From a wrist slap to jail time: how the SEC deals with dodgy accounting

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Standing guard in 2004 at the then-headquarters of the SEC. **BLOOMBERG NEWS**

GRPN -2.40%

What exactly does it take for a company to move from getting a slap on the wrist from the Securities and Exchange Committee for accounting issues to being slapped with criminal charges that could lead to jail time?

That's a pertinent question, coming a week after the former head of real-estate investment company American Realty Capital Partners was charged with accounting fraud for using a metric that didn't comply with Generally Accepted Accounting Principles and that inflated his company's results.

While criminal charges for accounting issues in quarterly earnings reports are relatively rare, companies can face enforcement actions for failing to follow SEC rules on earnings reports. In May, the SEC updated its guidelines to take full aim at the use of non-GAAP measures, which have proliferated in recent years and been widely condemned for misleading investors.

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The new rules allow companies to use non-GAAP metrics to provide further clarity and depth on the state of their businesses, but they must lead with GAAP numbers, they must give equal prominence to both, and they must explain how they are reconciled.

The SEC explains the workings of its corporation finance division on its website, outlining how 11 industry teams staffed with about 80% of the division's employees, are the primary movers. The members of these teams — accountants, lawyers and other professionals — are assigned filings from companies in 11 sectors, based on their individual expertise.

In reviewing filings, staffers take the viewpoint of an investor and what that person might want to know when reading a document.

However, "the division's review process is not a guarantee that the disclosure is complete and accurate — responsibility for complete and accurate disclosure lies with the company and others involved in the preparation of a company's filings," according to the site.

The teams don't follow the S&P 500 sector classes but are assigned as follows: health transportation and leisure; manufacturing and construction; financial services; real estate and commodities, beverages, apparel and mining; electronics and machinery; and telecommunications.

Under Sarbanes-Oxley regulations, which were put in place after the collapse of the energy trading giant Enron, the division is obliged to do some kind of review of each reporting company at least once every three years, although some companies are scrutinized more regularly. The division also reviews filings related to transactions, such as mergers and acquisitions, spinoffs, debt and equity offerings and proxy solicitations, on a selective basis.

If a staffer identifies an area where disclosure could be improved, he or she can provide comments to the company, either informally by phone or, in more complex cases, by letter.

Companies can resolve a comment with a simple explanation; in other cases there may be more back-and-forth. The SEC makes the comment letters and the company's responses public via its SEC Edgar system, no earlier than 20 business days after it has completed a review.

The members of the division, no matter how senior, are available to companies for discussion of disclosure and financial-statement presentation. A CFO can take an issue all the way to the director, or head of the accounting office, if he or she wishes. In the end, however, companies need to satisfy comments from the SEC staffers and may be required to amend filings. The SEC can ask for supplemental information to better understand a company's disclosure or may ask it to provide different disclosure in a future filing.

The SEC took its first ever enforcement action for misleading earnings against none other than current GOP presidential candidate Donald Trump's Trump Hotels & Casino Resorts Inc. in 2002, for statements in its third-quarter earnings release three years before.

under GAAP. Trump Hotels' chief executive officer said the company's positive results and improvement from the third quarter in 1998 were the result of improvements in the company's operations. The SEC alleged that the company violated the law in highlighting "purportedly" positive results but failing to disclose that those results had occurred because of an unusual one-time gain rather than ongoing activities.

Stephen M. Cutler, the director of the commission's enforcement division at the time, said in the press release that the case starkly illustrated how pro forma numbers "can be used deceptively" and demonstrated "the mischief that they can cause."

The Trump company settled with the SEC by agreeing to a cease-and-desist order.

Since then, a slew of companies have faced probes for accounting irregularities, and some have been forced to restate past earnings and pay fines or other penalties.

Valeant Pharmaceuticals International Inc. US:VRX has faced wide criticism over its accounting for sales made by specialty pharma network Philidor, with which it had close ties. In August, the Wall Street Journal reported that the issue had drawn the attention of federal prosecutors, who are investigating whether Valeant defrauded insurers by hiding its ties to Philidor.

Tech companies, particularly in their early stages, have been raked over the coals for using metrics that are entirely of their own devising. Groupon Inc. **GRPN, -2.40%** , for example, was asked to explain a measure that it had invented itself that showed up in the prospectus for its initial public offering back in 2011, as the Wall Street Journal reported.

The measure in question was adjusted consolidated segment operating income (also called adjusted CSOI). The company described it as profit excluding marketing costs and other expenses. Analysts rightly pointed out that the company was trying to draw to attract customers — hardly a noncash item. In Groupon's case, adjusted CSOI came to $81.6 million for the first quarter of 2011, or a loss of $98 million once marketing costs were included.

The SEC effected a delay of the Groupon IPO by ordering the company to amend its prospectus to let investors know the measure could not be relied upon as a measure of cash available to invest in the growth of the business.

Meanwhile, Brian Block, the former CFO of American Realty, the REIT charged with intentionally misleading investors with a non-GAAP metric, is facing charges that carry a maximum prison sentence of up to 20 years.

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