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SEC Enforcement Action Demonstrates Potential Risks of "Flash" Reporting

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A recent SEC fraud case underscores the dangers of corporations relying on internal memos (or emails)—frequently called "flash reports"—to keep track of earnings progress. Too often these reports can be used in hindsight to suggest earnings manipulation.

That was the approach taken by the SEC in a case brought against Diebold, Incorporated, in which the corporation and three of its former financial executives were charged with fraudulently managing the company's earnings to meet analyst forecasts between 2002 to 2007. *SEC* v. *Diebold, Inc*. (complaint); *SEC* v. *Geswein* (complaint), Litig. Rel. No. 21543 (June 2, 2010). The complaints filed by the SEC allege that Diebold's management received flash reports that compared the company's actual earnings to the consensus analyst earnings forecasts—which forecasts, the complaints allege, were referred to by management as "required" or "necessary" earnings. Thereafter, according to the SEC, management would prepare "opportunity lists" setting forth potential ways in which Diebold's actual earnings could be brought in line with the analysts' forecasts. While some of the items listed were legitimate business adjustments, others, the SEC alleges, were fraudulent accounting techniques designed to manipulate earnings.

Obviously management needs real-time information, and flash reports are a useful tool for presenting preliminary earnings data. But implementing certain controls can minimize second-guessing. These include:

- omitting references in flash reports to analyst forecasts to avoid the appearance that subsequent earnings changes were improperly made to meet analyst expectations;
- requiring that material changes to the earnings numbers presented in the flash report be documented and explained by the individual responsible for the change;
- requiring that all material post-quarter adjustments, including reserving decisions and asset valuations, be documented and reviewed by appropriate senior finance professionals; and
- ensuring that flash reports are distributed not only to senior management, but also to the company's outside auditor.

While adopting these policies will not, of course, protect a company that engages in fraudulent accounting practices, doing so will hopefully reduce the risk that legitimate lateperiod adjustments are misconstrued by regulators reviewing company actions in hindsight.

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