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Improper Accounting Alleged to Inflate Quarterly Earnings

Public company financial management teams should take heed of the allegations set forth in two complaints recently filed by the SEC against Diebold and one current and two former officers of the company.[1]

Pursuant to an agreement in principle with the SEC, which Diebold had previously disclosed in its periodic reports, the company settled an enforcement action by neither admitting nor denying the civil securities fraud charges while paying a penalty of $25 million and agreeing to an injunction against committing or causing any violations or future violations of certain specified provisions of the federal securities laws.

The case remains ongoing for persons who had formerly served Diebold in the positions of CFO, controller, and director of corporate accounting, who the SEC alleged engaged in fraudulent accounting practices designed to inflate earnings to meet forecasts from at least 2002 to 2007. The SEC seeks judgment from the U.S. District Court of the Northern District of Ohio that, if imposed, could, among other things, order each defendant to disgorge benefits obtained as a result of the alleged fraudulent conduct, impose civil monetary penalties, prohibit the two defendants who had served in the position of CFO from acting as an officer or director of a public company, and require those defendants to reimburse the company for cash bonuses or other incentive-based or equity-based compensation received during the time periods in which they served as CFO when the company was required to prepare a restatement of its financial statements due to material noncompliance as a result of misconduct.

The complaint filed against the company included similar allegations as the complaint filed against the members of the financial management team. According to the complaints filed by the SEC, when end-of-quarter earnings reports (or "flash reports") internally received by company management showed that the company's actual earnings were below analyst consensus forecasts, the company's financial management allegedly would use fraudulent accounting transactions that had been designed to improperly recognize revenue or otherwise inflate the company's financial performance in order to reach the analyst forecasts.

Some of the accounting practices that the SEC alleged occurred during various quarters over a period of multiple years include:

- **Improper use of "bill and hold" accounting**

Provided that specific criteria are properly met, a sale may qualify for recognition as a bill-and-hold transaction?- an exception to the general GAAP rule that revenue may not be recognized until the goods sold have been delivered to the customer. The SEC alleged that, in violation of GAAP, the defendants took actions that resulted in the company's improper recognition of revenue for products that failed to meet the required criteria for bill-and-hold sales.

For example, the SEC contended that the company used form agreements drafted by its financial management that made it falsely appear that the company's customers had requested that the transaction be on a bill-and-hold basis. For a transaction to properly qualify for bill-and-hold treatment, the buyer (not the seller) must request bill-and-hold treatment, and such request must be for the buyer's substantial business purpose.

The SEC also asserted that in other circumstances, revenue was improperly recognized as a bill-and-hold transaction even though software had not yet been loaded on the products or quality testing had not yet been performed. For a transaction to properly qualify for bill-and-hold treatment, the product must be complete and the seller must not retain any specific performance obligations.

In other cases, the SEC alleged that revenue was improperly recognized on certain professional services and upgrades on a bill-and-hold basis?- although these types of sales do not qualify for such accounting treatment.

The SEC also alleged that at certain times the company would manufacture and ship products to warehouse before the shipment date on the sale agreement, without customer approval or knowledge, in order to prematurely "pull in" revenue to the applicable open quarter rather than record the revenue in accordance with GAAP in the quarter in which the products were originally scheduled to ship.

The SEC stated in its complaint against the company that "prior to 2007, Diebold never disclosed to shareholders that it had any bill and hold transactions, even though purported bill and hold transactions constituted a material portion of Diebold's revenues." In the complaint against the company, the SEC also alleged that at a meeting where public disclosure of certain changed company revenue recognition practices related to bill-and-hold transactions was discussed, company management "decided against disclosure because they were concerned disclosure would create an 'investor relations issue.'"

- **Improper recognition of revenue on a lease agreement subject to an undisclosed side buy-back agreement**

The SEC alleged that financial management took actions that resulted in the company improperly recognizing the entire amount of revenue from a sale transaction, even though the products sold were subject to a separate buy-back agreement under which the buyer had the right to sell back the products at a later date. The SEC noted in its complaints that "under GAAP, the full amount of revenue from a transaction cannot be recognized if the transaction is subject to significant future obligations or contingencies, such as a buy-back agreement."

- **Manipulating reserves and accruals**

According to the SEC complaint, during 2003, in order to fund the under-accrued liability for the company's long-term incentive plan (LTIP), the company reduced unrelated accounts rather than adjusting the LTIP liability accrual on a quarterly basis, as required under GAAP variable accounting rules. The SEC also made allegations related to improper material under-accruals for other incentive- and commission-related liabilities. In addition, the SEC alleged that a $7.5 million reserve, which was established after the company's auditor concluded that the company had prematurely recognized revenue on certain transactions, was released without a legitimate accounting basis under GAAP in order to fill shortfalls in the company's operating results, and a corporate obsolescence and excess inventory account was also used as a "cookie-jar reserve," in violation of GAAP.

- **Improperly delaying and capitalizing expenses**

The SEC alleged that the company allowed two accounts to remain overstated, improperly deferring expenses or spreading the expenses over several reporting periods, which led to inflated income for multiple periods. In addition, the SEC alleged that in connection with the company's replacement of its older internal software systems, the company improperly capitalized certain costs that should have been expensed in the period in which they were incurred, which had the effect of materially reducing expenses and increasing reported earnings.

- **Improperly writing up the value of used inventory**

Although GAAP requires used equipment inventory to be valued at the lower of cost or market value, the SEC alleged that the company improperly "wrote up" the value of certain inventory, which had the effect of reducing the cost of goods sold and inflating earnings.

The SEC asserted that, as a result of the practices described above and other practices described in its complaints, the company "filed at least 40 annual, quarterly, and current reports with the Commission, and issued dozens of press releases, that contained material misstatements and omissions concerning the company's financial performance," and that the company's "improper, and in many instances fraudulent, accounting practices misstated the company's pre-tax earnings by at least $127 million." On September 30, 2008, the company restated its financial statements for the years 2003 through 2006, for the first quarter of 2007, and in its Form 10-K for 2007.

These enforcement actions emphasize the importance of careful scrutiny of all aggressive or tenuous accounting transactions for adherence to GAAP. As noted by the Director of the SEC's Division of Enforcement in the press release

issued in connection with the enforcement actions described in this Alert, "When executives disregard their professional obligations to investors, both they and their companies face significant legal consequences."[2]

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[1]?*SEC v. Diebold, Inc.*, Civil Action No. 1:10-CV-00908 (D.D.C.); and *SEC v. Gregory Geswein*, *Kevin Krakora, and Sandra Miller*, Civil Action No. 5:10-CV-01235 (N.D. Ohio).

The SEC also filed an action against Walden O'Dell, the former chief executive officer of Diebold, seeking reimbursement for bonuses and other incentive-based and equity-based compensation, pursuant to Section 304 of the Sarbanes-Oxley Act of 2002. The complaint did not allege that Mr. O'Dell engaged in the fraud, and he agreed to a final judgment ordering him to reimburse certain cash bonuses and shares of company stock and stock options. See *SEC v. Walden O'Dell*, Civil Action No. 1:10-CV-00909 (D.D.C.).

Links to each of the complaints are available on the SEC's webpage at http://www.sec.gov/litigation/litreleases/2010/lr21543.htm

[2] "SEC Charges Diebold and Former Executives With Accounting Fraud," available at http://www.sec.gov/news/press/2010/2010-93.htm