Diamond Foods Recovers from Accounting Scandal

INTRODUCTION

Diamond Foods, based in Stockton, California, is a premium snack food and culinary nut company with a diversified and successful portfolio. Diamond Foods has five premium product lines consisting of potato chips, popcorn, and a variety of nuts. Brands offered by Diamond Foods include Diamond of California, Pop-Secret, Emerald, and the Kettle Brand; these products are sold in over 100 countries. Diamond Foods has a historical reputation of making bold and expensive acquisitions. Due to the competition within the snack food industry, Diamond Foods developed an aggressive company culture that placed high emphasis upon performance. The company was known for operating according to the phrase "bigger is better," which was implemented by former CEO Michael Mendes. However, without strong ethical oversight, questionable behavior began to persist at Diamond Foods. In 2011, an investigation was launched into the company's financial measures and policies in response to multiple allegations of fraud. This investigation led to serious implications for the company, including major financial losses and the imminent need to restructure the company's top leadership. After the investigation, the company began to focus on rebuilding the company's image. Diamond's current president and CEO Brian J. Driscoll has aimed to develop comprehensive strategic initiatives to advance the company past its ethical dilemmas, instill trust among investors and consumers, and bounce back from the accounting scandal that created both financial and reputational losses. Diamond Foods agreed to pay $5 million to settle fraud charges.

BACKGROUND

Diamond Foods was founded in 1912 under the Diamond of California brand. In 1930, the company expanded internationally and in 2005 became a publicly traded company. Currently, Diamond Foods products are distributed globally, and the company has approximately 1,700 full-time employees. The company has become known for building up its brands and identifying opportunities to connect products to consumers, thus adding value to the product. It focuses its efforts on five product lines: 1.) Potato chips, 2.) Snack nuts, 3.) Popcorn, 4.) In-shell nuts, and 5.) Culinary nuts. In 1997, Diamond foods hired Michael Mendes as the company's Chief Executive Officer and President. He became a member of the board in 2005. Mendes was Diamond Foods' Vice President of International Sales and Marketing prior to becoming CEO and President. Mendes had worked for various companies in the competitive snack food industry prior to joining Diamond Foods, including the Dole Food Company and Hormel Foods Corporation. While at Diamond Foods, Mendes was known for his competitive nature and for implementing the philosophy "Bigger is Better." This viewpoint and the impact it had upon Diamond Foods' corporate culture will be discussed later in this case.

Although Diamond Foods looked as if it was progressing rapidly, in truth the firm was engaging in a number of questionable practices to hide losses and improve its chances of acquiring the Pringles brand from Procter & Gamble. In 2011, a number of accounting discrepancies revealed that the company was struggling. A year later Diamond Foods had a net loss of $86,336,000 and earnings (loss) per share of $3.98. During 2012 the company's stock price experienced volatility, dropping approximately 42 percent from its peak of about $21.50 in early November to its lowest in six years at $12.50 in late November. Since this large drop, the stock price has begun to increase once more, hitting a value of $33.22 in early 2015.

INDUSTRY AND CORPORATE CULTURE

The snack-food business is large and extremely competitive. In fact, the global snack food market is estimated to be about $374 billion. Diamond Foods competes with both regional and national companies. This competition also occurs in terms of retail shelf space. With significant competition, Diamond Foods has faced many pressures to be successful. Diamond's previous CEO Michael Mendes had ambitious goals for making the company more competitive, resulting in millions of dollars in loans for the acquisition of Pop Secret popcorn and loans amounting to $1 billion for the intended purchase of Pringles. The acquisition of the Pringles brand from Procter & Gamble would have raised Diamond Foods to become the second largest distributor of snack foods in the United States, second only to PepsiCo. This significant pressure to increase market share and become one of the largest snack food distributors, coupled with increasing competition, could have incentivized unethical behavior within the firm.

The company's highly ambitious and competitive culture could have also increased organizational pressures for fraud. Interviews with former employees and board members found that the company pushed very hard to meet increasingly ambitious earnings targets, allowing executives to gain large bonuses for meeting these goals. According to regulatory filings, in fiscal years 2009, 2010, and 2011, CEO Michael Mendes received approximately $2.6 million in bonuses for exceeding the company's earnings-per-share (EPS) goals. Furthermore, in September 2010, Mr. Mendes boldly promised 15 to 20 percent EPS growth for the next five years. This highly incentivized and competitive culture was exacerbated by the fact that Diamond Foods' culture did not encourage open communication. Nut suppliers of Diamond Foods were told what appeared to be misleading information concerning payments for their crops. Such a lack of communication likely increased the opportunity for unethical behavior.

ETHICAL CHALLENGES

In 2011 suspicion arose regarding Diamond Foods' accounting practices. Specifically, Mark Roberts, an analyst with the Off Wall Street Consulting Group, accused Diamond Foods of incorrectly reporting its payments to suppliers. This accusation claimed that Diamond Foods was issuing "momentum payments," in which the company would send payments to growers in September for walnuts that were delivered in Diamond's fiscal year 2011, which had already ended in July. Although it might not seem like a major issue, reporting payments in the wrong pay period significantly impacted how Diamond Foods' financial statements were perceived. If done intentionally, such conduct could be illegal. When first discovered, Diamond Foods denied any wrongdoing, arguing that these payments were an advance on the 2012 crop and had nothing to do with the previous year's crops.

However, growers quickly contradicted this defense. Some growers were told to cash their checks even if they were not going to provide crops for 2011. They were reportedly told that the checks were payments for the previous year. An investigation found that these payments were used by Diamond Foods to inflate the fiscal 2011 results by shifting costs into the upcoming year. This caused stakeholders to question whether the company was representing its finances and performance accurately. An internal investigation found that the company, specifically CEO Michael Mendes and CFO Steven Neil, had improperly accounted for these previously mentioned payments to walnut growers, thus skewing Diamond Foods' financial results. In addition, "continuity" payments to growers in August 2010 of approximately $20 million were also accounted for in the wrong period. The company improperly moved about $60 million in payments to walnut growers from the fourth quarter of fiscal year 2011 into the first quarter of fiscal year 2012.

Diamond Foods' "momentum payments" improved the full-year 2011 earnings per share from $1.14 to $2.61. These greater earnings allowed top managers to take home millions in additional compensation. It has also been speculated that the fraud was intended to encourage the sale of the Pringles brand of potato chips from Procter & Gamble. These increased earnings per share would incentivize Procter & Gamble's shareholders, as they were to be paid in Diamond's stock.

There were several factors which encouraged unethical behavior at Diamond Foods. Not only is the snack food industry very competitive, but so was the company's culture. The "bigger is better" ideology supported by then-CEO Michael Mendes placed significant pressures on Diamond Foods' attempted acquisition of Pringles, which would have greatly expanded Diamond Foods' growth. This ideology led to large debts, as the company was required to take out loans to make these acquisitions possible. Because of the loans, Diamond had debt agreements, which required certain performance standards to be met. The company also had a debt-to-earnings covenant in one of its debt agreements, requiring the company to have higher earnings. The debt-to-earnings covenant, increased compensation for stakeholders for meeting higher performance standards, and the pressures to acquire Pringles likely played a major role in Diamond Foods' inaccurate financial reporting.

Another major red flag is the fact that Diamond Foods' CFO had a seat on the company's board. This could have created a significant conflict of interest in Diamond Foods' corporate governance structure. A board member who directly receives compensation from the firm could sway the board into exerting less oversight over operations or making decisions that would not be in the best long-term interest of the firm.

The company was externally investigated for criminal fraud and an audit was completed. The investigation made stakeholders uneasy and prevented the company's acquisition of Pringles. As a result of the investigation, Diamond Foods had difficulty meeting the deadlines for filing financial results. Nut growers began complaining that Diamond Foods was paying them 10 cents a pound less than they could get from independent buyers, which began causing dissatisfaction among the firm's suppliers. Diamond Foods was quickly gaining the attention of both investors and regulators.

RAMIFICATIONS OF UNETHICAL CHOICES

Manipulating accounting results qualifies as a type of fraud that misleads stakeholders. The three points of the fraud triangle are opportunity, motivation, and rationalization. Using this model, it becomes clearer how the accounting fraud at Diamond Foods was allowed to take place. For instance, employees were given the opportunity to conduct fraud as internal controls were clearly not being implemented. Furthermore, top management did not set an ethical tone at the top, giving employees even more opportunity for unethical behavior. Indeed, investigations appear to show that top management itself was likely responsible for some of the unethical behavior.

There was also much motivation for Diamond Foods to improve its performance at any cost. Improving its EPS would help the company acquire the Pringles brand and allow Diamond Foods to meet its required debt-to-earnings ratio in its debt covenant. Furthermore, executives would personally gain large bonuses. In addition, the company faced both internal and external pressures to succeed at any cost. The nature of the industry, as well as Diamond Foods' highly competitive culture, provided the motivation to commit accounting fraud.

Finally, Diamond Foods likely rationalized its actions by denying that the momentum payments were illegal. After the payment irregularities were discovered, Diamond Foods' management denied that the payments were for the previous year's crops. The company instead stated that the payments were made to "optimize cash flow for growers." Diamond Foods claimed that the previous year's payments occurred and were accounted for in the previous year. It also appeared that the company's improper reporting and control environment may have dispersed these issues across the organization, limiting accountability. This could prevent any one person from fully understanding what was going on, allowing employees to rationalize their actions through denial.

As seen in Diamond Foods' six-year low stock price of $12.50, the company faced financial difficulties. This low stock price was the result of the company's restated financial results and update of the current year's performance. The restatement of Diamond Foods' financial results removed a previously reported $56.5 million in profits due to the accounting fraud. This issue was exacerbated by a 2011 SEC investigation into the company. Billionaire investor and activist David Einhorn was believed to be shorting the stock, leading to loss of trust and uncertainty from investors in the company.

In addition to its plummet in stock price, Diamond Foods lost its deal to purchase Pringles from Procter & Gamble. Additionally, the resulting audit found that significant weaknesses existed in the firm's internal controls for financial reporting, and these weaknesses breached the company's loan agreements with its creditors. Breaking these agreements could have led Diamond Foods into bankruptcy because creditors could have required Diamond Foods to repay all of its outstanding loans. Diamond Foods could have also faced increased interest rates in the company's outstanding loans.

Immediately after discovering the errors, CEO Michael Mendes and CFO Steven Neil were placed on administrative leave. Eventually, on November 19, 2012, Mendes resigned and Neil was removed from Diamond Foods. In accordance with Mendes's employment agreement, he did not receive his insurance benefits as his resignation was considered to be a violation of his duty as CEO. Diamond Foods entered into a Separation and Clawback Agreement with Mendes that required him to repay his fiscal 2010 and 2011 bonuses totaling $2,743,400. He also was required to pay back all of the common stock shares he had received from fiscal year 2010, amounting to 6,665 shares of Diamond Foods common stock. However, this amount was taken from his Retirement Restoration Plan, and he still received payment of $2,696,600. The company also announced that it would restate its financial reports for the two years involved in the incorrect payments.

The immediate aftermath of the scandal resulted in financial losses and reputational damage. In response to Diamond Foods' accounting blunders, the company faced risks of litigation, regulatory proceedings, government enforcement, and insurance claims. The company ended up paying $5 million to the Securities & Exchange Commission to settle fraud allegations. The SEC had also charged former CFO Steven Neil for his participation in falsifying walnut costs as well as former CEO Michael Mendes for his role in the misleading financial statements. Mendes forfeited $4 million in bonuses and benefits and paid a penalty of $125,000. While it was not proven that Mendes participated in the scheme, regulatory authorities believed he should have known about Diamond Foods' incorrect financial statements. Steven Neil initially fought the SEC charges but eventually settled by paying a $125,000 civil penalty. Investors also filed lawsuits against Diamond Foods, stating that the company misrepresented its financial standing. The company settled with investors for $100 million.

DIAMOND FOODS' RESPONSE

In a December 2012 letter to shareholders, Diamond Foods' new president and CEO, Brian Driscoll, outlined a number of comprehensive strategic initiatives aimed to advance the company past its ethical mistakes. These initiatives started with the company's remediation steps to improve the internal controls of financial statements. Six new directors were appointed to strengthen the board. Driscoll also emphasized the importance of open communication with stakeholders, specifically walnut growers.

In making strides to become a more ethical company and return from the accounting scandal, Diamond Foods has issued a forward looking statement of risks. This statement aimed to identify any possible problems that may arise in the future to prevent similar ethical wrongdoing. Within this statement, Diamond Foods identified three primary areas in which it needs to improve that the company felt led to the accounting scandal. These three specific areas included 1.) Control Environment, 2.) Walnut Grower Accounting, and 3.) Accounts Payable and Accrued Expenses. With this discovery, the company found its internal controls to have been ineffective.

The control environment includes the Company's Code of Conduct and Ethics Policy. It is top management's responsibility to set the tone of the organization as well as the foundation for an ethical culture and internal controls over financial reporting. Diamond Foods' former CEO Michael

Mendes did not create a culture in which there was open communication. This prevented a strong control environment. Although Mendes was an innovative leader, he made a number of ethical missteps in attempting to achieve his vision. Because ethical leaders are able to distribute and monitor the organization's values, they are able to contribute more meaningfully to the company's culture. Rather than relaying an ethical message, Mendes focused on competition and quick growth. Mendes's actions harmed the firm, as he did not provide ethical leadership or an environment in which employees followed acceptable behavior.

To rectify this issue, the company replaced the former CFO as well. Additionally, it improved financial and operational reporting packages in which managerial approval is needed for material and non-routine transactions. The company implemented ethics training led by the CFO to reinforce proper accounting procedures. This training attempts to help employees gain a greater understanding of financial reporting integrity and the company's ethical expectations. By placing the CFO and other top management in charge of training, the company demonstrates the importance of proper accounting procedures as well as an ethical tone at the top.

Previous leadership did not document accounting policies or design the process for which walnut grower payments and the walnut cost estimates were determined. This was exacerbated by the fact that management did not communicate the intent of the payments effectively. In this area, Diamond Foods modified its walnut cost estimation policy. This revision included adding a greater variety of inputs each quarter required to be reviewed and signed off by cross-functional management. Additionally, the company improved documentation and oversight of accounting procedures and supplier communication. Diamond also created a Grower Advisory Board to receive input from growers and enhance communication between growers and the company. Finally, in order to ensure compliance, Diamond Foods revised the Sarbanes-Oxley internal control policies involved with grower accounting procedures.

Diamond Foods deduced that its accounts payable and accrued expense controls of invoice processing were inadequately designed, leading to costs that were recorded in the incorrect accounting periods. Using a third party report entitled "Internal Control – Integrated Framework," Diamond Foods evaluated the effectiveness of its internal controls. The company found that processes intending to increase accounting and financial transparency were not up to par. For example, all outstanding accounts payable and accrued expenses were not adequately recorded. The company also did not require vendors to send invoices directly to Diamond Foods' central accounts payable department. This allowed for significant confusion and caused many inconsistencies within the company. It also helped to cover up the misconduct.

Diamond Foods is attempting to improve its accounting processes by increasing transparency in its finance and accounting departments. For instance, the company is improving period-end controls and requiring vendors to send invoices to the central accounts payable department. Finally, Diamond Foods is aiming to improve communication throughout the organization to ensure that information is adequately provided, allowing for better transparency in the company.

CONCLUSION

After significant volatility, Diamond Foods' stock prices began to steadily rise, especially after BlackRock investing group disclosed a stake in the company. This investment showed BlackRock's belief that Diamond Foods would rebound. In 2015 Diamond Foods had beaten second-quarter profit expectations by 10 cents, causing its stock to rise 1 percent. This upward trend in Diamond Foods' stock bodes well for the future of the company.

Even with the failed acquisition of Pringles, Diamond Foods still has a relatively strong brand portfolio. With brands like Pop Secret and Kettle, which are worth more than $800 million, Diamond Foods has seen strong sales and profit performance. According to CEO Brian Driscoll, Diamond Foods is launching upon a new strategic direction with an emphasis on innovation and brand building. It continues to rebuild relationships with stakeholders.

Diamond Foods aims to build and energize its portfolio of brands. Over the past 100 years, Diamond Foods has grown significantly from a small group of walnut growers to a million dollar company owning million-dollar brands such as Pop Secret and Kettle Chips. Although its performance seems to be improving, the accounting scandal in 2011 tarnished the firm's reputation, resulting in the removal of the CFO and resignation of the CEO. These major changes resulted in restatements of Diamond Foods' financials as well as a significant disruption in the firm's business operations. Despite the misconduct, the company is currently taking steps to address its ethical risk areas. Signs are indicating that Diamond Foods' ethical culture is improving. For instance, in 2013 the firm announced that its Stockton operation had received the Green Sustainable Business Award and Certification for leadership in sustainability. To rebound from its ethical disaster stronger than before, Diamond Foods must avoid complacency and remain vigilant in improving its oversight and internal controls.

QUESTIONS

1. How did weaknesses in Diamond Foods' internal controls contribute to the accounting scandal?

2. Why might top management have been willing to ignore red flags indicating misconduct?

3. Describe how Diamond Foods intends to address ethical risks to prevent similar misconduct in the future.

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