<u>Internal Controls, Accrual Adjustments and Loss Forecasting</u>

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By Tracy Richelle High, Partner, and Kamil E. Redmond, Associate, Sullivan & Cromwell LLP

The enforcement actions brought by the U.S. Securities and Exchange Commission (the "SEC") during 2013 and the first quarter of 2014 highlight how imperative it is for a company to implement proper internal controls to avoid financial reporting improprieties. The matters resolved during this time period involved not only multi-million dollar irregularities, but also relatively low dollar figure misconduct. Regardless of the amounts at issue, these cases demonstrate that if a company fails to implement an appropriate internal control system, challenged conduct can result in multiple quarters of improper reporting, requiring in many instances, numerous restatements.

<u>The Internal Controls Regime</u>

Section 13(b)(2)(B) of the Securities and Exchange Act of 1934 (the "Exchange Act"), as amended, requires that every publicly traded company: "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances[1] that—

> (i) transactions are executed in accordance with management's general or specific authorization;
> (ii) transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for assets;
> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
> (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences[.]"[2]

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[1] "Reasonable assurance" is defined as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." 15 U.S.C. § 78m(b)(7).

[2] 15 U.S.C. § 78m(b)(2) (B). Section 13(b)(2)(A), violations of which are frequently alleged in connection with Section 13(b)(2)(B), provides that every issuer shall "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." 15 U.S.C. § 78m(b)(2)(A); *see also* Letter from Annette Nazareth, Director, U.S. Securities and Exchange Commission, to Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and Douglas Roeder, Senior Deputy Comptroller, Large Bank Supervision, Office of the Comptroller of the Currency, Re: Guidance on the Potential Liability of Financial Institutions for Securities Law Violations Arising from Deceptive Structured Finance Products and Transactions (December 3, 2003) ("[R]ecordkeeping and internal controls violations often arise as a result of financial fraud. An issuer that

Additionally, Section 13(b)(5) prohibits any person from "knowingly circumvent[ing] or knowingly fail[ing] to implement a system of internal accounting controls or knowingly falsify[ing] any book, record, or account described in paragraph (2)."[3] Neither provision requires scienter, or proof of wrongful intent by the alleged wrongdoer, in order to impose civil sanctions.[4]

Neither the Exchange Act nor the SEC has specified an internal control procedure that a U.S. issuer must implement. The only SEC-recognized framework is a discretionary one established in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").[5] In June 2007, the SEC provided its Final Rule on

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engaged in a deceptive structured finance transaction may take steps to conceal the fraud, including manipulating books and records and bypassing internal controls."), *available at* http://www.federalreserve.gov/boarddocs/srletters/2004/sr0401a1.pdf.

[3] 15 U.S.C. § 78m(b)(5). *See also* SEC Spotlight on FCPA, *available at* http://www.sec.gov/spotlight/fcpa/fcpa-recordkeeping.pdf.

[4] *See SEC* v. *World-Wide Coin Investments, Ltd.*, 567 F. Supp. 724, 749 (N.D. Ga. 1983).

[5] *See* Section II.B.3.a of SEC Release No. 33-8238 ("The COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation and disclosure requirements. However, the final rules do not

Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,[6] requiring every issuer to "maintain disclosure controls and procedures . . . and interim control over financial reporting."[7] The SEC defines "internal control over financial reporting" as "a process designed by, or under the supervision of,

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mandate use of a particular framework[.]"); *see also* Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems*, 31 J. CORP. L. 949, 953 (2006) (discussing creation of the Treadway Commission and noting that "[i]ts report, *Internal Controls: An Integrated Framework*, was released in 1992, and now plays a significant role under Sarbanes-Oxley"). In November 2010, COSO announced that it intended to update the 1992 framework. The comment period for the proposal closed in March 2012. The December 2011 draft framework defines internal controls as a process "designed to provide reasonable assurance regarding the achievement of objections in . . . effectiveness and efficiency of operations[;] reliability of reporting[; and] compliance with applicable laws and regulations." Draft Framework, December 2011, *available at* http://www.coso.org/documents/coso_framework_body_v6.pdf.

[6] The Final Rule was promulgated in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which requires issuers to present information in their annual reports addressing the scope, sufficiency and effectiveness of their internal controls and procedures for financial reporting. *See also* Internal Controls at 954, *supra* note 5 (noting that Section 302 of Sarbanes-Oxley also imposes internal control obligations, namely requiring that chief executive officers and CFOs certify the issuer's 10-Ks and 10-Qs, including by stating that they are responsible for internal controls, have designed such controls to ensure that material information is brought to their attention, have evaluated the controls' effectiveness in the last 90 days, and have discussed in the report any changes to internal controls during the period under review).

[7] 17 C.F.R. 240.13a-15(a).

the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles."[8] That process must:

> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.[9]

[8] 17 C.F.R. 240.13a-15(f).

[9] *Id*.

Finally, Item 308 of Regulation S-K requires management to provide an annual report that:

> (1) states management's responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant;
> (2) identifies the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting;
> (3) provides management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective; and
> (4) states that the registrant's outside auditors have issued an attestation report on the registrant's internal control over financial reporting. This report must be included in the Form 10-K.[10]

Management's assessment of the effectiveness of its internal controls must disclose "any material weakness in the registrant's internal control over financial reporting identified by management."[11]

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[10] 17 C.F.R. 229.308.

[11] *Id*. (further stating that "[m]anagement is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting[.]").

Deferred Expense Recording: Pushing the Weight

Although a relatively small case based on the assessed penalty, the SEC's September 18, 2013 action against Medifast, Inc. ("Medifast") is emblematic of the SEC's laser focus on companies that deliberately understate expenses and overstate income. In the *Medifast* action, the SEC issued a cease-and-desist order with respect to misconduct by Medifast, a manufacturer and distributer of weight loss and other health and diet products and supplements. The SEC alleged that Medifast improperly accounted for its income tax provision for the years 2006 through 2008, thereby understating its income tax expense and overstating its net income after tax.[12]

On March 31, 2010, Medifast filed its Form 10-K for the year ending December 31, 2009 and restated its financial statements for the years ending December 31, 2006, 2007 and 2008. Medifast claimed that a restatement was required to correct material errors in its reported income tax expenses. These errors

[12] *See* In the Matter of Medifast, Inc., Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order and a Civil Penalty (Sept. 18, 2013) ¶ 6.

were the result of Medifast's improper accounting of its income tax provision in conformity with the Statement for Financial Accounting Standards 109, *Accounting for Income Taxes* (FAS 109),[13] and U.S. Generally Accepted Accounting Principles ("GAAP").[14] In its order, the SEC explained that the 2010 Restatement was required because Medifast failed to calculate a deferred tax liability to account for the depreciation of certain fixed assets. This failure resulted in an approximate 12.4%

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[13] The Financial Accounting Standards Board's summary of Statement No. 109 provides that:

> "The objectives of accounting for income taxes are to recognize (a) the amount of taxes payable or refundable for the current year and (b) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns.
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> The following basic principles are applied in accounting for income taxes at the date of the financial statements:
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> 1. A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
> 2. A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
> 3. The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
> 4. The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized."

Available at http://www.fasb.org/summary/stsum109.shtml.

[14] Financial statements that are not prepared in accordance with GAAP are presumed to be misleading or inaccurate. *See* Regulation S-C, 17 C.F.R. 210.4-01(a)(1).

overstatement of Medifast's net income between the end of 2006 and the end of 2008.[15] Further, Medifast's reported income tax provision in its Form 10-Ks for 2007 and 2008 did not match its internal worksheets for those years. For example, although in 2008 Medifast internally calculated its income tax provision as $2,576,108 and calculated a total deferred tax asset as $1,321,072, in its 2008 Form 10-K, Medifast reported a current income tax expense of $1,711,000 and a deferred tax expense of $705,000.[16] While a small discrepancy, the SEC expressed concern about Medifast's effort to minimize its tax expenses and inflate its income. Finally, the order noted Medifast's acknowledgment in the 2010 Restatement of inadequate internal controls: "[B]ecause the preparation and review process for the calculation of its tax provision was inadequate, [this] led to errors in the computation of

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[15] *Id*. ¶ 8.

[16] *Id*. ¶ 9. Similar disparities occurred in 2007. In that year, Medifast internally calculated its total tax expense as $1,805,708 and a deferred tax asset as $1,079,321. In its 2007 Form 10-K, however, Medifast reported a current income tax expense of $1,233,000 and a deferred tax expense of $473,000.

deferred tax assets, deferred tax liabilities, and the income tax provision."[17]

Shortly after Medifast filed its 2010 Restatement, it engaged a new audit firm, which identified "additional material errors related to Medifast's revenue recognition and expense recognition accounting."[18] The SEC contended that, in 2008 and 2009, Medifast regularly—and improperly—deferred recording expenses charged to a credit card until the following month when the credit card payment was due, rather than charging those expenses at the time of purchase.[19] As a result, Medifast's deferred recording led to expenses being recorded on a "cash basis rather than an accrual basis,"[20] contravening Statement of Financial Accounting Standards No. 5, Accounting for

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[17] *Id*. ¶ 11.

[18] *Id*. ¶ 12. Under SEC Staff Accounting Bulletin No. 104 ("SAB 104"), revenue is properly recorded when (i) persuasive evidence of an arrangement exists; (ii) delivery of a product or service has occurred; (iii) the fee or price is fixed or determinable; and (iv) the likelihood of collection and returns is reasonably assured. *See* SAB 104, 17 C.F.R. Part 211 (2003), *available at* http://www.sec.gov/interps/account/sab104rev.pdf.

[19] *Supra* note 12 ¶ 13.

[20] *Id*.

Contingencies ("FAS No. 5").[21] During the same period, Medifast failed to properly recognize revenue earned through its physical weight-loss clinics. These clinics allow Medifast customers to pre-pay for weight loss programs provided by Medifast over a period of time (depending on the amount of weight lost). The SEC charged that Medifast "prematurely recognized the revenue associated with these weight-loss programs at its [clinics] at the time that the clients paid the program fee," rather than over the period of time that Medifast actually earned the revenue, in violation of GAAP.[22]

Medifast's accounting irregularities thus caused it to overstate 2008 and 2009 net income. In 2009, Medifast

[21] The Financial Accounting Standards Board's summary of Statement No. 5 provides that:

> "This Statement establishes standards of financial accounting and reporting for loss contingencies. It requires accrual by a charge to income (and disclosure) for an estimated loss from a loss contingency if two conditions are met: (a) information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements, and (b) the amount of loss can be reasonably estimated. Accruals for general or unspecified business risks ('reserves for general contingencies') are no longer permitted."

Available at http://www.fasb.org/summary/stsum5.shtml.

[22] *Supra* note 12 ¶ 14.

overstated its revenue by $169,000 and understated its expenses by $539,000. These errors, in combination with Medifast's improper income tax adjustments, resulted in an overstatement of net income by $606,000 (or approximately 5.1%). In 2008, Medifast overstated its revenue by $143,000 and understated its expenses by $588,000. The 2008 errors, in concert with the tax errors, led to an overstatement of Medifast's restated net income by $523,000 or 10.8%.

In connection with its 2011 Restatement, Medifast's audit firm identified a series of internal control deficiencies, including that Medifast "did not maintain sufficient in-house accounting personnel with the technical accounting knowledge, training, and expertise in the selection, application and implementation of GAAP in the areas of revenue recognition and expense accrual."[23] And, notwithstanding the 2010 Restatement, the audit report claimed that Medifast "had continued ineffectiveness" with respect to its internal controls for income tax accounting.[24] Medifast agreed in its 2011 Restatement that it

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[23] *Id*. ¶ 16.

[24] *Id*.

lacked sufficient controls as to revenue recognition and expense accrual. It also acknowledged that material weaknesses remained in the preparation and review process for the calculation of its tax provision.

The SEC ordered Medifast to cease and desist from committing or causing to commit any violations in the future of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and rules promulgated thereunder.[25] It also imposed a civil file of $200,000. While neither an astronomical fine nor penalty, the *Medifast* case highlights the importance of having effective internal controls and the need to ensure that a company's internal books and records accurately reflect what is reported to the public.

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[25] Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 require all issuers to file periodic reports with the SEC, including quarterly reports known as Form 10-Qs and annual reports known as Form 10-Ks, that are accurate and do not omit information that would otherwise make the information in the reports misleading. *See* 15 U.S.C. § 78m(2); *see also SEC* v. *Savoy Industries*, 587 F.2d 1149, 1167 (D.C. Cir. 1978) ("[T]he requirement that an issuer file reports under Section 13(a) embodies the requirement that such reports be true and correct."). Financial statements incorporated in any of these reports must comply with Regulation S-X, which in turn requires conformity with GAAP. *See supra* note 14.

Delayed Recording: "Continuity" and "Momentum" Payments

In a tongue-in-cheek case of so-called "nutty accounting,"[26] the SEC instituted an action on January 9, 2014, against Diamond Foods, Inc. ("Diamond"), a California-based snack food company, based on similar allegations of deferred expense recording.[27] As described in the SEC's complaint, one aspect of Diamond's overall business model involved purchasing walnuts from its growers and then selling those walnuts to retailers. The SEC alleged that Diamond's Chief Financial Officer, Steven Neil, delayed recording monies paid to walnut growers, resulting in inflated earnings for fiscal years 2010 and 2011. As one commentator colorfully put it, "[n]ut seller Diamond Foods is shelling out $5 million after being accused of some unsavory accounting practices."[28]

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[26] *SEC Charges Diamond Food Over Nutty Accounting*, CNN MONEY, Jan. 9, 2014, *available at* http://money.cnn.com/2014/01/09/news/companies/diamond-foods-accounting/.

[27] *See* Complaint ¶ 1, *SEC* v. *Diamond Foods, Inc.*, 14-cv-00123, Dkt. No. 1 (C.D. Cal.). The SEC also brought similar actions against Diamond's Chief Executive Officer, Michael Mendes, and its Chief Financial Officer, Steven Neil.

[28] *Supra* note 27.

According to the SEC, Diamond's "practice" was to accept delivery of a walnut crop in the fall and then determine the final price that it would pay to growers by fiscal year-end (July 31 of the next calendar year).[29] Because Diamond purchased and sold walnuts throughout the fiscal year and before the final crop price was determined, it recorded the estimated cost of walnuts in its quarterly financial statements. This estimate was "supposed to reflect the best estimate of the final walnut cost Diamond intended to pay its growers."[30] Under the terms of its contracts with growers, Diamond issued a series of installment payments to growers with the final payment accruing at fiscal year-end. The total installment payments reflected the final price paid for the walnuts acquired during that fiscal year.[31]

The SEC alleged that Diamond "faced pressure to meet or exceed the earnings estimates of Wall Street stock analysts,"[32] given that Diamond had consistently reported earnings

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[29] *Id*. ¶ 19.

[30] *Id*.

[31] *Id*. ¶ 20.

[32] *Id*. ¶ 2.

above forecasted expectations. At the same time, Neil and Diamond "encountered sharp increases in walnut prices," requiring the company to pay higher prices to growers in order to maintain its "longstanding relationship with its growers."[33] Faced with the competing demands of having to increase the amounts paid to growers and exceed earnings estimates, the SEC contended that "Neil orchestrated a scheme to have it both ways."[34] Beginning in February 2010, that scheme entailed Neil instructing members of his finance team to adjust walnut costs so Diamond could hit earnings targets for the second quarter.[35] Accordingly, Diamond employees reduced the existing walnut cost estimate of 82 cents per pound to 72 cents per pound. Diamond's quarterly financial statements, as well as its books and records, reflected the adjusted estimate.[36]

[33] *Id.*

[34] *Id.* ¶ 3.

[35] According to the SEC's press release, "[i]n internal e-mails, Neil referred to these commodity costs as a 'lever' to manage earnings in Diamond's financial statements." *See* SEC Litigation Release No. 22902 (January 9, 2014), *available at* http://www.sec.gov/litigation/litreleases/2014/lr22902.htm.

[36] *Supra* note 27 ¶ 25.

To assuage walnut growers that were dissatisfied with the price paid by Diamond in comparison to that paid by other walnut handlers (Diamond reportedly paid 15 cents lower per pound than others), Neil and his finance team sought to "close the gap" by providing a "continuity" payment equal to $20 million. To avoid recording the expense, Neil and his team treated the "continuity" payment as an advance for a future, undelivered, walnut crop and did not, as they should have, recognized the payment in fiscal year 2010.[37] Although characterized as an advance, the SEC maintained that "Neil knew, however, that some growers believed that the payment was part of the payment for the already-delivered 2009 crop."[38] Further, Neil "did not instruct the Grower Relations Team to issue the payments to only those growers that were under contract or otherwise expected to deliver the 2010 crop. As a result, Diamond issued over $400,000 in 'continuity' payment amounts to growers who delivered a 2009 crop but were not under contract to deliver the 2010 crop, and another $450,000 in 'continuity' payments to growers who

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[37] *Id*. ¶ 30.

[38] *Id*. ¶ 32.

delivered a 2009 crop but did not ultimately deliver the 2010 crop."[39] The underestimation of walnut costs resulted in earnings per share ("EPS") that surpassed analyst expectations. On October 5, 2010, the same day that it filed its Form 10-K, Diamond touted its 52% growth in earnings and raised its EPS guidance for fiscal year 2011.

In fiscal year 2011, Diamond colloquially doubled-down on its misconduct. Diamond continued to understate its recorded walnut cost and overstate earnings and EPS, by "manipulating walnut cost accruals" and excluding portions of the final walnut cost.[40] In summer 2011, in response to walnut growers' concerns about the installment amounts paid by Diamond for the 2010 crop, Neil decided to issue a so-called "momentum" payment with its final payment. Because the final price for the 2010 crop, without the additional payment, would have been 40 cents per pound below the price paid by Diamond's competitors, the SEC claimed that Neil needed to close the

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[39] *Id*. ¶ 33.

[40] *Id*. ¶ 36.

"unusual and unprecedented" gap in price.[41] As in 2010, Diamond's finance team treated the "momentum" payment in its financial records as an advance for the crop to be delivered in the fall of 2011 and booked accordingly. However, Diamond admitted the truth to its growers: "At least some growers were told by Diamond personnel that the purpose of the 'momentum' payment was to 'make up' for the low final payment made only a few days earlier."[42] And, as it had previously, Diamond provided those momentum payments to growers who delivered a 2010 crop but were not under contract or otherwise expected to deliver a 2011 crop.[43] The SEC asserted that, due to the walnut cost understatement, Diamond's 2011 Form 10-K reported EPS that once again exceeded expectations. On the same day that it filed its 10-K, Diamond lauded its 37% increase in EPS during fiscal year 2011.

[41] *Id*. ¶ 41.

[42] *Id*. ¶ 42.

[43] As the SEC explained: "Diamond issued more than $3 million in 'momentum' payments to growers who delivered a 2010 crop but were not under contract to deliver a 2011 crop, and another $5.8. million in 'momentum' payments to growers who delivered a 2010 crop but did not ultimately deliver the 2011 crop." *Id*. ¶ 43.

The celebration was short-lived. Fifteen days after it filed its 2011 Form 10-K, Diamond filed a Form 8-K disclosing that its audit committee would be initiating an internal investigation with respect to walnut crop payments. On February 8, 2012, Diamond filed an updated Form 8-K stating that it would restate its annual reports for fiscal years 2010 and 2011 and that Neil and Diamond's CEO had been placed on administrative leave.[44] In its 2011 Restatement, Diamond admitted that it had overstated EPS in 2010 by more than 65% and overstated EPS in 2011 by more than 89%. After Diamond restated its financial results to reflect the actual costs of procuring walnuts, news that apparently "left investors feeling salty," Diamond's stock price slid to just $17 per share from a high of $90 per share in 2011.[45]

Among other things, the SEC criticized Diamond for failing to "devise and maintain an adequate system of internal controls" and "implement any policies to ensure the accuracy of

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[44] *Id*. ¶ 46. Michael Mendes, Diamond's CEO, resigned from the company on November 21, 2012. Mr. Neil was fired that same day. *See Diamond Foods Ex-CEO Mendes Formally Leaves Company*, REUTERS, Nov. 21, 2012, *available at* http://www.reuters.com/article/2012/11/21/us-diamondfoods-resignation-idUSBRE8AK0NV20121121.

[45] *Supra* note 26.

the reported walnut cost, the accounting for walnut payments, and the manner in which the walnut cost was incorporated into the financial statements."[46] Based on these transgressions, the SEC alleged that Diamond violated Section 17(a) of the Securities Act, and Sections 10(b),[47] 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and rules promulgated thereunder. In light of the amount of the overstatement and the effect on Diamond's EPS, as well as Diamond's succumbing to "pressure to meet or exceed . . . earnings estimates,"[48] the SEC imposed a $5 million penalty and

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[46] *Supra* note 27 ¶ 50.

[47] Like Section 10(b), Section 17(a) prohibits fraud and misrepresentations in the offer or sale of securities. However, unlike Section 10(b) claims, claims under Section 17(a) may be based on negligence and there is no private right of action under Section 17(a). Section 17(a) provides that:

> It shall be unlawful for any person in the offer or sale of any securities or any security- based swap agreement by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
> (1) to employ any device, scheme, or artifice to defraud; or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a).

[48] *Id*. ¶ 2.

enjoined Diamond from future violations of the securities laws. In response to the SEC's separately filed action against him, Diamond's CEO, Michael Mendes, agreed to pay a $125,000 penalty and forfeited more than $4 million in bonuses and other benefits received during the period of Diamond's fraudulent financial reporting. The SEC's action against Neil remains pending.

<u>Loss Forecasting: The "Exogenous"</u>

A derivation of deferred expense reporting and accrual adjustments is improper loss forecasting. Commentators have claimed that forecasts and similar "soft information"[49] are "highly relevant to investment decisions because they assess the future prospects of a company."[50] One of the many cases involving loss forecasting brought in the wake of the 2007-2008 financial crisis is the SEC's action against Capital One Finance Corporation ("Capital One"). Capital One provides, among other

[49] Such "soft information" is defined as opinions, predictions, analyses and other subjective evaluations and is distinguishable from "hard information" or "statements concerning objectively verifiable historical facts." Janet E. Kerr, *A Walk Through the Circuits: the Duty to Disclose Soft Information*, 46 MD. L. REV. 1071 n.2 (1987).

[50] Note, *The SEC Safe Harbor for Forecasts—A Step in the Right Direction?*, 1980 DUKE L.J. 607-608.

things, consumer and commercial lending and diversified banking services. On April 24, 2013, the SEC issued a cease-and-desist order against Capital One related to its deficient controls over loss forecasting with respect to its auto finance business, Capital One Auto Finance ("COAF"), which extended credit to subprime customers. According to the SEC, Capital One materially understated COAF's provision for loan losses for the second and third quarters of 2007, resulting in an understatement of approximately $72 million for its second quarterly filing and approximately $51 million for its third quarterly filing.[51]

As the SEC explained, the allowance for loan losses represents "a company's best estimate of incurred losses inherent in its loan portfolio at any given financial reporting date."[52] The provision for loan losses is the periodic cost of maintaining an adequate allowance. An increase to the allowance constitutes an expense on a company's income statement and

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[51] In the Matter of Capital One Financial Corporation, Peter A. Schnall and David A. LaGassa, Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings and Imposing Cease-and-Desist Order and Civil Penalties (Apr. 24, 2013).

[52] *Id*. ¶ 9.

decreases net income for that period.[53] FAS No. 5 requires that losses be recorded if they are both probable and reasonably estimable.[54] In addition, the amount of estimated loss may depend on the "current economic environment."[55] The SEC further stated in the order that "[g]iven that the allowance is subjective and represents one of the key elements in a bank's financial statements, it is critical to maintain rigorous internal controls over the allowance-setting process."[56]

To determine the best estimate of its loss allowance, Capital One used a loss forecasting tool called "Look

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[53] *Id*.

[54] FAS No. 5 ¶ 8: "An estimated loss from a loss contingency . . . shall be accrued by a charge to income if both . . . [i]nformation available prior to issuance of financial statements indicates that it is probable that an asset has been impaired or a liability had been incurred at the date of the financial statements . . . [and] the amount of loss can be reasonably estimated." *Available at* http://www.fasb.org/pdf/fas5.pdf.

[55] *Id*. ¶ 23: "Whether the amount of loss can be reasonably estimated (the condition in paragraph 8(b)) will normally depend on, among other things, the experience of the enterprise, information about the ability of individual debtors to pay, and appraisal of the receivables in light of the current economic environment."

[56] *Supra* note 53 ¶ 10.

Ahead."[57] In preparing its quarterly loss forecast for COAF, Capital One's Credit Risk Management group ("CRM") assessed information from Look Ahead, which used COAF historical loss data and certain primary loss drivers, including maturation, vintage, seasonality and the "exogenous," to calculate the most appropriate allowance. The "exogenous" factor encompassed losses driven by macroeconomic trends and other external factors, including, notably, changes in credit markets.[58] CRM's policies characterized the exogenous factor as a "key element" in loss forecasting and stated its "general bias" to estimate the exogenous factor at current observed levels unless a deviation was justified.[59] In the order, the SEC emphasized CRM's reliance on Look Ahead: "CRM, in fact, adopted the Look Ahead tool in COAF because of its ability to develop a more reliable exogenous output than the previous model generated[,noting in] its Look Ahead validation documents that accurate and timely understanding of the

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[57] *Id*. ¶ 13. The SEC claimed that "Capital One's internal controls over the loan loss expense component of its financial reporting, therefore, is directly impacted by Look Ahead." *Id*. ¶ 14.

[58] *Id*. ¶ 15.

[59] *Id*. ¶ 16.

exogenous factor was 'critical in an uncertain economic environment.'"[60]

The SEC claimed that, beginning in October 2006, and continuing through the third quarter of 2007, COAF, like most of Capital One's consumer lending businesses, experienced higher charge-offs and delinquencies for its loans than forecasted.[61] As a result, COAF feared that "it was experiencing a credit turn, which was understood within the company to mean a phenomenon where there is a general worsening in the credit environment in a way that drives credit losses for consumer lending businesses."[62] During the month of January, COAF's actual losses were 20% higher than forecasted. Notwithstanding Capital One's formation of a "swat team," which provided daily updates to senior executives regarding upticks in Look Ahead and declining economic conditions, it chose to "minimize" losses to the public. By the first quarter of 2007, Look Ahead confirmed that an "adverse exogenous turn" was

[60] *Id*. ¶ 18.

[61] *Id*. ¶ 2.

[62] *Id*. ¶ 20.

causing higher delinquencies and significant credit deterioration.[63] In light of those conditions, CRM increased COAF's loss allowance at the end of the first quarter. However, the SEC claimed that, despite CRM identifying exogenous worsening as a significant risk to its COAF loss forecasts, it did not integrate that risk in COAF's allowance reserves. Throughout the second quarter of 2007, COAF continued to suffer losses that were considerably higher than forecasted as the Look Ahead exogenous factor steadily climbed.[64]

Rather than incorporate the full impact of the exogenous factor into COAF's loss forecast, Capital One purportedly looked the other way and did not include any of those losses in its second quarter loss provision. The SEC concluded that, "[a]s a result, Capital One's second quarter loan loss expense for COAF did not appropriately incorporate information necessary to determine incurred losses under GAAP."[65] Indeed, had the full amount of the exogenous factor been considered, Capital One's

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[63] *Id*. ¶ 23.

[64] *Id*. ¶ 23-24.

[65] *Id*. ¶ 32.

consolidated second quarter loan loss expense would have increased by 18%. COAF's loan loss expense would have increased from $182 million to $254 million—a 40% increase. And, it would have reported a net loss of $13 million rather than net income of $38 million for the second quarter.[66]

Capital One and CRM persisted in proverbially burying their heads in the sand during the third quarter of 2007. During that quarter, COAF continued to suffer losses that exceeded Capital One's forecast and CRM recommended that COAF build its loss allowance to $100 million by year-end—$85 million of which addressed the full exogenous levels generated from Look Ahead. Despite the plethora of evidence that CRM should have fully incorporated the exogenous uptick in the third quarter loss provision, on the advice of David LaGassa, a divisional credit officer, and Capital One's Chief Risk Officer, Peter Schnall, CRM chose instead to address only one-third of the exogenous impact in COAF's provision.[67] According to the SEC, had Capital One incorporated the full exogenous factor, its third

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[66] *Id*.¶ 33.

[67] *Id*. ¶ 41.

quarter provision would have been 9% more than that actually reported and its consolidated net loss would have been $115 million, a 41% increase over the reported net loss of $82 million. Notably, COAF's $4 million reported net loss would have been *nine times greater than reported*, or approximately $37 million.[68]

The SEC attributed Capital One's reporting improprieties to its failure to maintain sufficient internal controls over COAF's allowance-setting process. If Capital One had implemented proper controls, the SEC maintained that Capital One's executives, including Schnall and LaGassa, would have required that CRM adhere to Capital One's policies and procedures governing the exogenous treatment. Moreover, through such controls, Capital One would have identified and properly documented an explanation as to why the exogenous factor was not incorporated in COAF's loan loss expense, rather than apparently ignoring the factor's impact. The SEC also seemed troubled by Capital One's violation of its own policies with respect to the use of loss forecasting. If, as CRM had claimed, the exogenous factor was a "key element" in loss

[68] *Id*. ¶ 43.

forecasting, Capital One's conduct was plainly inconsistent with that policy.[69]

Finally, the SEC faulted Capital One for failing to adequately address its internal audit group's concerns about COAF's loss forecasting. The SEC cited several internal audit reports concluding that CRM failed to have reliable processes to interpret the impact of the exogenous factor on COAF's loss reserve. Indeed, "[b]y the third quarter of 2007, Capital One's Internal Audit group identified in its audit planning materials that there was a 'significant risk' that COAF gave 'insufficient consideration of external factors (credit environment, economy, legislation, etc.)' in determining its allowance. This risk was identified by Internal Audit as 'high' in terms of impacting allowance decisions."[70]

In failing to give "insufficient weight to the evidence available at the time," [71] the SEC found that Capital One had violated the reporting, books and records, and internal controls

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[69] *Id*. ¶ 66.

[70] *Id*. ¶ 55.

[71] *Id*. ¶ 3.

provisions of the federal securities laws, namely Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. The SEC ordered Capital One to pay a civil penalty of $3.5 million and refrain from any future violations of the securities laws. The SEC also ordered Schnall to pay an $85,000 civil penalty, and LaGassa to pay a $50,000 penalty. In contemporaneous press reports, George Canellos, the SEC's co-director of the Division of Enforcement stated that: "Accurate financial reporting is a fundamental obligation for any public company, particularly a bank's accounting for its provision for loan losses during a time of severe financial distress."[72] Canellos further cited Capital One's failure to acknowledge the information provided in its own loan forecasting tool, noting its "underreporting expenses relating to its loan losses even as its own internal forecasting tool had signaled

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[72] *SEC Charges Capital One with Understating Loan Losses*, CREDIT UNION TIMES, Apr. 25, 2013, *available at* http://www.cutimes.com/2013/04/25/sec-charges-capital-one-with-understating-auto-loan; *see also Capital One Settles Accusations It Understated Loan Losses*, NEW YORK TIMES, Apr. 24, 2013, *available at* http://dealbook.nytimes.com/2013/04/24/capital-one-settles-accusations-it-understated-loan-losses/?_php=true&_type=blogs&_r=0.

an increase in incurred losses due to the impending financial crisis."[73]

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These actions point to the SEC's continued concern about the propriety of internal controls with respect to accrual adjustments and loss forecasting. Particularly because such adjustments and forecasts are predicated upon estimates, the SEC has maintained that a company must institute adequate controls to ensure that those estimates are grounded in verifiable information. "Financial institutions, especially those engaged in subprime lending practices, must have rigorous controls surrounding their process for estimating loan losses to prevent material misstatements of those expenses . . . The SEC will not tolerate deficient controls surrounding an issuer's financial reporting obligations, including quarterly reporting obligations."[74]

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[73] SEC News Digest, SEC Charges Capital One with Understating Auto Loan Losses, Issue 2013-78 (Apr. 24, 2013), *available at* https://www.sec.gov/news/digest/2013/dig042413.htm.

[74] Press Release, SEC Charges Capital One with Understating Auto Loan Losses, U.S. Securities and Exchange Commission (Apr. 24, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514928.