February 24, 2020

SEC Charges Failure to Disclose Trend Information

Last week, the Securities and Exchange Commission announced settled charges against beverage producer Diageo plc arising out of shipments of allegedly unneeded products by its North American subsidiary to distributors during fiscal years 2014 and 2015. Diageo agreed to pay $5 million to settle the action, without admitting or denying the SEC's findings.

According to the SEC's order, employees at the subsidiary pressured distributors to buy products in excess of demand in order to meet internal sales targets in the face of declining market conditions. The resulting increase in shipments enabled Diageo to meet performance targets and to report higher growth.

As a foreign private issuer, Diageo files annual reports with the Commission on Form 20-F. Similar to Form 10-K, Form 20-F requires an issuer to disclose in the Management Discussion and Analysis (MD&A) section, "the most significant trends in … sales … since the latest fiscal year," as well as to "discuss, for at least the current financial year, any known trends, uncertainties, demands, commitments or events that are reasonably likely to have a material effect on the company's net sales or revenues, income from continuing operations, profitability … or that would cause reported financial information not necessarily to be indicative of future operating results or financial condition."

While the SEC alleged that Diageo "overshipped" product to distributors, it is noteworthy that the SEC did not charge the company with improperly recognizing the associated revenue, and did not assert that any numbers in any financial statements were incorrect. Rather, the essence of the violation was the failure to disclose in the MD&A the "known trend" that revenue was unlikely to be sustainable at existing levels due to the overshipping and elevated distributor inventory levels. The order found that investors were instead left with the misleading impression that Diageo would be able to achieve growth in certain key performance indicators through normal customer demand for Diageo's products.

The SEC has pursued enforcement actions focused on MD&A disclosure before. As many public companies, both foreign and domestic, are now finalizing their year-end financial statements for 2019, this case provides a timely reminder that, even if publicly reported numbers are completely accurate, failing to disclose "known trend" information can expose a company to an SEC investigation and, ultimately, to a potential enforcement action. The case also demonstrates that the SEC will not hesitate to pursue enforcement action against a foreign issuer in the right circumstances.

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