# FLOYD ADVISORY LLC

## Summary of Accounting and Auditing Enforcement Releases for the Three Months Ended September 30, 2011

## Introduction and Our Objective

**Floyd Advisory LLC is pleased to present you with our Summary of the U.S. Securities and Exchange Commission, Division of Enforcement's Accounting and Auditing Enforcement Releases ("AAERs") for the three months ended September 30, 2011 ("Q3 2011").**

**As an independent boutique forensic accounting and business advisory firm, we are committed to contributing thought leadership and relevant research regarding financial reporting matters that will assist our clients in today's fast paced and demanding market. This report is just one example of how we intend to fulfill this commitment.**

**The Division of Enforcement at the U.S. Securities and Exchange Commission ("SEC") is a law enforcement agency established to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. As such, the actions they take and releases they issue provide very useful interpretations and applications of the securities laws.**

**For those involved in financial reporting, SEC releases concerning civil litigation and administrative actions that are identified as "accounting and auditing" related are of particular importance. Our objective is to summarize and report on the major items disclosed in the AAERs, while also providing useful insights that the readers of our report will find valuable.**

**We welcome your comments and feedback, especially any additional analysis you would find helpful.**

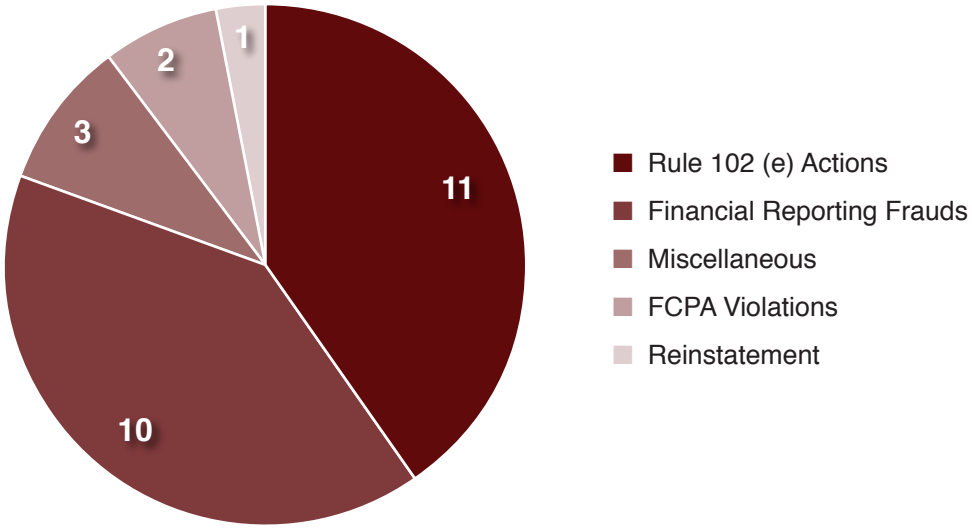
**Floyd Advisory LLC**
**October 2011**

# Contents

# The Q3 2011 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed twenty-seven AAERs during Q3 2011 which we have sorted into categories as shown in the pie chart. Notably, individual sanctions dominated this quarter's results, with over 40% of the releases being Rule 102 (e) actions. While seeing the categorical breakdown is analytically useful, a closer look into each category provides a clearer understanding of the SEC's actions.

**AAERs by Category**




## Our Process and Methodology

The SEC identifies and discloses accounting and auditing related enforcement actions from within its population of civil lawsuits brought in federal court, and its notices and orders concerning the institution and/or settlement of administrative proceedings as Accounting and Auditing Enforcement Releases ("AAERs"). Importantly, the disclosed AAERs are intended to highlight certain actions and are not meant to be a complete and exhaustive compilation of all of the actions that may fit into the definition above.

To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, **www.sec.gov**.

As part of our review, we gathered information and key facts, identified common attributes, noted trends, and observed material events. Applying our professional judgment, which is based solely on publicly disclosed information, we sorted the releases into major categories (notably: Rule 102(e) Actions, Financial Reporting Frauds, Foreign Corrupt Practices Act violations ("FCPA"), Reinstatements to Appear and Practice before the SEC and Miscellaneous) and classifications of the financial reporting issues involved (notably: Improper Revenue Recognition, Manipulation of Reserves, Intentional Misstatement of Expenses, Balance Sheet Manipulation, Options Backdating and Defalcations). Do note, when a release included more than one allegation, admission or violation, we placed the release into the category which represented the most significant issue. For our summary of financial reporting issues, we recorded each accounting problem identified as a separate item. Based on this process and methodology, we prepared a database of the key facts in each release.

## *Financial Reporting Frauds*

There were ten AAERs that we categorized as financial reporting frauds during the quarter. The types of fraudulent behavior described in a few of the more significant releases, including a couple that date back quite a few years, are as follows:

- The SEC charged two former executives of Basin Water, Inc., a company that built, sold, and leased water treatment systems that cleaned contaminated ground water, with fraudulently inflating its revenues, beginning with the company's first financial report after it went public. The specific GAAP violations included improperly recognized revenue transactions where the company did not have a final sale, did not have the customer's required acceptance of the system, allowed the customer to pay nothing until the customer resold the system, did not provide enough assurance that the customer would pay for the system, or had not yet shipped the system. As result, revenues were overstated in 2006 by 13% and in 2007 by 74%. The SEC also alleged insider trading violations by the CEO. In February 2009, the company restated its financial results and in July 2011 declared Chapter 11 bankruptcy. The company is now defunct.

- A Court granted an order sought by the SEC to establish a Fair Fund comprised of approximately $1.6 million dollars in disgorgement, post-judgment interest and penalties paid by two defendant former officers of American Home Mortgage Investment Corporation ("AHM"). The allegations against the defendants involved fraudulently understating AHM's first quarter 2007 loan loss reserves by tens of millions of dollars, thereby converting the company's loss into a fictional profit. Among the defendants wrongful acts were intentional understatement of the reserves required by GAAP for both loans held for investment and loans held for sale. For both asset classes, the defendants recorded reserves that were lower than the amount that the company's analyses indicated were necessary.

- The United States District Court for the Northern District of Illinois entered an Amended Final Judgment against the former Chief Financial Officer of Waste Management Corporation, ordering that he pay $2.5 million. The CFO's wrongful conduct occurred between 1992 and 1997, and involved a systematic scheme to falsify and misrepresent Waste Management's financial results with profits being overstated by $1.7 billion. The case has been in the Courts for years, and has finally settled as a result of a compromise over the monetary penalty reached through mediation while the case was on appeal. The permanent officer and director bar and injunction against the former CFO remain in full force and effect.

- The SEC also finally reached a settlement with the former Chief Financial Officer of AOL Time Warner Inc. and the former Chief Financial Officer of the AOL Division of AOL Time Warner. The final judgments resolve the SEC's actions against the individuals related to the overstatement of the company's online advertising revenue with a series of round-trip transactions from at least mid-2000 to mid-2002. The settlements involve disgorgement and penalties aggregating $260,000 and $150,000, respectively, and agreements enjoining the individuals from future violations of the securities laws.

## Rule 102(e) Actions

Rule 102(e) actions involve the censure and denial, temporarily or permanently, of the privilege of appearing or practicing before the SEC. For accountants, the standards under which one may be penalized with a Rule 102(e) action include reckless as well as negligent conduct, which is defined as a single instance of highly unreasonable conduct that violates professional standards or repeated instances of unreasonable conduct resulting in a violation of professional standards and indicating a lack of competence.

Notably, of the individuals receiving Rule 102(e) sanctions during Q3 2011, ten were certified public accountants (or the Canadian equivalent). One of these individuals was penalized for actions while working at a public accounting firm and nine were penalized for roles related to either financial reporting problems at corporations or for involvement in fraudulent schemes. Interestingly, this quarter, Rule 102(e) sanctions represent the most common type of AAER sanction. The improper conduct by two of the sanctioned CPAs warrants highlighting:

- *First, a CPA was found to be involved in the Forte LP's $80 million Ponzi scheme. The CPA performed back office and bookkeeping functions for Forte LP, including creating and issuing to investors false quarterly statements and tax documents prepared based on the false information provided by Forte. According to the release, the CPA disregarded red flags that should have alerted him that the information that he was forwarding on was false. The SEC argued that the individual was motivated by the millions of dollars paid for his services.*

- *The second situation involves the former CFO of Island Pacific, Inc. ("Island Pacific") who allegedly knowingly facilitated the alteration of a license agreement, thereby permitting Island Pacific to improperly record revenue of $3.9 million in its fiscal second quarter 2004. The SEC further alleged that the CFO directed Island Pacific to record a second transaction in the third quarter of fiscal 2004 that offset the $3.9 million receivable issued in the previous quarter, based on a sublicense agreement he knew was not finalized, and knew that it was therefore improper to record under both GAAP and Island Pacific's own revenue recognition policy. Even more troubling, in addition to taking part in the financial statement fraud, the CFO also tried to cover it up. Specifically, he took actions to terminate a whistleblower who sought to bring the improper accounting to light, and took steps to conceal the whistleblower's allegations from the company's outside auditor.*

## FCPA Violations

There were two FCPA related releases in Q3 2011: one related to Armor Holdings, Inc. ("Armor"), a manufacturer of safety equipment for the military and law enforcement, and one related to Diageo plc ("Diageo"), a global producer of premium alcoholic beverages.

The AAER for Armor provides such a detailed description of the company's fraudulent accounting scheme to conceal the cash flows related to the illegal kickbacks that we have designated the release as one of this quarter's "recommended reading" items discussed later in our report.

The Diageo matter concerns multiple FCPA violations occurring over more than six years, with payments exceeding $2.7 million to various government officials in India, Thailand, and South Korea. While some of the illegal payments do not appear significant when considered individually, the conduct was both systematic and pervasive over an extended period of time.

According to the release, from 2003 through 2009 Diageo made over $1.7 million in illicit payments to hundreds of Indian government officials responsible for purchasing or authorizing the sale of its beverages. In Thailand, from 2004 through 2008, Diageo paid approximately $12,000 per month to retain the consulting services of a Thai government and political party official. This official lobbied on Diageo's behalf in connection with multi-million dollar pending tax and customs disputes, contributing to Diageo's receipt of certain favorable dispositions by the Thai government. In 2004, Diageo paid 100 million won (KRW) (over $86,000) to a South Korean customs official as a reward for his role in the government's decision to grant Diageo significant tax rebates. Diageo also paid over $100,000 in travel and entertainment expenses for South Korean customs and other government officials involved in these tax negotiations. Separately, Diageo made hundreds of gift payments totaling over $230,000 to South Korean military officials in order to obtain and retain liquor business.

In accepting the cease and desist order, Diageo agreed to pay a disgorgement penalty of $11,306,081 and prejudgment interest of $2,067,739 to the United States Treasury.

## Reinstatements

During Q3 2011, a former Enron Corporation ("Enron") attorney was reinstated to appear and practice before the SEC. The attorney's suspension arose from his actions as the General Counsel of Enron Global Finance, and included allegations that he intentionally failed to disclose millions of dollars paid to the former Enron CFO in Enron's 2000 proxy statement. The individual also allegedly completed a fraudulent related party transaction with an entity controlled by the former CFO, failed to disclose the transaction as required in Enron's 2000 proxy statement, and made misleading statements regarding the CFO-related entities in Enron's second quarter Form 10-Q.

The reinstated attorney is currently a Vice President and the Chief Tax Officer at publicly traded multi-billion dollar company in the oil and gas industry. In this role, he is not a part of, nor does he report to, the General Counsel's Office. The attorney does not provide any legal advice in his current position, does not supervise any employees that provide legal advice as part of the General Counsel's Office, and is not required to be an attorney to serve in his current position.

## Miscellaneous

The three releases in the miscellaneous category include a disgorgement action under Sarbanes-Oxley Section 304, and a cease and desist order against a CPA for failing to follow GAAS for audit confirmations.

The Sarbanes-Oxley Section 304 matter involves the former CFO of Beazer Home USA, Inc. ("Beazer") who must reimburse the company more than $1.4 million that he received after the company filed materially false financial statements during fiscal year 2006. Interestingly, there are no allegations that the former CFO participated in any misconduct, which is consistent with the strict liability standard of Section 304, but it remains difficult to assess the discretionary use of the law among affected individuals; something we will continue to monitor.

With regard to the cease and desist order, the CPA was an audit partner licensed to practice in New York and the U.S. Virgin Islands with a firm responsible for conducting annual audits of the North American Globex Fund, L.P. ("Fund" or "Globex Fund") from 2001 through February 2009.

The central issue discussed in the release relates to the proper use of audit confirmation letters with regard to "confirming" the investments held by the Fund. In fact, the investments reported on the Fund's balance sheet – that the audit partner sought to confirm – were purportedly held by an affiliated client entity under common management control. Therein lies the source of the problem.

The SEC alleged that in conducting the audits in question, the CPA ignored the requirements of GAAS, and relied on a flawed confirmation process related to the confirmations sent to the affiliated entity. The CPA merely obtained confirmation of the investments through representations from the affiliate's management, "confirming" the value of the Fund's assets in its possession. No further work was performed to verify these balances. The audit partner chose to rely on the client's management team that controlled the affiliate, thereby negating the reliability of the confirmation process, which is designed to obtain independent corroboration for client assertions.

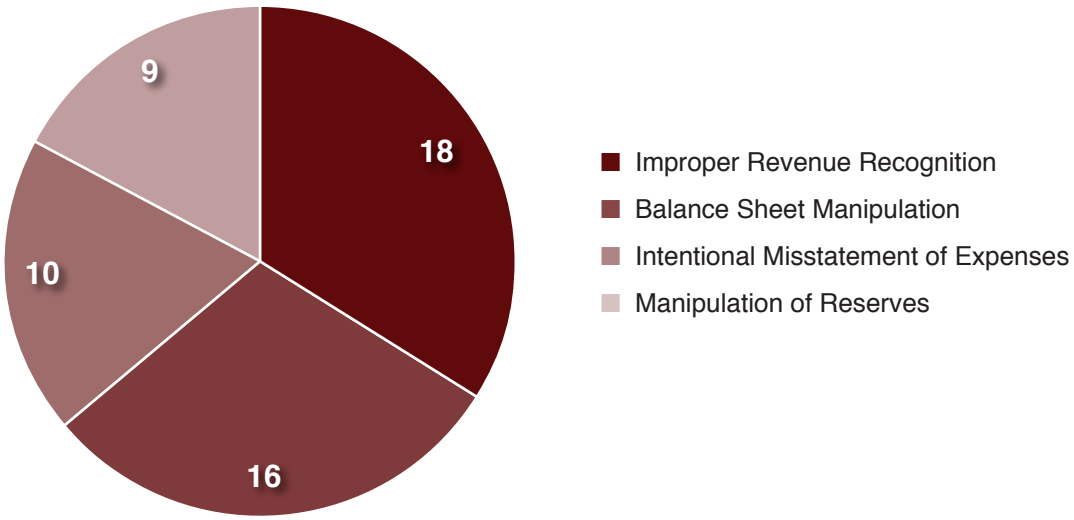
# The Q3 2011 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in the Q3 2011 AAERs, we identified the accounting problem(s) in each AAER based on the classification definitions below:

| Classification | Definition |
|---|---|
| **Improper Revenue Recognition** | Overstated, premature and fabricated revenue transactions reported in public filings |
| **Manipulation of Reserves** | Improperly created, maintained and released restructuring reserves, general reserves and other falsified accruals |
| **Intentional Misstatement of Expenses** | Deceptive misclassifications and understatements of expenses |
| **Balance Sheet Manipulation** | Misstatement and misrepresentation of asset balances, and the recording of transactions inconsistent with their substance |

The following chart provides the results of our financial reporting issue analysis for the Q3 2011 AAERs. Improper revenue recognition was the most prevalent problem in the quarter.

**AAERs by Financial Reporting Issue**



# Notable AAERs for "Recommended Reading"

While reviewing all of the SEC's AAERs may prove insightful, certain releases present information that is both useful, educational and worth further review and analysis by those involved with financial reporting matters. We deem these particular releases as earning the distinction of "recommended reading" for our clients.

We have identified two AAERs for "recommended reading" this quarter: the FCPA action involving Armor and the case against five former executives and Board members of Syntax-Brillian Corporation that were involved in a financial reporting fraud.

## *Securities and Exchange Commission v. Armor Holdings, Inc., Case No. 1:11-cv-01271(D. D.C.)(ESH) (filed July 13, 2011)*

The settlement with Armor a manufacturer of military and law enforcement safety equipment, for FCPA violations involved a payment of $5,690,744 for disgorgement, prejudgment interest, and civil penalties to resolve the SEC's charges, and the payment of a $10,290,000 fine to the U.S. Department of Justice.

Of greatest significance when reading the complaint attached to the AAER is the discussion regarding the fraudulent financial reporting scheme referred to as "distributor net" accounting. In substance, "distributor net" is a disguised accounting treatment to keep cash from being reported in financial statements and to effectuate a fraud.

From 2001 through June 2007, the company concealed approximately $4.4 million in payments made to third-party intermediaries who brokered the sale of goods to foreign governments by recording the sales on its books and records at an amount "net" of the illegal payment while invoicing the foreign government for the "gross" amount, inclusive of the illegal payment.

Under GAAP, since the intermediaries never obtained title to the goods and the company retained the risks and rewards of ownership prior to delivery, the company should have recorded the sales to foreign governments on its books and records at the full or "gross" sales price, with a separate display of any commission expense for amounts paid to an intermediary.

However, in the typical "distributor net" transaction, the company sent the foreign government customer a "gross" invoice, including the sales price of goods sold plus commission while internally recording sales at a "net" amount that did not include the commission due to the third-party sales intermediary. Thus, amounts received from the customer would be greater than the amount recorded internally for the sale, resulting in a credit balance in the customer's account receivable. The company would then transfer the overpayment through a series of non commission accounts before ultimately disbursing it to the third-party sales intermediary. These payments to sales intermediaries under "distributor net" accounting were never recorded as a commission expense on the books and records of Armor.

Armor's auditor was aware of certain aspects of the "distributor net" accounting scheme. In 2001, the auditor emailed senior management indicating that the "distributor net" practice understated accrued liabilities and accounts receivable and that the company should record a receivable for the gross amount due, together with an accrual for commissions. Nothing in the release indicates that the auditor knew about the real purpose for the unusual accounting treatment.

In addition, in late 2005, the comptroller of an Armor subsidiary who had refused to implement "distributor net" at his division advised senior officials that the accounting treatment was not appropriate under GAAP. Because Armor acted as a manufacturer rather than a distributor, the comptroller believed "it would be wholly inappropriate, based on the guidance in EITF [Emerging Issues Task Force] 99-19 to record the revenues net." Similarly, nothing in the release indicated the comptroller knew about the real purpose for the unusual accounting treatment.

Armor Holdings Products, LLC ("AHP"), subsidiary of Armor, used "distributor net" accounting in at least 92 transactions from 2001 through June 2007 resulting in approximately $4.4 million of undisclosed commissions in its books and records rendering those books and records inaccurate.

As described above, in substance, "distributor net" accounting brought cash into AHP that could be subsequently disbursed without being reflected in the financial statements; the accounting treatment did leave a trail of debits and credits, however those were only visible to a limited number of individuals.

## *Securities and Exchange Commission v. James Li (A/K/A Ching Hua Li), Thomas Chow (A/K/A Man Kit Chow), Roger Kao (A/K/A Chao Chun Kao), Christopher Liu (A/K/A Chi Lei Liu), And Wayne A. Pratt*

The SEC filed charges against five former executives and Board members related to a financial fraud at the now bankrupt Syntax-Brillian Corporation ("Syntax"). Syntax, a Chinese company that developed and distributed high definition LCD televisions, accessed US capital markets through a reverse merger or a "backdoor registration," whereby it was legally acquired by a shell US company that was registered by the SEC. However, in a reverse merger, the acquiree acts in all substantive ways as the acquirer, and is therefore treated as the acquirer for accounting purposes.

In its complaint, the SEC alleged that Sytnax's former CEO and Chief Procurement Officer – both of whom were Board members – engaged in a complex scheme to significantly overstate the sales of its televisions. The scheme included the use of fake shipping documents and circular payments whereby Syntax would remit funds to one of its manufacturers – an entity controlled by two of the other defendants – which would then funnel the funds to one of Syntax's purported customers, who would then use the funds to "pay" Syntax for televisions that were never delivered.

Three of the four executives involved in perpetrating the scheme reached settlement agreements with the SEC. The SEC is continuing to pursue charges against the fourth, the former Syntax Board member and Chief Procurement Officer. In its complaint, the SEC is seeking disgorgement, civil penalties, interest and an officer and director bar.

While the SEC did not allege that he directly participated in the scheme, the former CFO of Syntax was charged with ignoring red flags related to improper revenue recognition, and participating in backdating documents provided to the outside auditors in support of the fictitious sales. The CFO paid disgorgement along with interest and a civil penalty of approximately $200,000 and has been suspended from appearing or practicing before the SEC for a period of five years under Rule 102(e).

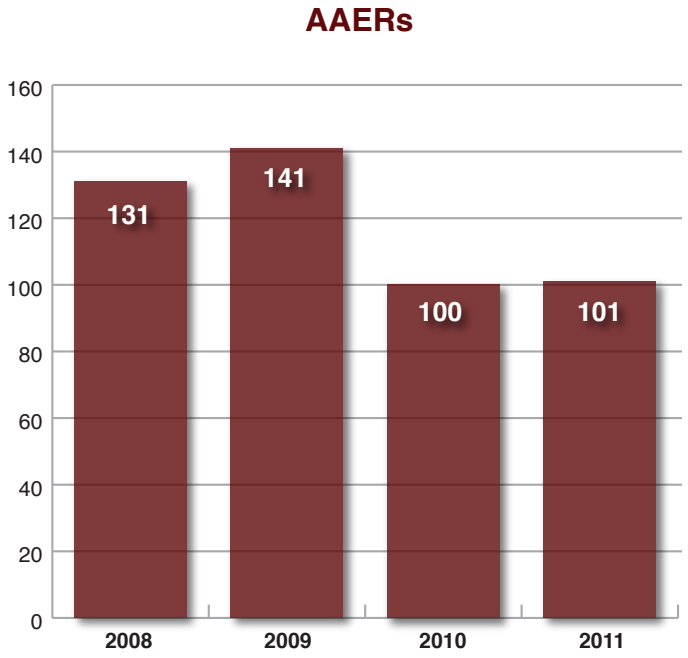
In an April 2011 speech, SEC Commissioner Luis Aguilar drew attention to what he termed a "growing number" of Chinese reverse mergers with "…significant accounting deficiencies or being vessels of outright fraud." Commissioner Aguilar noted that between January 2007 and the date of his speech, there had been 600 "backdoor" registrations, 150 of which involved Chinese companies.

The SEC recently set up an internal task force dedicated to investigating fraud in overseas companies registered in US markets, and in June 2011 the SEC released an investor bulletin warning investors of the significant risks involved in investing in such companies. Given this intense SEC focus, we will continue to monitor AAERs in the coming quarters for further examples of fraud at companies that engaged in backdoor registrations.

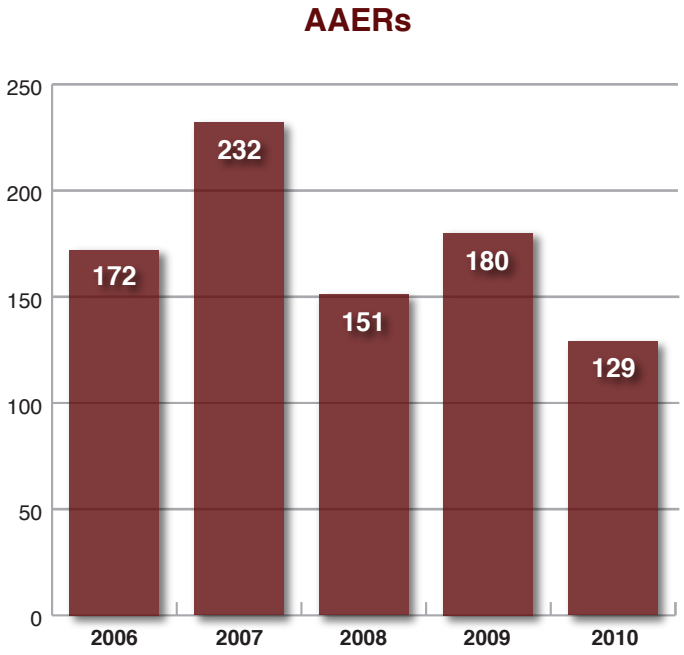
# Prior Period Comparisons: Year over Year and Quarter over Quarter Statistics

As described in our Process and Methodology section, AAERs are intended to highlight certain actions and are not meant to be a complete and exhaustive compilation of all of the actions that may fit into the definition the SEC provides for the classification. That said, comparisons of the number of AAERs between periods can be a useful gauge of the SEC's activities.

After observing increases in the volume of AAERs in the first two quarters of 2011, Q3 reflects the lowest quarterly amount year to date and is 34 percent less than Q2 2011 and 40 percent less than Q3 2010. As a result of the lower volume of AAERs in Q3 2011, the year to date volume for 2011 is now approximately equal to 2010, the lowest volume experienced during the five preceding years.




During 2010, the SEC issued 129 AAERs, remarkably the lowest number of AAERs for the prior five year period. For comparison, the SEC issued 180 AAERs in 2009 and the average of the prior four years from 2006 through 2009 was 183; both numbers indicating an approximate thirty percent reduction in AAERs for 2010.



# Acknowledgement

We wish to acknowledge the valuable contribution to this analysis by Janet M. Floyd, CFE and Liz Klyuchnikova.

## *Contact Information*

Joseph J. Floyd, CPA, JD, CFE, ABV
jfloyd@floydadvisory.com
212.867.5848

Jeffrey J. Szafran, CPA, CFF
jszafran@floydadvisory.com
617.586.1080

## *About Floyd Advisory LLC*

Floyd Advisory LLC is an independent boutique forensic accounting and business advisory firm with offices in Boston and New York City, providing services relating to: financial reporting problems, fraud investigations, SEC reporting issues, white collar defense matters, post-acquisition disputes, business damages, financial and valuation analyses.

www.floydadvisory.com