

SEC SHOWS NO GOODWILL FOR ISSUER

Dec 16, 2020

The SEC sued Sequential Brands on December 11 in Manhattan federal court, alleging that it failed to accurately calculate and disclose impairments to its goodwill in 2016 and early 2017. According to the Complaint, this resulted in Sequential's misleading investors by filing incomplete periodic reports, and failing to maintain both accurate books and records or a system of accounting controls to assure accurate transaction reporting.

Goodwill is an intangible asset recorded when one company pays more than net fair value to purchase another company. GAAP mandates that acquiring companies assess potential impairments to their goodwill at least once a year and after any "triggering events," and that any impairments to goodwill be recorded. As alleged in the SEC's Complaint, Sequential's annual goodwill testing beginning in fall 2016 that identified no goodwill impairment. But weeks later, the company performed two additional internal calculations in December 2016 using the same methodology employed in its annual testing (and described in public filings). These calculations indicated that Sequential's goodwill was likely impaired, but the company did not share these results with its auditor. The SEC alleges that rather than recording this impairment, Sequential performed a third, qualitative assessment that concluded goodwill was not impaired, but failed to account for internal fair value calculations and significant negative developments in its business. Sequential thus avoided recording any goodwill impairment in 2016, which the Complaint says preserved its operating income at an inflated level, conveyed a false impression of financial health, and led to its filing misstated financial reports for the better part of a year. The errors were not corrected until the fourth quarter of 2017, when Sequential recorded a \$304.1 million impairment of its goodwill.

The Complaint asserted that Sequential violated (i) Securities Act Section 17(a)(3) by negligently misleading investors as to its financial condition, (ii) Exchange Act Section 13(a) and associated rules by filing periodic reports that omitted required information, (iii) Section 13(b)(2)(A) by failing to maintain books and records that accurately reflected its financial condition, and (iv) Exchange Act Section 13(b)(2)(B) by failing to maintain internal controls to ensure transactions were recorded in a way that enabled filing accurate financial statements. The Commission asked the court to enter an Order finding that Sequential violated the securities laws as alleged, restraining and

enjoining Sequential and associated persons from further such violations, and ordering Sequential to pay civil money penalties.

The action against Sequential continues the Division of Enforcement's focus on issuer financial and accounting fraud, which has continued to rank among the top three subject areas for enforcement activity since 2017. The typical posture of these cases is that the charged entity chooses to resolve the enforcement action via settlement and the SEC files a settled action in court or an administrative proceeding. Sequential's choice to litigate the matter could indicate that it was offered unfavorable settlement terms and hopes litigation risk will garner it a better deal, or it has meritorious defenses that will lead to its vindication in court. Either way, issuers should be mindful of the SEC's continued scrutiny of financial disclosures and accounting practices as we near the year-end reporting period.

RELATED CAPABILITIES

- Securities & Corporate Governance

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