Mitigating Accounting Fraud Risk During the Pandemic: Regulators’ Concerns and Prospective Solutions

Posted by Colleen Conry, Jeremiah Williams, Ropes & Gray LLP, and Meaghan Schmidt, AlixPartners, on Sunday, June 7, 2020

Tags: Accounting, COVID-19, Disclosure, Financial reporting, SEC, SEC enforcement, Securities enforcement, Securities fraud, Securities regulation

More from: Colleen Conry, James Tsaparis, Jeremiah Williams, Meaghan Schmidt, AlixPartners, Ropes & Gray

The COVID-19 pandemic brought with it economic downturn forcing businesses to compete with fewer resources and major operational hurdles. Historically, economic downturn yields more accounting fraud: Old fraud is uncovered amid heightened financial scrutiny [1] while the conditions for new fraud flourish. [2] We saw this in the 2008 financial crisis, but expect swifter and fiercer enforcement this time around, as the DOJ focuses on coronavirus-related frauds [3] and the SEC bolsters its Enforcement Division to ensure that “Main Street investors are not victims of fraud.” [4] Now more than ever, businesses must be extremely careful in preparing their financial statements. In this post, we argue for risk-mitigation strategies to curtail accounting fraud in three key coronavirus-impacted areas: disclosures, revenue recognition, and impairment.

Two recent SEC publications provide insight into likely areas of concern. Accounting issues coming out of crisis include not only the statement of figures, but their associated explanations and disclosures. In guidance released on March 25, 2020, the SEC’s Division of Corporate Finance (the March 25 Guidance) underscored that it is closely monitoring how companies report the risks and effects of COVID-19. [5] The March 25 Guidance lists a number of questions to consider in assessing and disclosing the impact of COVID-19 and details the appropriate use of non-GAAP metrics for items impacted by COVID-19.

On April 3, 2020, the SEC’s Office of the Chief Accountant issued a statement on financial reporting in light of COVID-19, further enumerating accounting areas involving significant discretion and estimation due to the virus. [6] The list includes: fair value and impairment, leases, debt modifications/restructurings, hedging, revenue recognition, income taxes, going concern, subsequent events, and adopting new accounting standards. By highlighting certain particularly discretionary line items, the SEC is likely foreshadowing anticipated problem areas. Of these, the key hotspots for accounting fraud, in our view, are financial reporting disclosures and explanations, principles of revenue recognition, and impairment.

Disclosures & Explanations. In 2013, when financial regulators refocused on crisis-related accounting frauds, they relied in part on models that mined data from disclosures in order to determine whether risks were underreported or overlooked. [7] Given that pandemic-related risks will inevitably call for use of the terms “Coronavirus” or “COVID,” such modeling would be easy to redirect at financial statements coming out of the current crisis. [8] SEC analytics may also target changes to control processes and assumptions, making it important to document and disclose deviations from ordinary assumptions due to COVID-19.

Companies should fully and accurately disclose the impacts of COVID-19 on their operations, earnings, and outlook, but they should also incorporate the March 25 Guidance [9] on Coronavirus-related disclosures as a matter of process. We encourage public-filing companies to cross-reference the disclosure-related questions in the March 25 Guidance with their
Coronavirus disclosures in order to preempt scrutiny and underscore the added control measures taken in case the SEC decides to investigate.

Revenue Recognition. Historically, revenue recognition issues have constituted over 60% of financial reporting frauds investigated by the SEC. Given the cash constraints accompanying COVID-19, we view revenue recognition issues as a particularly likely area for heightened scrutiny. The timing of revenue recognition will be particularly important given the pandemic’s coincidence with the close of 2019. Particular care should be taken to review relevant customer contracts and determine due dates for performance obligations. In this vein, it may be advisable for companies to integrate legal departments into their review structures early in the process. In order to mitigate revenue-recognitions risks, companies should also consider additional transaction testing on an ad hoc basis with a focus on the dates of obligations and title transfers, and building out their internal audit capabilities.

Impairment Considerations. In light of great economic volatility, impairment considerations—especially impairment of goodwill, fixed assets, inventory, and accounts receivable—will be particularly problematic. Compounding the problem is the degree of discretion involved: even under GAAP, there is a high variance in acceptable testing for the same type of asset. While the onset and progression of COVID-19 may itself be a triggering event requiring value-testing, companies should brainstorm the particular environmental factors likely to impact their key line-items, develop a framework for identifying impairment events as they occur, and determine the right valuation.

* * *

Although increased accounting fraud and regulatory scrutiny appear likely coming out of the pandemic, companies need not fall prey to probabilities. A thoughtful approach to discretionary accounting figures and disclosures, with controls tailored to COVID-19 risks, should provide a safe springboard into a post-coronavirus world.

Endnotes

1 In the words of Warren Buffet, “only when the tide goes out do you discover who’s been swimming naked.” Mohamed A. El-Erian, ‘Only When the Tide Goes Out Do You Discover Who’s Been Swimming Naked’: How to Turn Meltdowns into Money, Fin. Post (Feb. 8, 2018), https://business.financialpost.com/investing/lessons-for-investors-in-turbulent-markets-mohamed-a-el-erian. (go back)

2 New fraud appears likely because financial pressure coupled with the unique opportunity to circumvent internal controls comes at a time when actors are especially able to rationalize the fraud—whether it’s to obtain incentive compensation, save their job or their coworkers’, or just keep the company afloat. See The Fraud Triangle, Ass’n Gov’t Accountants, https://www.agacgfm.org/Intergov/Fraud-Prevention/Fraud-Awareness-Mitigation/Fraud-Triangle.aspx (elaborating on Opportunity, Pressure, and Rationalization as precursors to fraud). (go back)


8 SEC models have also been used to screen for high volumes of off-balance sheet transactions. In this regard, particular care should be taken to independently verify account statements.

9 SEC Disclosure Guidance, supra note 5.


11 Key considerations include thinking about who will be responsible for monitoring and how frequently, which markets need to be actively watched, when stay-at-home orders are extended or abandoned, among others.

Trackbacks are closed, but you can post a comment.