# INSIGHTS

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# SECURITIES DISCLOSURE

## When Is Managing to a Forecast Illegal "Earnings Management"?

*The line that separates legitimate management practices to meet financial forecasts and illegal earning management often is not clearly understood. In fact, managing to a forecast is not illegal earnings management if the accounting and disclosure is handled correctly.*

**by Steven E. Bochner and Douglas J. Clark**

Where is the boundary between the legitimate efforts of corporate management to meet financial forecasts and conduct that could be viewed as manipulative and fraudulent earnings management? This article provides recommended disclosure-control processes intended to keep companies on the right side of the line.

One of the most important measures by which corporate managers are judged is the ability to accurately forecast financial results. Failing to meet planned results can create havoc within an organization and roil the market for an issuer's stock. Establishing the appropriate level of operating expense, the need for additional cash resources and maintaining credibility with investors all fundamentally depend pon management's ability to accurately target quarterly revenue, gross margins, operating expenses, and earnings.

Market forces and company-specific factors create powerful incentives for management teams to meet internal and external financial targets. Individual and company-wide compensatory arrangements typically are closely tied to meeting financial goals. The intense scrutiny directed at executive compensation in recent years, has resulted in stockholder pressure on corporations to increasingly tie executive compensation to the achievement of performance milestones. The stock price of public companies can be impacted dramatically by failing to meet forecasted quarterly results, sometimes by shockingly small amounts, creating employee morale and retention problems, as well as competitive problems and customer concerns. The stock drops that accompany the failure to meet guidance or street expectations often attract securities lawsuits. Finally, members of management who repeatedly fail to deliver on previous forecasts risk their very jobs. All of these factors make forecasting and meeting targeted results a critical function for public company executives.

Businesses are not on autopilot. In managing the business enterprise towards its financial goals, corporate executives have many time-tested and widely used tools at their disposal. These efforts often are modulated by how close


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the enterprise is to meeting its financial goals for the quarter. For example, if it appears highly likely that a particular company's targets will be met for the quarter, there is obviously no need for management to initiate measures to further incentivize the sales force or customer base to help meet the forecasted targets.

On the other hand, corporate management may provide steeper discounts or implement expense reduction measures when the quarter is not going so well. Sales teams may be driven to work harder and longer to achieve the company's financial goals. In any given quarter, management teams may apply various levels of effort to the many variables that can impact quarterly targets. All of the foregoing actions have the effect of "managing" earnings, *i.e.*, running the business to reach a certain desired result.[1] The critical question is what conduct constitutes crossing the line separating prudent management techniques from unlawful activity. The SEC's informal guidance and enforcement efforts have helped answer that question.

## Background

In 1998, then SEC Chairman Arthur Levitt decried "earnings management" as a "game that runs counter to the very principles behind our market's strength and success." He stated that "flexibility in accounting allows it to keep pace with business innovations. Abuses such as earnings management occur when people exploit this pliancy. Trickery is employed to obscure financial volatility. This, in turn, masks the true consequences of management's decisions." Chairman Levitt then discussed five common forms of "accounting hocus-pocus": "big bath restructuring charges, creative acquisition accounting, 'cookie jar reserves,' 'immaterial' misapplications of accounting principles, and the premature recognition of revenue."[2] In a similar vein, John Morrissey, then Deputy Chief Accountant of the SEC, stated "[e]arnings management is perhaps too polite a term—others refer to it as accounting irregularities, accounting hocus-pocus, or financial reporting fraud. It is the intentional misstatement of financial results to achieve a contrived result."[3] Also along the lines of manipulating accounting rules to achieve a desired result, another observer noted, "One of the most popular vehicles for [improper] earnings management...stems from a misuse or misunderstanding of the proper application of materiality...."[4]

The label "earnings management," however, does not apply to many of the types of decisions executives make every day to manage their businesses effectively, even if made for the purpose of achieving targets. Supporting this line of thinking, in 2003 the Public Oversight Board's Panel on Audit Effectiveness observed: "the term *earnings management* covers a wide variety of legitimate and illegitimate actions by management that affect an entities earnings."[5] The Panel continued: "this suggests that the wide variety of earnings management activities, which cannot always be classified easily, constitutes a continuum that ranges from complete legitimacy at one extreme to fraud at the other."[6] Similarly, in 2002 the CPA Journal published an article in which the authors observed, "The need to precisely define 'earnings management' arises because the SEC and accounting profession acknowledge that some earnings management techniques are not fraudulent."[7] The SEC's public statements on earnings management abuses rightfully focus on devices that violate GAAP or evidence some other kind of impropriety used to disguise negative trends or events, and/or involve misleading or incomplete disclosure.

## Failure to Disclose Often Creates the Problem

The question of whether a company's efforts to meet its quarterly financial targets create legal problems is more often than not determined when the company discloses its financial results for such quarter. As is the case with many high-profile government prosecutions in recent years, it is the cover up, or in this case, the lack of disclosure, that will get you. According to one commentator "by 'earnings management' I really mean 'disclosure management' in the sense of a purposeful intervention in the external financial reporting process, with the intent of obtaining private gain...."[8]

***Inadequate disclosure of special or unusual measures impacting current or future period results increases exposure to lawsuits.***

The SEC's principal disclosure requirement with respect to financial analysis is Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), set forth in Item 303 of Regulation S-K. The MD&A is a critical part of every annual (Form 10-K) and quarterly (Form 10-Q) report. As highlighted in several SEC releases, MD&A serves two important functions.[9] The first is to explain factors that impacted financial results for the relevant period that may not be evident from the face of the financial statements themselves; in effect, to give investors an understanding of the company's financial results through the eyes of management. Second, MD&A requires companies to describe "any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on [results of operations, financial condition, or liquidity.]"[10] This disclosure requirement encompasses a variety of actions taken by management during the quarter that could materially impact a future financial period, such as would be the case if a company engaged in special sales efforts to make a quarterly target, which efforts depleted backlog in a manner that would likely materially impact the next quarter.

The SEC has brought several high-profile enforcement actions over the years that illustrate the hazards of inadequate analytical and trend disclosure in periodic reports. For example, in *SEC v. Cardinal Health, Inc.,* Cardinal settled charges that it had engaged in an earnings management scheme that entailed improper disclosure and accounting practices.[11] The SEC had alleged that Cardinal inflated reported revenue by misclassifying $5 billion of bulk sales as operating revenue in order to meet earnings and revenue guidance. The SEC faulted Cardinal not just for the practice, but for failing to accurately disclose the practice and its impact on revenue, earnings and growth trends.[12] In addition to the risk of an SEC enforcement action, inadequate disclosure of special or unusual measures impacting current or future period results increases exposure to lawsuits brought by private class-action litigants.

Another form of earnings management proliferated during the dotcom era: The use of *pro forma* financial information to smooth or otherwise obfuscate less attractive GAAP financials. In its most egregious form, companies would report earnings on a *pro forma* basis, despite incurring losses in the relevant reporting period.[13] This practice largely was eliminated by SEC Regulation G adopted in response to such tactics. Regulation G requires companies electing to disclose non-GAAP or *pro forma* financial information to do so clearly and transparently.[14]

## Recommendations

In order to avoid disclosure problems of the type encountered in the enforcement cases cited above, companies should develop written


*Coming Attractions*

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disclosure controls and consider incorporating the following suggestions into their disclosure committee and other review processes:[15]

1. See that the Audit Committee, Disclosure Committee, and others involved in the reporting process make inquiry to understand what management efforts and/or changes in accounting policy were made during the quarter that might have been different from prior periods.
2. In the portion of the MD&A describing the company's results for the quarter, see that the impact of any special measures (including changes in accounting policies) taken during the quarter on revenue or other financial statement line items, if material, is adequately described so as to provide investors with a clear understanding of those measures as well as how such measures impacted the reported results.
3. If the measures taken during the quarter are reasonably likely to have a material impact on the company's financial results for the next quarter or another fiscal period, see that adequate disclosure of such risks or uncertainties is made in the MD&A. If the measures taken are judged not reasonably likely to impact a future period, but are still possible, consider the appropriateness of a related risk factor.
4. If the quarter was particularly difficult, take extra care to see the company's policies on revenue recognition, estimates, accruals and other reserves, as well as relevant accounting principles, have been complied with.
5. Provide for early senior management involvement in the MD&A preparation so that the individuals that possess an understanding of the quarterly results and the company's financial outlook are in a position to make the necessary judgments described above.
6. Consider required or elective backlog disclosure.[16]
7. See that the risks, trends and uncertainties disclosed internally in board packages, minutes, or other materials are assessed when drafting the above-described portions of the MD&A and the risk factor section. Differences between internally and externally disclosed information increase litigation risk for the organization.[17]
8. If the company elects to use non-GAAP, or *pro forma*, financial information in its written or oral financial disclosures, see that the requirements of Regulation G are satisfied.[18]
9. Close the trading window for insiders promptly upon learning of material developments impacting the current or a future quarter, and keep the window closed until the above disclosures are made public in a Regulation FD-compliant manner. Better yet, reduce the risk of an insider trading allegation by seeing that executives adopt, in an open window, and do not modify, a properly constructed Rule 10b5-1 plan.

## Conclusion

The line that separates legitimate management practices to meet financial forecasts and illegal earnings management often is not clearly understood by corporate management. Provided management makes adequate disclosure of the steps it has taken during a reporting period that are necessary to understand the historical financial results reported and, to the extent material, their impact on future periods, and provided such steps are consistent with applicable accounting standards and the company's own policies, such activities fall into the category of managing to a forecast legitimately. Put another way, managing to a forecast is not illegal earnings management if the accounting and disclosure is handled correctly.

## NOTES

1. Public Oversight Board "3." Panel on Audit Effectiveness, 2002, 77 "virtually all managerial activities have a potential effect on earnings, and in that sense constitute earnings management; otherwise the activities presumably would not be undertaken."
2. Arthur Levitt, Chairman of the SEC, Remarks at NYU Center for Law and Business (Sept. 28, 1998), available at *http://www.sec.gov/news/*

*speech/speecharchive/1998/spch220.txt*. Examples of earnings management SEC enforcement actions include *In the Matter of Edison Schools, Inc.*, Admin. Proc. File No. 3-10781 (May 14, 2002) (accounting and disclosure improprieties); *In the Matter of Terex Corp.*, No. 3-9877, 1999 SEC LEXIS 788 (April 20, 1999) (improper revenue recognition); *In the Matter of National Partnership Investments Corp.*, Admin. Proc. File No. 3-9340, 1997 SEC LEXIS 1347 (June 25, 1997) (improperly accounting for an acquisition).

3. Remarks at the General Audit Management Conference (March 21, 2000), available at *http://www.sec.gov/news/speech/spch357.htm*.

4. C. Terry Grant, "Earnings Management and the Abuse of Materiality," *Journal of Accountancy* (Sept. 2000).

5. *See supra* n.2, at 77.

6. *See id.* at 78.

7. Larraine Magrath and Leonard G. Wald, "Abusive Earnings Management and Early Warning Signs," *The CPA Journal* (2002), *http://www.nysscpa.org/cpajournal/2002/0802/features/f085002.htm*.

8. Katherine Schipper, Commentary, "Earnings Management," *Accounting Horizons*, 92 (December 1989).

9. SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operation, Release No. 33-6835 (May 18, 1989); Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8350 (December 29, 2003).

10. 17 C.F.R. § 229.303.

11. *SEC v. Cardinal Health, Inc.,* No. Civ.A. 07-6709 (S.D.N.Y. filed July 26, 2007).

12. Other failures to disclose that gave rise to enforcement actions include *In the Matter of the Coca-Cola Company*,Admin Proc. File No. 3-11902, 2005 WL 883699 (April 18, 2005) (failure to disclose impact of "gallon-pushing" on future revenue targets); *In the Matter of Caterpillar, Inc.*, Admin. Proc. File No. 3-7692, 1992 SEC LEXIS 786 (March 31, 1992) (failure to disclose anticipated poor performance of Brazilian division); *In the Matter of Sony Corp.*, Admin. Proc. File No. 3-9666, 1998 SEC LEXIS 1650 (August 5, 1998) (failure to disclose that motion picture division had suffered continual losses since its acquisition); *In the Matter of Advanced Micro Devices, Inc.*, Admin. Proc. File No. 3-9102, 1996 SEC LEXIS 2657 (September 26, 1996) (failure to disclose risks of adverse judgment in on-going litigation when those risks included being unable to sell several major products); *In the Matter of Nolan*, Admin. Proc. File No. 3-11106, 2003 SEC LEXIS 1081 (May 6, 2003) (failure to disclose that the company was considering whether a substantial portion of the company's revenue could continue to be reported as revenue because of potential impact on the company's future performance).

13. Kevin L. James & Franklin A. Michello, "The Dangers of Pro Forma Reporting," *The CPA Journal* (February, 2003), available at *http://www.nysscpa.org/cpajournal/2003/0203/dept/d026403.html*.

14. 17 C.F.R. § 244.100. For a discussion of the requirements of Regulation G, *see* Steven E. Bochner and Richard Cameron Blake, "The Earnings Release: Legal Requirements and Best Practices," *Insights*, March 2008.

15. For more information about the SEC's requirements regarding disclosure controls and procedures and the value of disclosure committees, *see id.* at 7.

16. *See* Item 101(c)(viii) of Regulation S-K.

17. *See Caterpillar, Inc.*, Proc. File No. 3-7692, 1992 SEC LEXIS 786 (Caterpillar's management and board knew that the performance of its Brazilian subsidiary had a disproportionate impact on Caterpillar's financial condition as reported in its Annual Report on its Form 10-K. Management and the board failed to disclose this disproportionate impact, as well as their knowledge that it was uncertain that the subsidiary would be able to repeat its financial performance because of country-specific risk factors).

18. If the non-GAAP financial information is included in an earnings press release that is furnished on Form 8-K, or is filed in another SEC filing such as Form 10-Q or Form 10-K, requirements in addition to Regulation G are also required. *See supra* n.14 at 5.

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