that entities have made, and we will continue to apply this perspective." Office of Chief Accountant, Statement on the Importance of High-Quality Financial Reporting in Light of the Significant Impacts of COVID-19 (April 3, 2020).

In context of the foregoing, it remains critically important that companies document their decisions and reasoning on what to accrue and what not to accrue, so that they can provide evidence in the future that their judgments were as sound as possible under current circumstances.

Contemporaneous evidence of thoughtful disclosures and reasonable financial reporting will enable a company to defend its decisions in the future, regardless of the ultimate impact of COVID-19 on its business. Being proactive now with such documentation may help you avoid a costly SEC investigation in the future.

BCLP has assembled a COVID-19 Securities/Corporate Governance taskforce to assist clients with U.S. corporate earnings management issues across various jurisdictions. You can contact the taskforce at COVID-19SecuritiesCorporateGovernance@bclplaw.com

1. In the Matter of Marvell Technology Group, Inc., Adm. Proc. File No. 3-19454 (Sept. 16, 2019).

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