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INSIGHT: Accounting Compliance Is Key During SEC Pandemic Scrutiny

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During the Covid-19 pandemic, transparency from public companies is more important than ever and accounting practices are remaining an enforcement priority for the SEC. In Part 2 of a two-part series on public company disclosures, Ballard Spahr attorneys explore accounting judgments and compliance with Generally Accepted Accounting Principles.

As the country continues struggle with the financial effects of the Covid-19 pandemic, the reporting of accurate information and transparency from public companies is more important than ever. In the first article of this two-part series, we examined guidance for public companies regarding supply chain and workforce disclosures. In this article, we will explore accounting judgments and compliance with Generally Accepted Accounting Principles (GAAP) in the age of Covid-19.

The pandemic will bring careful inspection of companies' accounting judgments and compliance with GAAP, which already form the basis of nearly a quarter of federal securities class action suits. In a recent statement, Sagar Teotia, the SEC's chief accountant, noted that "many accounting areas [] may involve significant accounting judgments and estimates in light of the evolving status of Covid-19." Among these areas, the chief accountant listed "fair value and impairment considerations; leases; debt modifications or restructurings; hedging; revenue recognition; income taxes; going concern; subsequent events; and adoption of new accounting standards."

Teotia's comments comport with those of his predecessor, Wesley Bricker, who once observed, "[i]t is hard to think of an area more important than ICFR [internal control over financial reporting]." Areas such as revenue recognition have received particular attention, including the Financial Accounting Standards Board's 2014 update to the standards application to recognizing revenue from customer contracts.

ACCOUNTING PRACTICES REMAIN ENFORCEMENT PRIORITY

Nevertheless, accounting practices have remained an enforcement priority for the SEC. In its Fiscal Year 2019 Report, the Division of Enforcement noted that the commission brought actions against public companies for "deficient disclosure controls, misleading risk factor disclosures, and misleading presentation of non-GAAP metrics"

Specifically, the commission recently filed a $30 million settled action against a global pharmaceutical company that allegedly failed to timely disclose and accrue for liability arising out of a Justice Department investigation into the classification of a product under the government's Medicaid Drug Rebate Program.

Similarly, the commission filed a $40 million settled action against the U.S. subsidiary of a global car manufacturer that allegedly incentivized car dealers to report inaccurate monthly sales and to maintain a "cookie jar" of unreported sales from which the dealerships could draw when the dealers fell short of monthly targets.

The Division of Corporation Finance's March 25 guidance provides some factors for companies to consider in connection with their financial reporting:

- How has Covid-19 impacted your capital and financial resources, including your overall liquidity position and outlook? Has your cost of or access to capital and funding sources, such as revolving credit facilities or other sources changed, or is it reasonably likely to change?

- How do you expect Covid-19 to affect assets on your balance sheet and your ability to timely account for those assets? For example, will there be significant changes in judgments in determining the fair-value of assets measured in accordance with U.S GAAP or IFRS?

- Do you anticipate any material impairments (e.g., with respect to goodwill, intangible assets, long-lived assets, right of use assets, investment securities), increases in allowances for credit losses, restructuring charges, other expenses, or changes in accounting judgments that have had or are reasonably likely to have a material impact on your financial statements?

As Division of Corporation Finance's guidance suggests, it may be prudent to review and, if necessary, strengthen internal controls over financial reporting. For example, with respect to revenue recognition, pressure to meet prior or interim revenue projections, or to minimize the impact of the crisis, may tempt the premature recognition of revenue.

Companies should consider more robust testing of revenue, as well as the broadening of inquiries beyond those who already provide certifications or sub-certifications, to ensure that revenue can be recorded accurately for the appropriate periods.

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