Corporate Accounting Fraud in 2010 and 2011: Highlighted SEC Activity and Whether to Hire Outside Counsel When Conducting an Internal Investigation

By Tracy Richelle High, Partner, and Adrienne A. Harris, Associate, Sullivan & Cromwell LLP

During the time period, the most frequent type of financial irregularity pursued by the SEC's Division of Enforcement remained improper revenue recognition.[1] The rate of issuer financial statement and reporting-related enforcement actions was 18% of total enforcement actions,[2] down 4% from 2009.[3] Below we provide a brief overview of the most recent federal lawsuits and administrative proceedings brought by the SEC, and also identify key issues internal corporate counsel should consider in determining whether to engage outside counsel to assist with an internal investigation.

Revenue Recognition

SEC Staff Accounting Bulletin No. 104 ("SAB 104") remains definitive guidance as to when the SEC considers revenue realized and earned. Under SAB 104, revenue is properly recorded when: (1) persuasive evidence of an arrangement exists, (2) delivery of the product or service has occurred, (3) the fee or price to be received is fixed or determinable, and (4) the likelihood of collection and returns is reasonably assured.[4]

---

[1] *See* PricewaterhouseCoopers LLP, 2010 Securities Litigation Study 37 (2010), *available at* http://10b5.pwc.com/PDF/NY-11-0484%20SEC%20LIT%20STUDY_V6BONLINE.PDF.

[2] *See* SEC, Select SEC and Market Data 2010, at 3, *available at* http://sec.gov/about/secstats2010.pdf.

[3] *See* SEC, Select SEC and Market Data 2009, at 3, *available at* http://sec.gov/about/secstats2009.pdf. For a discussion of SEC enforcement actions in years 2005 through 2009, please review Ms. High's 2009 PLI article. Although enforcement actions often address multiple forms of accounting errors, irregularities regarding cost or expense recognition and accounting for reserves are the other most frequent forms of accounting errors. These errors will be discussed as well.

[4] *See* SEC Staff Accounting Bulletin No. 104, 17 C.F.R. Part 211 (2003), *available at* http://www.sec.gov/interps/account/sab104rev.pdf (2003) (originally issued in 1999).

At the time this article was written, one of the most recent actions involving revenue recognition improprieties was the January 13, 2011 complaint against NutraCea—a company that manufactures and sells health food products—three of its former executives (CEO, CFO and Controller), and two of its former accounting personnel, overstated NutraCea's product sales revenues by $2.6 million in its 2007 fiscal year by booking false sales and improperly recording $1.9 million in revenue from a bill and hold transaction.[5] While these transactions might appear relatively small in aggregate, they accounted for 36.8% of NutraCea's product sales revenue, causing the company to misstate operating losses by 89% in its second quarter of 2007.[6] These misstatements from NutraCea's Form 10-K were later incorporated in the company's Form S-3A filing for its common stock, preferred stock, warrants and depositary share offering. The SEC's complaint alleged a panoply of claims under Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13b2-1, 13b2-2, and 13a-14 thereunder, and Section 17(a) of the Securities Act.[7]

While the falsification scheme was quite typical—executive management's tenacity in reporting these sales was anything but.[8] When NutraCea's outside auditors refused to allow the company to record $2.6 million in sales to one customer, the CEO attempted to subsequently convince the auditors that it should be recorded to another customer. When the auditors likewise refused, the CEO attempted to convince the auditors to allow the revenue to be

---

[5] *See* Press Release, SEC, SEC Charges Arizona-Based Health Food Company and Former Executives with Accounting Fraud (Jan. 20, 2011), *available at* http://sec.gov/litigation/litreleases/2011/lr21819.htm.

[6] *See id*.

[7] *See* SEC v. *NutraCea*, No. 11-CV-00092, at 13–22, (D. Ariz. Jan. 13, 2011) *available at* http://www.sec.gov/litigation/complaints/2011/comp21819.pdf.

[8] *See e.g.*, *id*. at 4 (noting that the CEO "fought hard" with outside auditors about when to book revenue from sales to Bi-Coastal Pharmaceutical, and that he "was determined to recognize revenue from the sales . . . .").

recorded to yet another customer.[9] Once again, the auditors refused. To ensure that the $2.6 million was recorded as revenue in the following quarter, the CEO induced a customer to issue sham purchase orders totaling $2.6 million, and also arranged for that customer to receive a loan to make a down payment on the purchase.[10] The SEC's complaint describes the company's CFO as covering his ears and stating, "'No, no, no, no, no, no, no, no, no. I don't want to hear it,'" when approached by the company's Controller about her suspicions about the loan.[11]

As for the bill-and-hold scheme, NutraCea sold 150,000 units of a meal replacement product to a customer for $1.9 million and engaged a third party to manufacture the order. NutraCea executives successfully obtained letters from the customer and the manufacturer stating that the customer would take possession of the product by December 31, 2007. In late 2007, it became clear to NutraCea executives that the order could not be manufactured by the end of 2007 because, among other reasons, the manufacturer lacked sufficient raw materials. NutraCea's failure to bill the customer in January 2008 raised red flags within NutraCea, but the CEO convinced his management team to remain silent and sign management representation letters that stated, among other things, that the company's financial records and data were presented in accordance with U.S. GAAP. Accordingly, NutraCea's auditors allowed the company to record the revenue from the $1.9 million sale on its 2007 year-end financial statements.

The complaint makes much of "the tone from the top" and the CEO's dogged insistence that the company meet its earnings projections, even if it had to record sham

---

[9] *See id*.

[10] *Id*. at 5.

[11] *Id*. at 6.

transactions to do so. NutraCea and its executives settled the matter shortly after being charged, agreeing to officer and director bars and $150,000 in civil penalties.[12]

On February 9, 2011, the SEC accepted an Offer of Settlement from ArthroCare, a medical device company, concerning the SEC's allegations that, between the company's fourth quarter of 2005 and the first quarter of 2008, ArthroCare materially overstated and prematurely recognized revenue.[13] The transactions in question occurred at or near the end of each quarter and were intended to help the company reach earnings targets and satisfy analysts' expectations. Specifically, the SEC alleged that ArthroCare would often turn to DiscoCare, Inc. ("DiscoCare"), a distributor, to help overcome revenue shortfalls. ArthroCare recorded revenues from large orders shipped to DiscoCare, even if DiscoCare had no need for the inventory nor hope of selling it within a reasonable time period. ArthroCare accommodated DiscoCare by offering extensive extended payment terms while agreeing that DiscoCare did not have to pay for products unless and until it could afford to do so.[14] In addition, in violation of the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards No. 48 (governing revenue recognition when there is a right of return), ArthroCare permitted DiscoCare to return products shipped just before a quarter's end immediately after the next quarter began, and ArthroCare's accounting staff was never told the true reason for the returns.[15] ArthroCare also recognized revenue from product shipments that did not conform to customers' orders because,

---

[12] *See* Press Release, SEC, SEC Charges Arizona-Based Health Food Company and Former Executives with Accounting Fraud, *supra* note 5.

[13] *See In the Matter of ArthroCare Corp.*, Securities Exchange Act Release No. 63883 at 2 (Feb. 9, 2011), *available at* http://www.sec.gov/litigation/admin/2011/34-63883.pdf.

[14] *Id*.

[15] *Id*. at 2–3.

for instance, the product was shipped after its expiration date and was therefore immediately returnable.[16]

In *SEC* v. *Joseph D. Radcliffe and Michael J. Radcliffe*, the SEC filed a complaint in the United States District Court for the District of Columbia, alleging that the Radcliffes created fictitious sales of their company's sports memorabilia merchandise and booked the revenue using false invoices to support their entries.[17] In total, the company recorded $6.1 million in revenue in 2004 and $464,502 in the first quarter of 2005. Amazingly, approximately 92% of the company's reported revenue in those time periods was fabricated.[18]

Cost or Expense Recognition

Under the accrual method of accounting, an expense should be recorded during the accounting period it was "incurred" even if the company prepays the expense or does not pay for the expense until a later accounting period.[19] Improper expense recognition understates or defers expenses, and therefore overstates net income.[20]

On August 5, 2010, the SEC issued a cease-and-desist order (the "Order") against Navistar International Corporation ("Navistar") and several of its executives, including its CEO

---

[16] *Id*. at 2. As part of the settlement offer, ArthroCare agreed to cease and desist from committing or causing any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder. The company also cooperated extensively with the SEC and undertook several remedial actions, including creating a compliance department.

[17] *See* Press Release, SEC, SEC Charges Father and Son in Financial Fraud at Sports Memorabilia Company (Jan. 14, 2011) *available at* http://www.sec.gov/litigation/litreleases/2011/lr21814.htm.

[18] *Id*. Joseph Radcliffe agreed to pay $955,000 in disgorgement, $299,541 in prejudgment interest, and $175,000 in civil penalties. (The SEC also alleged that Joseph Radcliffe sold shares of his company without registering those sales.) Michael Radcliffe agreed to pay $10,000 in disgorgement, $3,060 in prejudgment interest, and $75,000 in civil penalties. *Id*. Father and son both agreed to final judgments enjoining them from committing future violations of the Securities Act and the Securities Exchange Act.

[19] SEC, Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002, at 14 (2003), *available* at http://www.sec.gov/news/studies/sox704report.pdf [hereinafter Report Pursuant to SOX].

[20] *See id*.

and former CFO.[21] The SEC alleged that between 2001 and 2005, the company overstated its pre-tax income by approximately $137 million through various types of misconduct, including by improperly (i) booking rebates and receivables and (ii) recapturing and booking income from previously amortized agreements, and (iii) miscalculating expenses. With respect to expenses, the Order stated that the company improperly deferred certain start-up costs from the fourth quarter of 2001 through the fourth quarter of 2002.[22] In particular, Navistar deferred $57 million of pre-production costs incurred in connection with its supply contract with an automobile manufacturer to develop and manufacture V-6 diesel engines.[23] The company deferred $4.3 million in costs in the fourth quarter of its fiscal year 2001, $12.8 million in the first quarter of its fiscal year 2002, and $13.3 million in each of the second and third quarters of its fiscal year 2002, with the $12.8 million, $13.3 million and $13.3 million representing "12.5 percent, 65.5 percent and 25.4 percent, respectively, of the Company's previously reported loss before income tax if adjusted to reverse these deferrals for each of the first three quarters of fiscal year 2002."[24] These deferrals were in violation of the FASB Emerging Issues Task Force Issue No. 99-5 ("EITF 99-5"), which requires that such costs be deferred if an objectively verified and measured

---

[21] *See* Press Release, SEC, Navistar Settles with Commission Over Certain Restated 2002–2005 Financial Results (Aug. 5, 2010) *available at* http://www.sec.gov/litigation/litreleases/2010/lr21616.htm.

[22] *See id*.

[23] *See SEC* v. *Mark T. Schwetschenau*, No. 10-cv-4904, at 2–3 (N.D. Ill. Aug. 4, 2010) *available at* http://www.sec.gov/litigation/complaints/2010/comp21616-mts.pdf.

[24] *See id* at 3. Among other sanctions, the Order directed Navistar to cease and desist from committing or causing any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder. Navistar's CEO and former CFO were ordered to refrain from future violations of Section 13(B)(2)(B) of the Exchange Act, and also agreed to comply with the forfeiture provisions of Section 304(a) of the Sarbanes-Oxley Act of 2002. *See* Press Release, SEC, Navistar Settles with Commission Over Certain Restated 2002–2005 Financial Results, *supra* note 21.

contractual guarantee for reimbursement exists.[25] The SEC alleged that Navistar sought such a guarantee, but was unsuccessful, and therefore, was not entitled to defer these costs.

Accounting for Reserves

A subcategory of expense recognition includes accounting for reserves. Companies set reserves to cover the estimated costs of expenses, such as taxes, litigation, debts and acquisitions.[26] If a company intentionally overestimates reserves, this can give a false appearance of increased earnings. Once the costs are incurred, the excess amount in the reserve can be reversed to boost earnings.[27]

On July 22, 2010, the SEC charged Dell Inc. ("Dell") and several of its executives with failing to disclose material information to investors and using fraudulent accounting to make it appear as if the company was meeting its earnings projections and reducing operating expenses.[28] Among other accounting errors, the SEC alleged that three senior accounting personnel maintained a series of "cookie jar" reserves that were used to cover shortfalls in operating results from the company's 2002 through 2005 fiscal years. Under the FASB's Statement of Financial Accounting Standards No. 5 ("FAS 5") (governing accounting for contingencies), a loss accrual is recognizable as a charge to income when the loss is probable and reasonably estimable. Dell executives allegedly maintained excess accruals in reserve accounts to offset unforeseen expenses in order to meet earnings expectations in future periods in violation

---

[25] *See id*.

[26] *Report Pursuant to SOX*, *supra* note 19, at 16-17.

[27] *See id.*

[28] *See* Press Release, SEC, SEC Charges Dell and Senior Executives with Disclosure and Accounting Fraud (July 22, 2010) *available at* http://www.sec.gov/litigation/litreleases/2010/lr21599.htm.

of FAS 5.[29] These manipulations further allowed Dell to misstate operating expenses as a percentage of revenue.[30] In one example of misconduct, executives identified excess tax reserves in Dell Japan in the fourth quarter of fiscal year 2003. Instead of releasing the excess reserve to the income statement as required by GAAP, the bulk of the excess was transferred to the "cookie jar" reserves. Two quarters later, Dell released the excess to offset income statement impact from a litigation settlement.[31]

On June 2, 2010, the SEC filed a complaint against Diebold, Inc. ("Diebold") alleging that the company and several of its executives improperly inflated the company's earnings to meet earnings forecasts. The complaint alleged that from 2002 to 2007, the company employed a variety of improper accounting practices, including (i) recognizing revenue subject to a side agreement, (ii) fraudulent use of bill-and-hold accounting, (iii) delaying and capitalizing expenses, and (iv) manipulating reserves and accruals.[32] With respect to the manipulation of reserves, the complaint alleged that, in January 2004 as part of its 2003 year-end audit, the company's auditor tested the company's bill-and-hold transactions and found that the company had prematurely recognized revenue.[33] Instead of reversing the errors as required by GAAP,

---

[29] *See* Press Release, SEC, SEC Charges Former Dell Chief Accounting Officer with Accounting Fraud (Aug. 27, 2010) *available at* http://www.sec.gov/litigation/litreleases/2010/lr21634.htm.

[30] *See id*.

[31] *See id*. The executives consented to the entry of an order permanently enjoining them from violating certain Exchange Act provisions. *See id*. They also agreed to pay monetary penalties ranging from approximately $40,000 to $4,000,000, and the company paid a $100 million penalty. *See id*., Press Release, SEC Charges Dell and Senior Executives with Disclosure and Accounting Fraud, *supra* note 28. The SEC also noted that its investigation was ongoing.

[32] *See* Press Release, SEC, SEC Charges Diebold and Former Financial Executives with Accounting Fraud (June 2, 2010) *available at* http://www.sec.gov/litigation/litreleases/2010/lr21543.htm.

[33] *SEC* v. *Diebold, Inc.*, No. 10-CV-00908, at 7 (D.D.C. June 2, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp21543-diebold.pdf.

however, Diebold established a reserve of $7.5 million of profit margin.[34] (In February 2004, Diebold's management learned that the company had prematurely recognized an additional $5.2 million in revenue that had not been identified during the auditor's transaction testing.[35] The company's management also failed to correct this error.) Instead of appropriately releasing the $7.5 million profit margin reserve, Diebold's management released the reserve throughout 2004 to fill in shortfalls in operating results and meet consensus estimates.[36] Diebold released $1 million in its first quarter of 2004, $1.25 million in the second quarter, and the remaining $5.25 million in the third quarter, meeting the consensus for the first two quarters and revised earnings estimates for the third quarter.[37] Diebold also maintained "cookie jar" reserves to manage earnings, including a $4.5 million corporate obsolescence and excess inventory account.[38] Diebold consented to a final judgment in which the company agreed to pay a $25 million civil penalty and was permanently enjoined from future violations of the securities laws.[39]

* * *

Although the overall number of actions dropped in 2010, the SEC still remained quite busy, and you may inevitably be called upon to investigate perceived accounting irregularities. Below we list several factors you should consider in determining whether outside counsel should assist you in your inquiry.

---

[34] *See id*.

[35] *See id*. at 8.

[36] *See id*. at 11.

[37] *See id*.

[38] *See id*. at 13.

[39] *See* Press Release, SEC, SEC Charges Diebold and Former Financial Executives with Accounting Fraud, *supra* note 32. The company's former CEO also consented to a final judgment ordering him to reimburse $470,016 in cash bonuses, 30,000 shares of Diebold stock, and stock options for 85,000 shares of Diebold stock. *Id*. Actions against other executives are still pending.

Genesis of the issue. The manner in which an issue is first raised is critical to determining how to proceed. Were the allegations raised through an anonymous call to your company's ethics hotline? Through a face-to-face meeting with your corporate ombudsperson? In an employee review? Which manner of communication does your corporate culture encourage? The more difficult employees perceive it is to raise a potential issue will give you a sense of whether you should engage outside counsel to signal that the company takes the issue very seriously and will do what it takes to get the matter resolved.

Materiality. Assuming the allegations raised are true, how would they impact the company's financial statements? NutraCea is particularly informative in this regard. $4.5 million in errors accounted for 36.8% of NutraCea's product sales revenue, causing the company to misstate operating losses by 89%. $4.5 million dollars may not sound significant in the abstract for a public company, but 89% of anything sure does. When the potential accounting impact to the company is a restatement—a fire alarm to the government and plaintiffs' counsel—you should consider involving outside counsel at the outset.

Composition of Your Internal Team. Does the issue require specialized accounting knowledge to resolve? Are potential witnesses individuals with whom your team members have close or longstanding relationships? Assessing the strengths and weaknesses of your team will help you determine whether you need external assistance, and whether that assistance should be in the form of lawyers, accounting professionals, or both.

Type of Issue Being Raised. Is this a one-off question about whether a particular entry was recorded properly or a question about the way reserves are calculated generally? Is this an issue involving one individual or a whole department? Does the matter involve an entry clerk or the company's highest ranking executives? Do the allegations span one or multiple reporting periods? Can you foresee that the resolution of the issue may require institution of new corporate initiatives? In *ArthroCare*, the company was required to establish a compliance department and hire personnel to staff that department. Consider the magnitude of the potential remedial efforts the company may need to implement to determine the best way to move forward.

Quality of Available Information. Are the allegations specific or generalized? Have there been multiple tips about the same issue? Was the individual certain something bad was happening or unsure? Is there enough work for external advisors based on what you currently know, or should your internal team do more fact gathering?

Pattern of Conduct. Is this the first or tenth investigation involving Joe Smith? Does the Accounting Department never have a quarter where someone is not disgruntled? Is someone always raising issues about premature revenue recognition? If the same issues keep surfacing, it is time to consider addressing the issue on a larger scale than previously has been done. Does your company have the internal resources to do so?

Conclusion

In a survey conducted during a Deloitte webcast about reducing fraud risks, over half of approximately 2,100 business professionals said they think more financial statement fraud would be uncovered in 2010 and 2011 as compared to 2007 through 2009.[40] In the current economic and regulatory environment, it is vitally important for internal counsel to remain well informed and vigilant.

---

[40] "Poll: More Financial Statement Fraud Expected to be Uncovered in 2010, 2011," Deloitte (April 28, 2010) *available at* http://www.corporatecomplianceinsights.com/2010/deloitte-poll-more-financial-statement-fraud-expected/.