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Penalties for Fraud Are Insufficient to Deter Wrongdoing

The SEC charged two former executives of Diamond Foods, Inc., with the falsification of quarterly and annual results for fiscal years 2010 and 2011. Their punishment was a slap on the wrist compared to what they should have received.

The Securities & Exchange Commission (SEC) Annual Financial Report for fiscal 2013 shows that total penalties and disgorgement ordered totaled $3.4 billion, an increase from the prior fiscal year. According to SEC Chair Mary Jo White, the SEC's "robust enforcement program" is aggressive and creative and will continue to focus on financial statement and accounting fraud. Despite these positive assertions, SEC penalties don't seem to be sufficient to deter future wrongdoing.

In a recent egregious case, investors of Diamond Foods, Inc., suffered significant losses because of the deliberate falsification of quarterly and annual results at the company. "Diamond Foods misled investors on Main Street to believe that the company was consistently beating earnings estimates on Wall Street," said Jina Choi, director of the SEC's San Francisco, Calif., regional office. "Corporate officers cannot manipulate fiscal numbers to create a false impression of consistent earnings growth." Despite these strong words, the SEC assessed a penalty of only $5 million against Diamond, which is listed on NASDAQ with fiscal year 2013 revenues of $864 million.

Management's rationale for engaging in the accounting scandal was the perceived absolute necessity to continue to beat Wall Street estimates. In April 2011, Diamond management decided to acquire the Pringles brand from Procter & Gamble and needed to maintain its strong earnings performance in order to pull off the acquisition. The company had previously seen earnings increase from $0.53 per share in 2007 to $1.42 in 2009.

Before going public in 2005, Diamond was predominantly a cooperative of walnut growers. Its most important business and accounting issue each year dealt with the walnut price paid to growers, which easily provided the most feasible means to falsify earnings. The fiscal 2011 10-K annual report to the SEC stated a critical accounting policy:

> "We have entered into long-term Walnut Purchase Agreements with growers, under which they deliver their entire walnut crop to us during the Fall harvest season and we determine the minimum price for this inventory by March 31, or later, of the following calendar year. The final price is determined no later than the end of the Company's fiscal year. This purchase price will be a price determined by us in good faith, taking into account market conditions, crop size, quality, and nut varieties, among other relevant factors. Since the ultimate price to be paid will be determined subsequent to receiving the walnut crop, we must make an estimate of [final] price for interim financial statements. Those estimates may subsequently change and the effect of the change could be significant."

Diamond allegedly managed quarterly and yearly earnings by shifting part of the cost of walnut sales to later periods, thus enabling it to report a strong performance in 2010 and 2011. Its 2011 10-K annual report to the SEC, filed on September 15, 2011, shows diluted per share earnings of $2.22 and $1.36 for fiscal 2011 and 2010, respectively.

On October 3, 2011, Diamond

announced that it had "made a pre-harvest momentum payment [$80 million] to walnut growers in early September, prior to the delivery of the fall walnut crop to reflect the fiscal 2012 projected market environment. The payment is accounted for in fiscal 2012 cost of goods sold and is reflected in the guidance provided by the company on September 15, 2011." The stock price peaked on September 20, 2011, closing at $92.47, up from $28.20 on July 31, 2009. An October 27, 2011, special stockholders' meeting approved the Pringles acquisition.

But bad news was on the horizon as growers were confused by the payments they received. On November 1, 2011, a Diamond press release announced a delay in the Pringles closing. The audit committee had decided to initiate an internal investigation because it received "an external communication regarding Diamond's accounting for certain crop payments to walnut growers." The stock price closed on November 7 at $39.09, a drop of 57.7% from the peak. A later press release reported the employment of an independent Big 4 audit firm and a law firm for assistance in conducting the investigation.

On February 14, 2012, the audit committee announced that it had substantially completed its investigation and that Diamond's fiscal 2011 and 2010 financial statements and accompanying independent auditor reports should no longer be relied on. Two new audit committee members were appointed in March 2012, and in April the company reported the termination of its previous agreement with Procter & Gamble to acquire the Pringles business.

Because Diamond wasn't able to report quarterly financial results for fiscal 2012 following its release of 2011 results, it requested forbearance against delisting from NASDAQ. It finally amended its annual report on Form 10-K in November 2012 with restated results for fiscal years 2011 and 2010. The amounts of reductions in earnings were significant, as were the narrative descriptions of material weaknesses in internal control that allowed the misstatements.

Instead of diluted earnings per share (EPS) of $2.22 for 2011 as originally reported, the restated amount was only $1.17, a reduction of nearly half. For 2010, restated EPS was $0.82 compared to $1.36 originally reported, a reduction of nearly 40%. The closing stock price the day after the announcement was $15.36, a whopping 83% decline from its peak just more than a year earlier.

While the correction of walnut cost accounted for the majority of the difference (reductions of 101% in 2011 and 117% in 2010), there were other corrections as well, including previously unrecognized and unrecorded accounts payable and accrued expenses, such as advertising, and other corrections related to stock-based compensation, foreign currency translation, timing of prepaid and expense recognition, capital lease designation, and deferred income tax. Apparently all of these corrections were considered to be immaterial—individually and in total—when the original financial statements were prepared.

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The report of the independent audit firm contained in the 2012 annual report on Form 10-K to the SEC issued just days later contains additional insight as to the causes of the fraud. It notes three material weaknesses in internal control that still existed as of July 31, 2012:

- **Control environment:** "Management's operation style and concentrated decision making increased the risk of management override of certain controls, limited effective communication and flow of information throughout the organization and to those charged with governance and did not provide an environment that consistently encouraged open discussion of alternate views or opinions."
- **Walnut grower accounting:** "The material weakness in the control environment contributed to material weaknesses in walnut grower accounting control activities."
- **Accounts payable and accrued expenses:** "The controls over recording accounts payable and

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> accrued expenses were improperly designed and were not operating effectively to ensure that all expenditures were identified and recorded in the appropriate account and period." (In other words, the accounting was very sloppy.)

The two individuals allegedly involved in this mess are then-CFO Steven M. Neil, whose total fiscal 2011 compensation was $2.4 million, and then-CEO Michael J. Mendes, whose total fiscal 2011 compensation was $7.3 million. Both were placed on administrative leave in early 2012 and resigned a month later.

The settlement with the SEC, announced in January 2014, didn't even involve an admission of guilt. The almost trifling $5 million penalty seems to be more like a slap on the wrist than an amount designed to deter future wrongdoing by others. More importantly, shareowners not only have lost much of their investment, but they have also been burdened with more than $200 million in costs related to acquisitions and integration, settlement of a securities class action lawsuit, audit committee investigation, restatement-related expenses, legal investigation expenses, consulting fees, accrued contract termination expenses, and retention and severance accruals. This is according to the non-GAAP (Generally Accepted Accounting Principles) analysis contained in the September 30, 2013, earnings press release.

The SEC also reported settling with Mendes, who should have known that Diamond's reported walnut cost was incorrect at the time he certified the company's financial statements. He paid a minimal penalty of $125,000 but didn't admit or deny the fraud charges. His attorney says Mendes is focusing on new opportunities in his professional career. In my view, the SEC should have barred Mendes from ever again serving as an officer or director of a public corporation.

The SEC's litigation continues against Neil, who is fighting the fraud charges and looks forward to trial. His attorney says he has done nothing wrong: "He followed long-standing company practice and an accounting treatment that was approved by the company's outside auditors." Stakeholders in the investment community deserve a verdict that provides appropriate penalty for Neil's unethical and fraudulent behavior that will deter future wrongdoing by others. **SF**

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