

***EARNINGS MANAGEMENT, FINANCIAL
STATEMENTS AND SECURITIES
FRAUD: HOW TO AVOID AN SEC
INVESTIGATION***

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Earnings Misses = Huge Market Losses

- 9/20: Sprint misses earnings by a mere 2 cents, suffers 5% market cap loss of about \$1 **BILLION**
- 9/27: Kodak Eastman announces will miss, loses 25% or about \$3 **BILLION**
- 9/27: Lexmark misses numbers, loses 29%, or about \$1.2 **BILLION**
- 9/29: Apple announces will miss by large margin, loses **50%** or about \$7 **BILLION**

September 1998 -- “*The Numbers Game*”

Speech by Chairman Levitt

- **Attacks:**
 - “Big Bath” restructuring charges
 - Creative acquisition accounting
 - “Cookie jar” reserves
 - “Immaterial” misapplication of accounting principles
 - Premature revenue recognition
- **Announces 9-point Plan -- really 3 major initiatives:**
 - Enforcement actions
 - Staff Accounting Bulletins (“SABs”) and other “guidance,” *i.e.*, speeches by staff, Commissioners
 - Focus on auditor independence and Audit Committee issues

Five Rules to Live By

1. Don't commit fraud, or let your people commit fraud.
2. Understand what the SEC means by "materiality."
3. Understand the SEC's views on revenue recognition.
4. Ensure and implement proper internal accounting controls.
5. Be proactive.

Rule No. 1:

Don't commit fraud, or let your people commit fraud.

- Don't value dirt as gold worth \$20 million or a \$600k asset at \$10 million (*Countryland, YourBankOnLine*)
- Don't set the computer clock back (*Sirena, Sensormatic*)
- Don't book sales that aren't (*Knowledgeware, ABS*)
- Don't create, change or literally erase the numbers (*Unison, Livent, McKesson HBOC*)

How can I prevent fraud?

“Fear is good.”

- See WSJ 10/10/00 article “Scared Straight, White-Collar Style”
- 200 cases to date -- prime SEC priority
- criminal sanctions increasingly sought -- McKesson HBOC (Fortune 100 company) executives just indicted on 13 counts of securities fraud
- operational people increasingly charged
- civil sanctions can be (and usually are) career-ending

Typical Charges

- Fraud
- False Filings
- Inaccurate Books and Records
- Inadequate Internal Controls
- Circumventing Internal Controls
- Lying to Auditors
- Rule 102(e)

- Criminal Charges – securities fraud, wire fraud, mail fraud

Typical “Targets”

- CEOs -- more often than not -- 11 of 15 CEOs charged in 1999 sweep, count continues for 2000
- CFOs -- always
- Controllers -- nearly always
- Assistant Controllers or other Accounting officers, *i.e.* VP Accounting Department
- Operational People -- General Managers, VP Sales, VP Operations
- Outside Auditors
- General Counsels
- Investor Relations types???

Typical Sanctions

- Criminal Sentences: 5 yrs./violation; one CEO sentenced to 9 years
- Permanent Injunctions: Consent decrees to “obey the law”
- Cease-and-Desist Orders: Administrative equivalent of injunction
- Officer and Director Bar: Only where fraud charged
- Civil Penalties: Ranging from \$5,500 to \$550,000, per violation
- Disgorgement: Repayment of “ill-gotten gains”
- Prejudgment interest: Can be very substantial amount

Rule No. 2:

Understand what the SEC means by “Materiality”

- *W.R. Grace*: prototype “earnings management” case
 - too much in earnings --\$50-60 million in earnings stashed in “excess reserves” accounts -- so-called “Brian Smith Reserves”
 - material at subsidiary because of amount, material at parent because of plan
- *ABS*: “an intentional scheme to manage earnings”
 - earnings overstated by 2.5% in 1994, but by more than 40% in 1995
 - “reasonable investors would have considered [latter amount] -- in the context of a scheme to manage earnings -- to be material”
- *OaksGrigsby*
 - earnings at subsidiary overstated by 108%, but only by 2%-15% at parent

SAB NO. 99 - “Materiality”

MATERIALITY = SAME AS IT EVER WAS

- “substantial likelihood that reasonable person would consider matter important”
- GAAP 5% threshold only beginning of inquiry
- Must consider both “quantitative” and “qualitative” factors
- Small misstatement may be material if:
 - masks change in earnings or other trends
 - hides failure to meet analysts’ expectations
 - involves “crown jewel” or earnings engine of operation
 - has effect of hitting compensation benchmark

Rule No. 3:

Understand Revenue Recognition Issues

- Majority of financial fraud enforcement cases involve revenue recognition issues
- Generally, recognition issues fall into three categories:
 - Timing
 - “Bill and Hold”
 - Side Deals and Parking

Revenue Recognition

Timing is everything in Life

- *Sensormatic*
 - backdated computer clock in order to recognize later sale in earlier period
 - quarterly statements misstated by understatement of \$1.9 million to overstatement of \$5.2 million
 - IS Manager charged
- *Sirena Apparel*
 - like *Sensormatic*, kept computer clock at March 31 well into April to book April sales in 2Q
 - overstated earnings by 30%
 - CEO and CFO criminally indicted

Revenue Recognition

“Bill and Hold” Cases

- *ABS:*
 - sales for goods that were neither billed nor shipped and in some cases did not exist
 - earnings overstated by 2.5% in 1994, but by more than 40% in 1995
 - GM of plant charged
- *Digital Lightwave*
 - goods not segregated in Digital’s warehouse for purchasers, and sometimes not even produced
 - attorney in charge of financials charged, but not as attorney -- C&D only

Revenue Recognition

Side Deals

- *McKesson HBOC*
 - Fortune 100 company
 - booked sales of software despite contingencies concealed in side letters -- rights to cancel, contracts not finalized
 - April 1999 announcement by McKesson re financial irregularities resulted in \$9 billion market cap loss
 - CEO, CFO criminally indicted on 13 counts
- *KnowledgeWare*
 - “parked” inventory with resellers and customers who had right not to pay for software -- created \$8 million in fake revenue
 - 11 people charged, including Fran Tarkenton (CEO), who was flagged with \$100,000 penalty

SAB NO. 101 - “Revenue Recognition in Financial Statements”

- Under GAAP, revenue recognized when earned *and* realized or realizable
- *All* of following criteria must be met:
 - persuasive evidence that an arrangement exists
 - delivery of goods must have occurred or services rendered
 - price must be fixed and determinable
 - collectibility is reasonably assured
- SAB provides numerous examples
- See Forbes October 16, 2000 article, “Baby Out With The Bath Water”

Rule No. 4:

Ensure and Implement Internal Controls

- Most cases involve lack of internal controls and inaccurate books and records
- Strict liability offenses -- no intent required
 - Books and records must be accurate
 - Must have (and not circumvent) system of internal accounting controls
 - Internal accounting controls must be sufficient
 - to ensure preparation of financial statements in conformity with GAAP and
 - to maintain accountability for assets

Internal Controls

- Waste Management
 - one of very few cases solely against company (but is on-going)
 - false forecasts based on faulty internal information
 - important message: “Companies whose accounting and management systems do not provide adequate information from which they can make reasonable projections either must refrain from making any such statements about future performance or must disclose the basis on which any such statements are made and any other material information necessary to make any such statements not misleading.”

Rule No. 5:

Be Proactive.

- Monitor these issues carefully
- If identify a problem, consider restating
 - SEC expects restatements in view of SAB No. 101
- But remember: no good deed goes unpunished
 - several cases in the pipeline due to restatement:
 - Celeris Corp.: earnings restatement
 - Schick Technologies: earnings restatement
 - Raytheon: earnings restatement based on review of bill and hold transactions after issuance of SAB No. 101

And, if restate, do it right.

- *Boston Scientific*
 - subsidiary (Boston Japan) booked thousands of false sales totaling more than \$75 million, resulting in overstatement of income by between 10 and 46%
 - Boston discovered problem in Fall 1998 and, “after consulting with the staff of the Commission’s Office of Chief Accountant,” restated immediately
 - as result, very moderate sanctions imposed -- no fraud, no officers, no money
 - C&D on books and records and internal controls

Wrong:

- *KnowledgeWare*

- “parked” inventory with resellers and customers who had right not to pay for software -- created \$8 million in fake revenue
- when restated results, said sales questionable due to “collectibility” issues, without disclosing that any collection issues were of Company’s own making

Issues for the Future

- Intentional misstatements by senior management
- Receivables and other revenue recognition items
- Adequacy of internal controls
- Individuals - financial, operational, legal
- Auditors
- FASB Statement No. 133
- Regulation FD
- Focus by Wall Street on the “top line” - revenues

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