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Diamond Foods, Inc.

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INTRODUCTION

This case examines an interesting real-life occurrence of alleged financial statement fraud by Diamond Foods, Inc. Specifically, the company purportedly understated walnut costs in two fiscal years in order to falsify earnings to meet estimates by stock analysts. The facts of this case are drawn from Securities & Exchange Commission (SEC) accounting and auditing enforcement releases and administrative proceedings releases.

OVERVIEW

The SEC filed separate actions in January 2014 against Diamond Foods, Inc., its former Chief Executive Officer Michael Mendes, and its former Chief Financial Officer Steven Neil for their roles in a scheme to understate walnut costs in order to falsify earnings to meet estimates by stock analysts.[1] The SEC contends that Diamond materially falsified its financial statements in fiscal years 2010 and 2011.[2] Diamond has since restated its financial results for those periods. The company's reported earnings decreased by $10.5 million for its 2010 fiscal year and by $23.6 million for its 2011 fiscal year.[3] Additional specific information is provided in the following sections of the case.

DIAMOND FOODS: MORE THAN NUTS

Diamond Foods, Inc., based in San Francisco, Calif., has a significant line of business that involves buying walnuts from growers and then selling the walnuts to retailers. The company diversified into potato chip and microwave popcorn product lines, introducing these lines after Diamond became a publicly traded company in 2005. Diamond first entered the microwave popcorn business when it acquired the Pop Secret popcorn brand from General Mills in 2008. Two years later, Diamond Foods expanded into potato chips by acquiring the Kettle Foods potato chip company. The potato chips are sold under the Kettle Brand label in the United States and Kettle Chips brand in the United Kingdom.[4] As of August 31, 2011, Diamond had issued 22,011,196 shares of common stock.

Although Diamond Foods diversified into other product lines, walnuts remained its primary product. In 2010, a significant increase in the cost of walnuts threatened Diamond's financial results, and, as described in the following paragraphs, two of Diamond's top officers allegedly manipulated financial information.

THE ACCOUNTING SCHEMES

In fiscal year 2010, there were significant increases in the average prices demanded by walnut growers.[5] Accordingly, Diamond needed to pay significantly more to its growers in 2010, compared to prior years. Yet an increase in the cost of walnuts would decrease net income at a time when Neil, Diamond's then-CFO, was facing pressure to meet or exceed the earnings estimates of Wall Street analysts.[6] Neil gave "extra" payments to Diamond's walnut growers but allegedly improperly excluded portions of these payments from the cost of walnuts by instructing his finance team to consider the payments as advances on crops that had not yet been delivered. Mendes, Diamond's then-CEO, was not only involved in the decision to make special payments to growers but also was aware of the way these payments were recorded in the financial statements.[7] By allegedly falsifying the financial statements for fiscal years 2010 and 2011, Diamond was able to hit quarterly earnings per share (EPS) targets and exceed analysts' estimates.[8] The SEC also alleges that both Neil and Mendes personally benefited from the alleged fraud by receiving cash bonuses and other compensation based on reported EPS in both fiscal years 2010 and 2011.[9]

FISCAL YEAR 2010: "CONTINUITY" PAYMENTS

Diamond began manipulating the financial statements by understating its walnut cost in the second quarter of fiscal year 2010. In accordance with Diamond's accounting policy, the cost of the 2009 walnut crop is reported in the 2010 financial statements. Diamond had previously recorded an estimated average walnut cost of $0.82 per pound in the first quarter of fiscal year 2010 based on the 2009 crop. But in order to beat the analysts' consensus second quarter EPS forecast, Neil reduced the walnut cost estimate to $0.72 per pound.[10] The resultant increase in stock price from beating analysts' forecasts supported Diamond's expansion into potato chips and the imminent acquisition of the Kettle Foods potato chip company.

Diamond subsequently paid a final minimum price to the walnut growers of $0.71 per pound, which was significantly lower than market price for the 2009 crop. Therefore, Neil created a scheme to "close the gap" between the final minimum price and the market price, which was to pay the walnut growers extraordinary payments of approximately $0.10 per pound, termed as a "continuity" payment. Only the final minimum price of $0.71 per pound was included in the 2010 financial statements. To avoid including the continuity payment in the 2010 financial statements, Neil instructed his finance team that the payment was an advance for the 2010 walnut crop. But the growers were paid the continuity payment and final 2009 crop payment in one check, the continuity payment went to growers not under contract to deliver the 2010 crop, and continuity payments were made to growers who ultimately did not deliver a 2010 crop. Mendes reviewed and approved correspondence sent to the growers related to this matter. Excluding the continuity payments from the 2010 financial statements resulted in Diamond beating its EPS forecasts and reporting a 52% growth in earnings.[11]

FISCAL YEAR 2011: "MOMENTUM" PAYMENTS

Neil also allegedly manipulated walnut costs in the 2011 fiscal year, resulting in the continuation of the trend of beating analysts' earnings estimates. A competitive price for the 2010 walnut crop was approximately $1 per pound. Diamond paid the walnut growers an average first installment payment of $0.57 per pound and agreed to pay a final payment of $0.08 per pound. Diamond subsequently recorded the final 2010 crop walnut cost as $0.74 per pound. The cost of the 2010 walnut crop is recorded in 2011 fiscal year's financial statements.

Neil knew that Diamond's "final" price for the 2010 crop of walnuts, not including the "momentum" payment, was about $0.40 per pound below prices being paid by Diamond's competitors. This gap was considered unusual and unprecedented.[12] To close the gap in payments to the walnut growers, Neil issued an extraordinary and unusual payment to growers of $0.30 per pound, termed the "momentum" payment. This payment was treated by the finance team as an advance for the 2011 crop and therefore was excluded from 2011 fiscal year's reported earnings. The payment, however, was paid to all growers who delivered the 2010 walnut crop to Diamond, including those not under contract to deliver a 2011 crop and those who ultimately did not deliver a 2011 crop.

The fiscal year 2010 "continuity" payments and the fiscal year 2011 "momentum" payments could be termed "earnings management" activities. As noted in this case, the SEC took exception to the earnings management methods used by Diamond. But not all methods used to increase net income are unethical.

EARNINGS MANAGEMENT METHODS

Earnings management is the purposeful intervention in the external financial reporting process with the intent of obtaining some private gain.[13] Several methods may be used to manage earnings. Accruals management (AM) is the manipulation of accounting accruals (or prepayments) in order to manage earnings. AM is relatively common and relatively easy to justify since it is based on accounting estimates and assumptions. Real transaction management (RTM) involves the timing and structuring of actual business activities in order to achieve a desired financial reporting result.[14] Non-GAAP earnings management is another type of earnings management where GAAP (Generally Accepted Accounting Principles) is violated in order to manipulate the reported earnings number. Although both AM and RTM do not generally violate GAAP, there may be instances when AM does violate GAAP.[15]

In his article "Overvaluation and the Choice of Alternative Earnings Management Mechanisms," Brad Badertscher argues that there is a pecking order to managing earnings. He argues that firms are likely to first use AM because it does not affect business operations and therefore is the least costly form of earnings management. But use of AM is limited because of the reversing nature of accruals. RTM generally follows AM but is more costly than AM because it impacts the company's long-term performance. In addition, companies will eventually run out of RTM opportunities and either stop managing earnings or transition to the most costly form of earnings management.[16] Companies use non-GAAP earnings management because it is difficult to detect and enables large-scale changes to reported earnings. Yet Badertscher argues that non-GAAP earnings management is the most costly form of managing earnings because of legal fees and capital market costs once the GAAP violation has been revealed. Therefore, non-GAAP earnings management is generally the last method used to manage earnings.

Auditors have the responsibility to conduct their audit to provide reasonable assurance that there are no material misstatements in the financial statements. This responsibility includes ascertaining that any "earnings management" techniques do not violate GAAP.

THE AUDITORS

Neil approved the walnut cost and determined the accounting for walnut payments. He supervised Diamond's finance and accounting team ("finance team") and the team that managed relationships with growers ("grower relations team"). As the CFO, Neil directly interacted with Diamond's external auditors. Neil prepared an internal memorandum each quarter that justifyed the quarterly estimated cost of walnuts and a memorandum to the external auditors that justifyed the final walnut costs. The SEC notes that the auditors relied on the memos when issuing their opinions about Diamond's financial statements.[17]

FISCAL YEAR 2010

During the audit of the 2010 financial statements, the auditors asked Neil for information to justify his decision to account for the "continuity" payment as an advance on the next year's crop of walnuts. The SEC contends that Neil made material misrepresentations to the auditors and withheld material information from them. Specifically, he falsely stated that walnut growers had asked for an advance payment for next year's crop and omitted the fact that he and other Diamond representatives had assured growers a competitive price for the current year.[18] Further, the auditors relied on a "management representation letter" that Neil signed, which stated that the "continuity" payment was for the 2010 crop and did not represent a payment for 2009 walnut costs. Mendes was cognizant of representations made to the external auditors and signed the related management representation letter related to the 2010 financial statements audit.[19]

FISCAL YEAR 2011

Neil continued to manipulate walnut costs during fiscal year 2011. In e-mails, Neil referred to the walnut costs as a "lever" to manage earnings in Diamond's quarterly financial statements. As a result of the cost manipulations, Diamond reported EPS that met or exceeded analysts' expectations for every quarter in 2011. It should be noted that Diamond's stock price was central to a proposed acquisition of a major potato chip business unit in spring 2011.[20] The company's stock price reached approximately $92.50 per share in September 2011.

EPILOGUE

DIAMOND FOODS

As a result of media speculation of accounting irregularities and an internal investigation, Diamond Foods issued restatements on November 14, 2012. Around the time of the announcement, the price of Diamond's stock declined to approximately $15.40 per share.

Diamond Foods, Inc., without admitting or denying the allegations, agreed to pay $5 million to settle the charges filed against it by the SEC.[21] Diamond also consented to the entry of a permanent injunction against future violations of the relevant securities laws.[22]

MICHAEL MENDES

Michael Mendes, Diamond's former CEO, agreed to settle charges against him by paying a civil money payment of $125,000 to the SEC and agreeing to "cease and desist" from committing or causing any future violations of Sections 17(a)(2) and (a)(3) of the Securities Act as well as other Sections and Rules of the Exchange Act.[23] In addition, Mendes returned or forfeited more than $4 million in bonuses and other benefits he received as a result of Diamond's allegedly fraudulent financial reporting.[24]

STEVEN NEIL

The SEC's litigation against Steven Neil, Diamond's former CFO, continues and, at the time of this writing, is still pending.[25] The SEC is seeking several things from Neil, including:

- Permanently enjoining Neil from directly or indirectly violating certain rules of federal securities laws;
- Prohibiting Neil from serving as an officer or director of any entity having securities registered with the SEC pursuant to the Exchange Act;
- Surrendering any wrongfully obtained benefits (Neil received $1.18 million in bonuses, including $687,043 tied to meeting EPS goals);
- Reimbursing Diamond for all compensation received or obtained during the relevant statutory time period established by Section 304 of the Sarbanes-Oxley Act (SOX); and
- Paying civil penalties.[26]

GENERAL QUESTIONS:

1. In this case, Diamond Foods was accused of "managing earnings" in an unethical manner. Provide two specific examples of how a company could *ethically* improve net income.

2a. Why do you think accounting personnel (the "finance team") seemed to "go along" with the schemes to understate the cost of walnuts in both fiscal year 2010 and fiscal year 2011? Provide as many possible reasons you can think of.

2b. Instead of agreeing to record the extra payments to growers as "advances" and, in effect, helping the company falsify the financial statements, what other alternative actions were available to the finance team? Consider professional standards, such as the *IMA® (Institute of Management Accountants) Statement of Ethical Professional Practice* or the AICPA (American Institute of Certified Public Accountants) Code of Professional Conduct, when answering this question.

3. At the time of this writing, charges against Steven Neil, the former CFO of Diamond Foods, were still pending. Conduct research to determine the status of these charges. In your opinion, why do you think Michael Mendes, the former CEO of Diamond Foods, chose to settle charges with the SEC, whereas Neil is disputing the charges?

AUDITING QUESTIONS:

4. Describe the "fraud triangle." Discuss the components of the fraud triangle in the context of this case.

5a. The auditors were misled by both Michael Mendes and Steven Neil. Neil even signed a "management representation letter." Describe what a "management representation letter" is. Do you believe that it, and other representations by management, constituted sufficient appropriate audit evidence in this case? Defend your answer. (Hint: Review the requirements of Statement on Auditing Standards (SAS) No. 99, paying particular attention to the concept of fraud risk factors ("red flags") in an auditing context.)

5b. Describe what the terms "analytical procedures" and "professional skepticism" mean in an auditing context. Do you think the auditors *should have* discovered the alleged fraud perpetrated in the financial statements in fiscal year 2010 and fiscal year 2011? Defend your answer.

5c. Conduct research as to (1) who the auditors were during the timeframe of this case and (2) the current status of any litigation against the auditors. Discuss any allegations against the auditors, including your opinion as to the merits of the allegations.

6. If the auditors *had* discovered the alleged fraud, what is the appropriate action, or series of actions, for an audit firm of a publicly traded company (such as Diamond) that becomes aware of illegal acts by the client's management?

COST/MANAGERIAL ACCOUNTING QUESTIONS:

7. How could management accounting tools, such as variance analysis, benchmarking, and Cost-Volume-Profit analysis, have been used to highlight Diamond's profitability challenges?

8. How could the budgeting process have been used to help Diamond achieve its targets *without* resorting to the alleged financial statement irregularities?

9. Reconcile the 2010 walnut cost payments with the final walnut cost of $0.74 per pound recorded in the 2011 financial statements.

10. Why was the 2010 "momentum" payment larger than the 2009 "continuity" payment? If the earnings management was not exposed, do you believe the earnings management could have continued? If the earnings management did continue, how would it likely have been done?
11. Describe the different reasons for managing earnings.
12. What are the disincentives for managing earnings?
13. Which IMA ethical guideline(s) was violated by Diamond's CFO?

ENDNOTES

[1]The material presented in this case was drawn from several SEC accounting and auditing enforcement releases, litigation releases, and administrative proceedings. Since some of the information from these sources is overlapping, endnotes include the primary sources where the information is located.

[2]U.S. Securities & Exchange Commission (SEC), Litigation Release No. 22902, January 9, 2014, www.sec.gov/litigation/litreleases/2014/lr22902.htm.

[3]SEC, Administrative Proceeding File No.3-15674, In the Matter of Michael Mendes, Respondent, January 9, 2014, www.sec.gov/litigation/admin/2014/33-9508.pdf.

[4]Learn more about Diamond Foods at www.diamondfoods.com/about.

[5]Fiscal year 2010 ended July 31, 2010.

[6]SEC, Litigation Release No. 22902.

[7]SEC, Administrative Proceeding File No. 3-15674.

[8]Fiscal year 2011 ended July 31, 2011.

[9]SEC, Litigation Release No. 22902, and SEC, Administrative Proceeding File No. 3-15674.

[10]SEC, Litigation Release No. 22902.

[11]*Ibid*.

[12]SEC, Complaint relating to Case 3:14-cv-00122, *Securities and Exchange Commission v. Steven Neil*, January 9, 2014, www.sec.gov/litigation/complaints/2014/comp-pr2014-4-neil.pdf.

[13]Katherine Schipper, "Commentary on Earnings Management," *Accounting Horizons*, December 1989, pp. 91-102.

[14]Amy Zang, "Evidence on the Trade-Off between Real Activities Manipulation and Accrual-Based Earnings Management," *The Accounting Review*, March 2012, pp. 675-703.

[15]Brad A. Badertscher, "Overvaluation and the Choice of Alternative Earnings Management Mechanisms," *The Accounting Review*, September 2011, pp. 1,491-1,518.

[16]Michael Ettredge, Susan Scholz, Kevin R. Smith, and Lili Sun, "How Do Restatements Begin? Evidence of Earnings Management Preceding Restated Financial Reports," *Journal of Business Finance & Accounting*, April/May 2010, pp. 332-355.

[17]SEC, *Securities and Exchange Commission v. Steven Neil*.

[18]*Ibid*.

[19]SEC, Administrative Proceeding File No. 3-15674.

[20]SEC, *Securities and Exchange Commission v. Steven Neil*.

[21]SEC, Litigation Release No. 22902, and SEC, Complaint relating to Case 3:14-cv-00123, *Securities and Exchange Commission v. Diamond Foods, Inc.*, January 9, 2014, www.sec.gov/litigation/complaints/2014/comp-pr2014-4-diamond.pdf.

[22]SEC, Litigation Release No. 22902.

[23]SEC, Administrative Proceeding File No. 3-15674.

[24]SEC, Litigation Release No. 22902.

[25]*Ibid*.

[26]SEC, *Securities and Exchange Commission v. Steven Neil*.