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Recent SEC Enforcement Actions Involving Revenue Recognition Fraud

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Overview

The U.S. Securities and Exchange Commission (SEC, or the Commission) brought a total of 821 enforcement actions to obtain disgorgement and penalties totaling approximately $3.9 billion for FY 2018.[1] In FY 2018, issuer reporting, accounting, and auditing actions made up 16% of enforcement activity,[2] which is slightly less than FY 2017, when they constituted approximately 20% of the caseload.[3]

Revenue recognition improprieties, and premature revenue recognition in particular, continue to be areas of special interest to the SEC. Our advice is that companies remain committed to ensuring that they have robust internal controls, conduct thorough audits of those controls, and ensure warning signs from audits are given sufficient management attention. This article highlights the past year's significant developments and discusses the final phase-in of the updated revenue recognition standard and three noteworthy enforcement actions.

Revenue Recognition Fraud and the Impact of the New Revenue Recognition Standard

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, and the International Accounting Standards Board (IASB) issued International Financial Reporting Standards (IFRS) 15.[4] These revisions updated revenue requirements for all entities that provide goods and services to customers.[5]

ASU No. 2014-09 makes clear that "an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."[6] In furtherance of this principle, the update requires reporting entities to:

1. identify the contract(s) with a customer;
2. identify the performance obligations in the contract;
3. determine the transaction price;
4. allocate the transaction price to the performance obligations in the contract; and
5. recognize revenue when (or as) the entity satisfies a performance obligation.[7]

ASU No. 2014-09 went into effect for public companies after December 15, 2017, and after December 15, 2018, for non-public companies.[8] The goal of the FASB and IASB was to provide a single framework for revenue recognition.[9]

ASU No. 2014-09 is designed to affect every aspect of a business that relates to revenue, from a company's financial results to compliance with debt covenants and executive compensation. Accordingly, the new standard aims to:

- help eliminate inconsistencies and weaknesses with the old standard;
- provide more detail about how to deal with revenue recognition;
- make revenue more comparable across different industries;
- provide more useful information to users of financial statements through improved disclosure requirements; and
- simplify the preparation of financial statements by reducing the number of requirements to which an organization must refer.[10]

Figure 1 highlights the differences between the two standards.

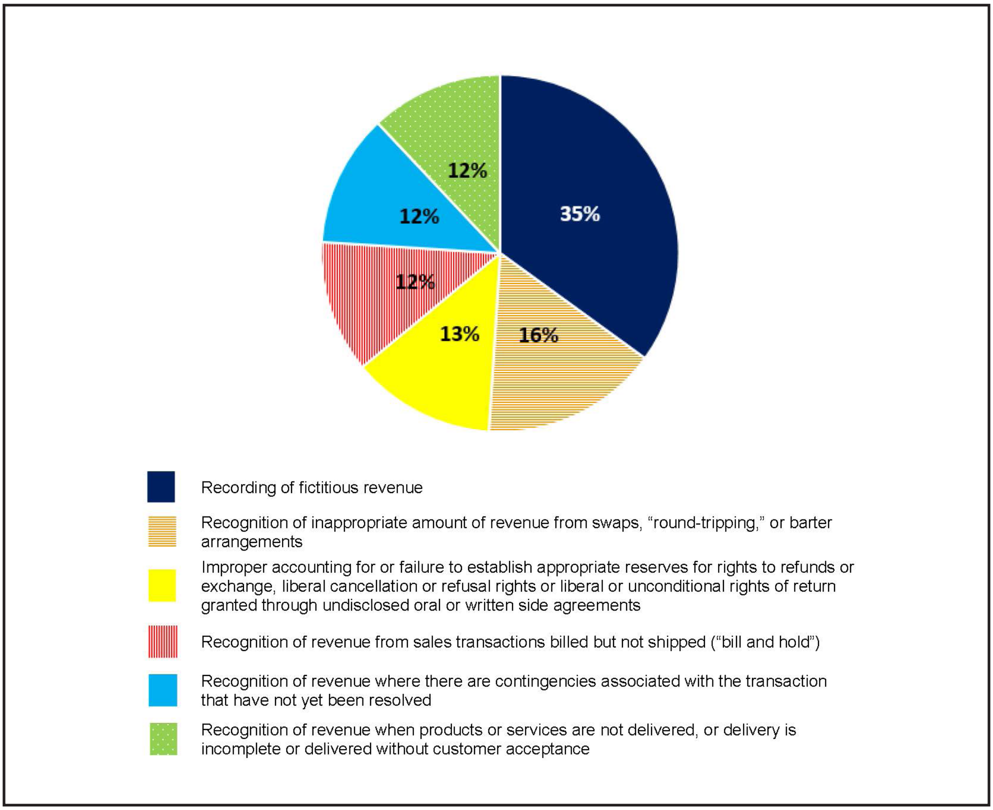
Fig. 1
Comparison of Old and New Guidance on Revenue Recognition[11]

Old Guidance	New Guidance
Numerous requirements for recognizing revenue.	Consistent principles for recognizing revenue, regardless of industry and/or geography.
Other than disclosures in accounting policies and segment reporting, most companies and other reporting organizations provide limited information about revenue contracts.	A cohesive set of disclosure requirements that will provide users of financial statements with useful information about the organization's contracts with customers.

Old Guidance	New Guidance
Many goods or services promised in a contract with a customer are deemed not to be distinct revenue-generating transactions, when in fact those promises might represent separate obligations of the entity to the customer.	Reporting organizations: • Identify each of the goods or services promised to a customer; • Determine whether those goods or services represent a performance obligation; and • Recognize revenue when (or as) each performance obligation is satisfied.
In a multiple-element arrangement, the amount of consideration allocated to a delivered element is limited to the amount that is not contingent on delivering future goods or services.	Companies allocate the transaction price to each of the performance obligations in the contract on the basis of the relative standalone selling price of the underlying goods or services, except when a discount or a variable amount of consideration relates entirely to one or more of the performance obligations in the contract.
Accounting for variable consideration differs greatly across industries.	A single model to consider for variable consideration, which includes rebates, discounts, bonuses, or a right of return.

As depicted in Figure 2, recording fictitious revenue is the most common type of revenue recognition fraud.[12] The next is recognizing inappropriate revenue from swaps, round-tripping, or barter arrangements.[13] The four other subtypes are more evenly distributed. The top six schemes displayed below account for 70% of all revenue recognition schemes identified, according to the American Institute of Certified Public Accountants.[14]

Fig. 2
Six Common Types of Revenue Recognition Fraud



Specific Enforcement Actions

We have seen these revenue recognition issues play out in the Panasonic Corp., Maxwell Technologies, Inc., and Hertz settlements. These three cases exemplify both the wide range of improper tactics employed by companies, as well as the underlying causes motivating these practices.

In re Panasonic Corp.[15]

Panasonic Corp. (headquartered in Osaka, Japan) and its U.S. subsidiary, Panasonic Avionics Corp. (PAC), engaged in a number of inappropriate activities, including bribery, in an effort to secure lucrative contracts and gain inside information, which included confidential material on competing companies, customers, and various airlines.[16] On April 30, 2018, the SEC settled charges against both entities for violating sections 30A, 13(a), 13(b)(2)(A), 12(b)(2)(B), and 10(b) of the Securities and Exchange Act of 1934, and Exchange Rules 10b-5, 13a-16, and 12b-20, based on allegations that PAC:

(i) entered into a bribery scheme in 2007;

(ii) materially overstated its pretax income and net income in 2012; and

(iii) lacked appropriate internal accounting controls with respect to its use of consultants and sales agents.[17]

Improper Revenue Recognition

The SEC alleged that Panasonic fraudulently overstated pretax and net income by prematurely recognizing more than $82 million in revenue for the fiscal quarter ending June 30, 2012. According to the SEC, this premature revenue recognition was accomplished by PAC backdating an agreement with a government-owned airline and providing misleading information about the agreement to PAC's auditor in order to include the revenue in the quarter.[18] The SEC found that PAC had been backdating contracts from as early as 2006,[19] with an especially egregious instance occurring around June 2012.[20] This specific agreement was referred to as "Amendment Six," as it served as an amendment to a ten-year master product supply agreement from 2004 between the two parties.[21] Negotiations were ongoing in June 2012, but were not completed by the end of the quarter.[22]

PAC's written revenue recognition policy at the time was consistent with generally accepted accounting principles (GAAP) and set forth four requirements that generally must be met before revenue could be considered realized and earned:

(1) Persuasive evidence of an arrangement exists;

(2) Delivery has occurred, or services have been rendered;

(3) The seller's price to the buyer is fixed or determinable; and

(4) Collectability is reasonably assured.[23]

The SEC explained that, based on PAC's revenue recognition policy, it could not recognize revenue for a quarter unless, among other requirements, a contract was signed by the customer during the quarter in which the revenue was recognized.[24] Moreover, PAC's external auditor specifically advised PAC that a signed contract was required to recognize revenue from customers, such as Amendment Six.[25] In a classic example of backdating, the SEC found that:

> [o]n July 3, 2012, the Government Airline provided PAC with an executed, but undated, signature page for Amendment Six. A PAC contracts manager then caused the date June 28, 2012 to be added to the Government Airline signature page even though he and other PAC employees and executives knew that it was not signed on that date and that the Government Airline was still seeking additional pricing discounts.[26]

Improprieties Concerning Sales Representatives and Consultants

In February 2009, PAC strengthened its process to hire sales agents, requiring, among other things, that the company:

(i) review whether a new agent was needed;

(ii) perform background checks;

(iii) analyze whether red flags existed; and

(iv) engage a third party to conduct diligence vetting.[27]

Panasonic maintained an internal review committee (IRC), which was charged with evaluating all requests for new sales agents. The SEC alleged that the IRC never reviewed the due diligence reports or red flags identified by the third party and, indeed, did not ever reject a request to hire new agents.[28] For example, although an internal audit report found that a sales agent had forged references and another had been flagged for a potential Foreign Corrupt Practices Act (FCPA) violation, PAC hired them anyway.[29] The SEC also found that no executive questioned suspicious issues—for instance, why the number of sales agents decreased after the company implemented more stringent hiring practices, or how a small Malaysian consulting practice could work on roughly fifty different programs for twenty different airlines.[30]

Other allegations such as bribery in the Middle East and retention of unqualified consultants and sales representatives occurred from roughly 2007 to 2015.[31]

As one example, PAC offered a consulting position to an individual who was then employed as a contracting manager at a state-owned commercial airline based in the Middle East and involved in negotiating a $700 million airline contract amendment with PAC.[32] After the contract amendment was entered, ultimately resulting in $92 million in profits for PAC, the individual resigned from the Middle Eastern airline and accepted a position as a PAC consultant, in violation of Panasonic's policies and procedures.[33] The SEC found that PAC subsequently paid the individual $875,000 over a six-year period in exchange for few, if any, legitimate consulting services.[34]

The SEC also found that PAC had made substantial payments to foreign and domestic consultants who provided little to no actual consulting services and used a middleman to pay foreign sales agents who had failed PAC's internal due diligence requirements.[35] As an example, PAC hired a U.S. airline consultant as a consultant.[36] While working as both a PAC and an airline consultant, that individual: (i) provided PAC with non-public, inside, or otherwise sensitive information through his position at the U.S. airline; and (ii) served as part of the airline team that evaluated bids from PAC and other vendors.[37] PAC paid the U.S. airline consultant $825,000 over a six-year period.[38]

To make the payments to both the former employee of the Middle Eastern airline and the U.S. airline consultant, a PAC executive used a corporate fund that was within the executive's sole control.[39] The PAC executive then sent the payment from the corporate fund to one of PAC's U.S.-based vendors, which in turn paid the foreign official and the U.S. airline consultant.[40] The SEC explained that PAC mischaracterized these payments as consulting payments, when in fact "little or no legitimate services were provided,"[41] thus causing Panasonic to falsely book the payments as legitimate expenses for services provided.[42]

PAC also concealed payments to sales agents in its Asia region who did not pass PAC's internal due diligence requirements.[43] Specifically, PAC began strengthening its controls related to third-party agents in 2007 and formally terminated a number of agents who did not comply with PAC's new due diligence requirements.[44] However, PAC secretly continued to use some of those terminated agents by having an agent that had passed PAC's due diligence requirements (the "verified agent") hire the terminated agents as subagents.[45] In sum, the SEC concluded that PAC paid thirteen such terminated agents a total of over $7 million through the verified agent by increasing the commission rates paid by PAC to the verified agent from 1% to 2%.[46]

As a result of this wide-ranging misconduct, PAC entered into a deferred prosecution agreement on April 30, 2018, admitting that it had knowingly and willfully caused Panasonic to falsify its books, records, and accounts, in violation of the FCPA.[47] Panasonic and PAC were both placed under cease-and-desist orders and Panasonic was ordered to pay disgorgement of $126,900,000 and prejudgment interest of $16,299,018.93 to the SEC.[48]

In re Maxwell Technologies, Inc.[49]

The Maxwell Technologies, Inc. (Maxwell) enforcement action involves an entity the SEC termed "an SEC recidivist."[50] Maxwell, a California-based energy storage and power delivery product manufacturer, historically recorded revenue when its product was delivered to the customer. In 2011, in order to push revenue to a prior quarter to meet street estimates, one of Maxwell's former sales executives, Van Andrews, caused the company to record revenue when the product left the warehouse in certain cases.[51] The scheme went on through January 2013 and caused the company to improperly recognize $19 million in revenue from sales contracts based on entry into side deals with customers with contingency payment terms and rights of return, extending payment terms and falsifying purchase orders.[52]

On March 27, 2018, the SEC charged Maxwell and several executives with violations of the antifraud provisions of Exchange Act section 10(b) and Rules 10b-5(a) and 10b-5(c) thereunder, and Securities Act section 17(a); the reporting provisions of Exchange Act section 13(a) and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder; the books and records provisions of Exchange Act section 13(b)(2)(A); and the internal accounting control provisions of section 13(b)(2)(B).[53]

Revenue Recognition Scheme

The SEC found that Maxwell had prematurely recognized revenue from the sale of ultracapacitors, which are small energy storage and power delivery products.[54]

The SEC explained that Maxwell's finance and accounting department repeatedly overrode and ignored automated controls and missed red flags that should have alerted them to "material revenue recognition departures."[55]

The SEC alleged that David Schramm, Maxwell's chief executive officer and president, put undue pressure on the sales department to reach specified revenue and earnings targets.[56] In particular, Schramm required weekly status updates from Van Andrews, Senior Vice President of Sales & Marketing, on shortfalls between actual and expected revenue and an associated "detailed contingency plan" to close that gap.[57] These particular requirements, coupled with a high-pressure environment, created a perfect storm for improper conduct to thrive. Part of Schramm's 2011 bonus was tied directly to the company's revenue performance, providing yet another layer of incentive to engage in improper activity.[58]

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Maxwell's contract with a large German distributor included a contingency term stating that the distributor would not pay Maxwell until the distributor was first paid by the ultimate customer, named in the order as "Global Automotive Consumer" (GAC).[59] Beginning in March 2011, the GAC began to receive an oversupply of Maxwell's products.[60] By October 2011, the GAC refused to accept future deliveries and, in November 2011, canceled all remaining shipments, including for 125,000 units Maxwell had in its warehouses.[61] This left Maxwell with a $3.7 million revenue shortfall.[62] To avoid this shortfall, Van Andrews caused the company to create deviations from Maxwell's standard payment terms and conditions.[63] Specifically, payment terms were modified during the final days of reporting periods solely to persuade the GAC (and other customers) to accept product they did not need or want.[64] Van Andrews also got the German distributor to accept additional ultracapacitors for delivery to the GAC, notwithstanding that the GAC had canceled its outstanding commitments.[65] Van Andrews then falsified purchase orders to take out the contingency payment terms to make it appear as if the revenue was collectible.[66] Through this additional revenue Maxwell was able to beat analyst estimates for the first time in years.[67]

The accounting fraud came to an end on January 9, 2013, when an internal whistleblower, Maxwell's former director of SEC compliance and reporting, delivered a multi-page letter detailing the accounting misconduct at Maxwell.[68] This kicked off an internal investigation, which resulted in Maxwell's announcement that it would restate its 2011 and 2012 financials.[69]

Maxwell's Lack of Sufficient Internal Accounting Controls

At Maxwell, credit blocks to the German distributor were overridden several times, without performing a creditworthiness check.[70] Maxwell also coerced the German distributor to provide a false confirmation that its transactions contained no contingencies.[71] The company's control deficiencies were further evidenced by Maxwell's longtime auditor abruptly resigning because he could no longer rely on management's representations, citing continuing material weaknesses in Maxwell's internal controls over revenue recognition.[72] Ultimately, Maxwell's shareholders were the ones most negatively impacted by Maxwell's knowing misconduct, suffering millions of dollars in losses when the company's stock plummeted.[73] Specifically, Maxwell filed Form 8-Ks—publicly revealing their revenue recognition issues—on March 7, 2013, and March 19, 2013, which led to stock price drops of 11.09% and 20.57%, respectively.[74]

As a result of the misconduct, Maxwell was ordered to pay a $2.8 million civil money penalty to the SEC; Van Andrews, a $50,000 penalty; and Schramm, a $40,000 penalty. Moreover, Van Andrews was prohibited for five years from acting as an officer or director of any SEC registrant.[75]

In re Hertz Global Holdings, Inc. & Hertz Corp.[76]

A pressured corporate environment also led Hertz Global Holdings ("Hertz") and its subsidiary Hertz Corp. to engage in multiple improper accounting practices, including:

(1) misstating pretax income;

(2) using unreasonable subrogation methods; and
(3) omitting key information in financial statements.

On December 31, 2018, the SEC settled charges against Hertz for violating sections 17(a)(2) and 17(a)(3) of the Securities Act and sections 13(2), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, 13a-11, and 13a-13 thereunder, and against Hertz Corp. for violating section 15(d) of the Exchange Act and Rules 12b-20, 15d-1, 15d-11, and 15d-13 thereunder.[77]

Improper Revenue Recognition

The restatement acknowledged that $235 million in pretax income was improperly recorded under GAAP and that the subrogation methodology accounted for $48 million of that misstatement.[78] The subrogation methodology, or the effort to account for expenses resulting from vehicle damage during rentals, changed several times during the period in question, lacked historical data that would allow the company to assess the propriety of the changing methodologies, and was used in an effort to close budget gaps and revenue shortfalls, including through post-closing adjustments.[79] Hertz also omitted key information concerning the extension of fleet holding periods (depreciation rates) in its financial statements. Specifically, in 2013, Hertz extended the holding periods of its top models from twenty months to twenty-four or thirty months,[80] which immediately augmented revenue. This change, and its resulting $15 million cut from depreciation expenses, was not properly recorded in the company's 2013 Form 10-Q.[81] Hertz restated its 2011, 2012, 2013, and 2014 financial statements and reduced its previously reported pretax income by $235 million for those reporting periods, identifying seventeen areas with material accounting errors across its business units.[82]

Hertz's Lack of Sufficient Internal Accounting Controls

Hertz attributed its accounting errors to material accounting issues and deficiencies in internal controls over financial reporting. After conducting an internal investigation, the audit committee concluded that as of December 31, 2014, "there were four categories of material weaknesses in [its] internal control over financial reporting that contributed to the material misstatements in the 2011, 2012, and 2013 consolidated financial statements."[83] The four categories were:

(1) control environment;
(2) risk assessment;
(3) information and communication; and
(4) monitoring.[84]

Overall, Hertz did not have an adequate process for internally communicating information between the accounting department and other operating departments necessary to support the proper functioning of internal controls.[85] The SEC agreed and found that Hertz was riddled with internal control deficiencies, which encouraged employees to manufacture accounting adjustments to enable Hertz to achieve the desired financial results. As a result of the misconduct, Hertz was required to pay a civil penalty of $16 million to the SEC.[86]

Conclusion

Time and time again, the SEC's cease-and-desist orders refer to the pressure executives felt to meet consensus estimates. In fact, in the case of Hertz, a "pressured corporate environment" is the primary cause the SEC cites for its fraudulent reporting.[87] The other two cases also show the impact that a stressful corporate environment can have when executives are focused solely on the bottom line and are willfully blind to, or even encourage, control deficiencies. The Panasonic order makes clear that PAC executives and employees understood that particular deals were critical to Panasonic's bottom line and that failing to recognize the revenue from those deals in a certain quarter was, as one PAC executive noted, "a big problem for all of us."[88] However, resorting to fraudulent revenue recognition tactics is only a temporary solution: The problem becomes even bigger when the SEC is forced to take action.

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NOTES

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15. Exchange Act Release No. 83,128 (Apr. 30, 2018), www.sec.gov/litigation/admin/2018/34-83128.pdf.
16. *Id.*

17. *Id*. at 2.
18. “As early as 2006, PAC backdated certain customer contracts in order to recognize revenue in time periods prior to when those contracts were actually signed.” Exchange Act Release No. 83,128, ¶ 3.
19. *Id*. at ¶ 44.
20. *Id*. at ¶ 3.
21. *Id*. at ¶ 10 *et seq*.
22. *Id*. at ¶ 45.
23. *Id*. at ¶ 43.
24. “Consistent with the Auditor’s prior advice, and PAC’s past practice in accounting for agreements with the Government Airline, the Auditor advised PAC that PAC could recognize revenue from Amendment Six in the quarter ending June 30, 2012 (‘First Quarter’) if the agreement was signed prior to the end of June 2012.” *Id*. at ¶ 45.
25. *Id*.
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27. *Id*. at ¶ 36.
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29. *Id*. at ¶ 40.
30. *Id*. at ¶ 36 *et seq*.
31. *Id*. at ¶ 7 *et seq*.
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33. *Id*. at A-12.
34. *Id*.
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60. *Id*.
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64. *Id*. at 2–3, 6, 8, 11, 13–14.
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67. *Id*. at 9.
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69. *Id*.
70. *Id*. at 12–13.
71. *Id*. at 14.
72. *Id*.
73. *Id*. at 15–16.
74. *Id*.
75. *Id*. at 22–23.
76. Exchange Act Release No. 10,601 (Dec. 31, 2018), www.sec.gov/litigation/admin/2018/33-10601.pdf.
77. *Id*. at 2.
78. *Id*. at 2–3.
79. *Id*. at 2, 4.
80. *Id*. at 2, 5.
81. *Id*. at 6.
82. *Id*. at 3.
83. Hertz Global Holdings, Inc., Annual Report (Form 10-K) at iv (July 16, 2015), www.sec.gov/Archives/edgar/data/1364479/000136447915000013/hgh2014form10-k.htm.
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86. *Id*. at 11.
87. *SEC Charges Hertz with Inaccurate Financial Reporting and Other Failures*, U.S. Sec. & Exch. Comm'n (Feb. 1, 2019), www.sec.gov/enforce/33-10601-s.
88. Exchange Act Release No. 83,128, at 9–10.