DAY PITNEY LLP

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"Earnings Management" Continues to be an Enforcement Target for the SEC Staff

The Securities and Exchange Commission has again targeted for enforcement members of company financial management who were alleged to have been involved in adjusting reserve accounts not in accordance with GAAP. While the subject of "earnings management" and "smoothing earnings" is an old one, it has certainly not faded in terms of SEC enforcement emphasis.

On August 27, 2010, the SEC charged both the former chief accounting officer and a former assistant controller of Dell with being involved in improperly adjusting reserves over a course of years in order to allow the company to meet financial targets. Without admitting or denying the SEC's allegations, each of the individuals agreed to settle the allegations, with the former chief accounting officer agreeing to pay a $175,000 penalty and the former assistant controller agreeing to pay a $25,000 penalty, along with disgorgement and prejudgment interest.

Each of the individuals also consented to an administrative order suspending him from appearing or practicing before the SEC as an accountant, with the former chief accounting officer having the right to apply for reinstatement after five years and the former assistant controller having the right to apply for reinstatement after three years.

The SEC charges arose from Dell's restatement of its financial statements announced in August 2006. Following that announcement, the Audit Committee of Dell's Board of Directors conducted an extensive independent investigation into certain of Dell's accounting and financial reporting practices.

Dell summarized certain of the findings of the Audit Committee investigation in Dell's 2007 Form 10-K as follows:

> "The investigation raised questions relating to numerous accounting issues, most of which involved adjustments to various reserve and accrued liability accounts, and identified evidence that certain adjustments appear to have been motivated by the objective of attaining financial targets. According to the investigation, these activities typically occurred in the days immediately following the end of a quarter, when the accounting books were being closed and the results of the quarter were being compiled. The investigation found evidence that, in that timeframe, account balances were reviewed, sometimes at the request or with the knowledge of senior executives, with the goal of seeking adjustments so that quarterly

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performance objectives could be met. The investigation concluded that a number of these adjustments were improper, including the creation and release of accruals and reserves that appear to have been made for the purpose of enhancing internal performance measures or reported results, as well as the transfer of excess accruals from one liability account to another and the use of the excess balances to offset unrelated expenses in later periods…."

Among the many accrual and reserve adjustments determined by the SEC enforcement staff to have been in violation of GAAP were the following:

- The company maintained a separate reserve, called the "Strat Fund" (short for "Strategic Fund"), for contingencies, consisting of excess unsupported balances that resided in various other corporate accounts, including the company's "other accrued liabilities" account. The company used amounts from this "contingencies" reserve account allegedly to reduce other operating expenses by releasing the excess accruals to offset other unforeseen operating expenses in later quarters, improving the operating results and financial metrics for those later quarters.

- An example of the creation and improper transfer of reserve amounts was an alleged use of an excess tax reserve related to the company's Japanese subsidiary. After management determined that this tax reserve was no longer necessary, the reserve was not immediately released to income. Instead, a significant portion of the tax reserve was maintained as an excess "contingency" reserve and released in a later quarter to offset part of an unrelated litigation settlement, which had not been reserved against, with the balance released to improve operating results for that later quarterly period.

- In another instance, the company apparently identified an excess relocation accrual in one quarter, and rather than immediately release the excess accrual into income for that quarter, as required by GAAP, allegedly carried the excess accrual into the immediately following quarter, which improved income for that later quarter.

- The company was alleged to have improperly built excess accruals into its restructuring reserve and, over the course of a number of subsequent quarters, improperly used the excess accruals to offset unrelated subsequent period costs, which improved operating expenses as a percentage of revenue for such later periods.

- In another quarter the company was alleged to have "earmarked" certain quarterly segment income earned in excess of financial targets to restructuring expenses, resulting in improper restructuring reserves, rather than reporting it as income. Related to this, in a future quarter when the bulk of the restructuring expense had been incurred, the financial director wrote that "I know this is messy but it was always going to be when you try to hide $25M to offset future restructuring costs and you are not allowed to call it restructuring."

- The company also allegedly improperly failed to release excess bonus and profit-sharing accruals at the time these accruals should

> have been released to income under GAAP, and instead was alleged to have "bled down" the excess accruals over a number of following quarters. In an email exchange, the former chief accounting officer apparently wrote: "I have assumed that the prior year over accrual will be fully bled out by the end of this year. (As discussed this morning, a lot of these bleeds have been built into the Corporate budget for Q2–Q4.)"

A significant portion of the SEC's allegations against these two individuals was based on intercompany emails among financial personnel concerning directions as to how these accruals were to be handled.

While the financial penalties in these settled charges are not substantial, the impact of these matters on financial management is enormous. Company financial management needs to continue to be vigilant in its application of GAAP, particularly with respect to the creation, review and release of reserves and contingency accruals, which are often based on very subjective judgments as to the likelihood and timing of the occurrence of future events. Financial management needs carefully to ensure that it strictly applies GAAP and timely creates, adjusts and releases reserves and accruals in accordance with applicable GAAP, with appropriate and timely disclosure.

Subjective judgments form part of everyday life for financial management, particularly with the review, adjustment and release of contingencies and reserves. Seldom is there a clear "black line" or certainty in these areas, and financial management generally exercises its best professional judgment. The key, often, is always staying the course, applying judgments in the best objective manner, with careful documentation and a clear and appropriate "tone at the top" financial culture.

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