



*Summary of Accounting and  
Auditing Enforcement Releases  
for the Quarter Ended  
March 31, 2013*

Q 1 R E P O R T 2 0 1 3

## CONTENTS

<b>Our Process and Methodology .....</b>	<b>1</b>
<b>The Q1 2013 AAERs: Summary by Category and Insights from the Releases .....</b>	<b>2</b>
<b>The Q1 2013 AAERs: Summary of Financial Reporting Issues .....</b>	<b>8</b>
<b>Notable Q1 2013 AAERs for “Recommended Reading” .....</b>	<b>9</b>
<b>Prior Period Comparisons: Year over Year and Quarter over Quarter Statistics.....</b>	<b>11</b>

### *Introduction and Our Objective*

We are 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 quarter ended March 31, 2013.

As an independent business advisory and forensic accounting 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  
APRIL 2013



# 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](http://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 information provided by the SEC, we sorted the releases into major categories (e.g., Rule 102(e) Actions, Financial Reporting Frauds, Foreign Corrupt Practices Act violations (“FCPA”), Reinstatements to Appear and Practice before the SEC and Other) and classifications of the financial reporting issues involved (e.g., 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 that 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.

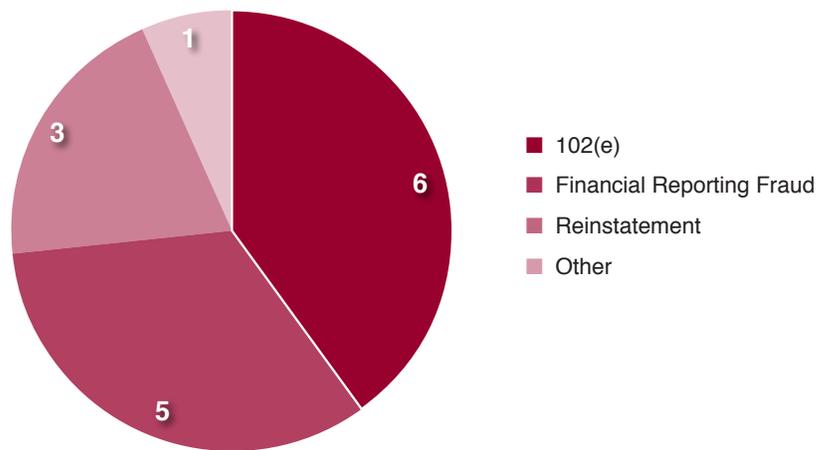
## REVIEW PROCESS

- Gathered information and key facts
- Identified common attributes
- Noted trends
- Observed material events
- Sorted the releases into major categories
- Prepared a database of the key facts

# The Q1 2013 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed fifteen AAERs during Q1 2013 which we have sorted into the following categories as shown in the pie chart.

**AAERs by Category**



AAERs reported for  
Quarter Ended  
March 31, 2013:  

---

15

While seeing the categorical breakdown is analytically useful, a closer look into each category provides a clearer understanding of the SEC's actions.

## Rule 102(e) Actions

As reflected in the chart, Rule 102(e) actions accounted for forty percent of the releases issued in Q1 2013.

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, 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.

Examples of the types of actions reported in this quarter's Rule 102(e) releases include:

- ***The United States District Court for the Southern District of New York entered a final judgment against a former chief financial officer (“CFO”) of a digital financial media company.*** The SEC's complaint alleged, among other things, that the former CFO aided and abetted a fraud resulting in his company filing materially false and misleading financial statements in the company's annual report on Form 10-K for the fiscal year ended December 31, 2008, and in the company's quarterly reports on Form 10-Q for the first three quarters of fiscal year 2008. Additionally, the complaint alleged that the former CFO engaged in a number of improper accounting practices that materially increased the company's operating income, or decreased its operating loss, in a departure from generally accepted accounting principles (“GAAP”). These practices included, among other things: (1) recognizing revenue based on purported contracts for services when the former CFO knew or recklessly disregarded that his company had not performed the related services and/or had no basis to believe that such services had been performed; and (2) prematurely recognizing revenue based on services contracts. The former CFO was ordered to pay a \$125,000 civil money penalty, ordered to reimburse his former employer \$34,149 pursuant to Section 304 of the Sarbanes Oxley Act of 2002, and prohibited for 3 years from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.
- ***The U.S. District Court for the Southern District of Texas, Houston Division, entered a final judgment by consent against the former CFO (who also was a CPA) of an internet services company.*** The SEC's First Amended Complaint (“FAC”) alleged, among other things, that the former CFO engaged in a fraudulent scheme which involved the “monetization” of certain assets resulting in the immediate recognition of earnings from a long term agreement with another industry participant to develop and provide video-on-demand services.

### OPENING REMARKS AT FOREIGN BRIBERY AND CORRUPTION TRAINING CONFERENCE

“Failure to enforce laws can put honest companies at a disadvantage, harming those that play by the rules. It can mean higher costs and economic inefficiencies for countries that lack the will or the expertise to crack down on corruption—benefiting a few individuals or groups while harming the larger populace and a nation's development goals.”

---

Chairman Elisse Walter  
U.S. Securities and  
Exchange Commission  
Washington, D.C.  
February 11, 2013



KEYNOTE SPEECH  
AT THE 7TH GULF  
COOPERATION COUNCIL  
REGULATORS' SUMMIT

“Instead, what we can and must do is focus on protecting investors from certain categories of risk—not the market risk of investments falling in value, but instead risks posed by unscrupulous market participants who mislead, deceive, and steal.”

Commissioner Daniel M. Gallagher  
U.S. Securities and  
Exchange Commission  
Doha, Qatar  
February 26, 2013

The former CFO carried out the scheme by forming a purported joint venture, assigning the industry participant agreement to the joint venture, and selling an interest in the joint venture based on the value of future revenues from the industry participant agreement to a third party. The FAC further alleged that the scheme was a sham from its inception since it had no economic substance and was created solely for the purpose of generating earnings. Additionally, the FAC alleged that the former CFO was aware that the joint venture partner was an entity that never intended to participate as a partner, and its equity was not at risk because the CFO's entity guaranteed the entity a short term take-out at a specified rate of return. The FAC alleged that the former CFO did not inform the CFO's entity outside auditor about the true nature of the transaction, and in meetings and conversations with the auditor made false and misleading statements about the transaction. As a result, the former CFO's entity recognized \$53 million in earnings in the fourth quarter of 2000 and \$58 million in earnings in the first quarter of 2001, thus enabling the former CFO to meet his earnings targets. The final judgment also prohibits the former CFO from serving as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act. The former CFO was also ordered to pay a \$65,000 civil money penalty.

- ***The U.S. District Court for the Northern District of Oklahoma entered a final judgment against the former chief executive officer (“CEO”), of an oil and gas leasing entity.*** The SEC's complaint alleged that from year-end 2004 through the first-quarter of 2008, the former CEO misled the investing public by fraudulently inflating the revenue and assets and fraudulently omitting major liabilities in the company's SEC filings, and making other false and misleading public disclosures. From year-end 2004, the company conveyed working interests in oil-and-gas leases to investors in Asia for over \$43 million. Because the company promised full repayment of the working interest to investors' initial investment with a 9% guaranteed annual return of principal, these transactions were, in reality, loans. Nevertheless, the company improperly recognized the loan proceeds as revenue in the company's financial statements. These improper revenues were incorporated in the company's quarterly and annual public filings with the SEC.
- ***The United States District Court for the Northern District of California entered a final judgment against a former member and CFO (who was also a CPA) of an investment adviser.*** The SEC's complaint alleged, among other things, that the former CFO, acting with her husband who was also a member of the investment adviser, misused so-called “soft dollars” that then the entity had obtained as rebates on commissions paid for securities trades executed in the accounts of the entity's clients. According to the complaint allegations, contrary to assurances to clients and others that the entity would only use soft dollars to pay for a limited category of services that benefitted the investment adviser's clients, the soft dollars were instead used for prohibited purposes, including for the company's rent, salaries, and for office equipment. The former CFO was also ordered to pay a \$50,000 civil money penalty.

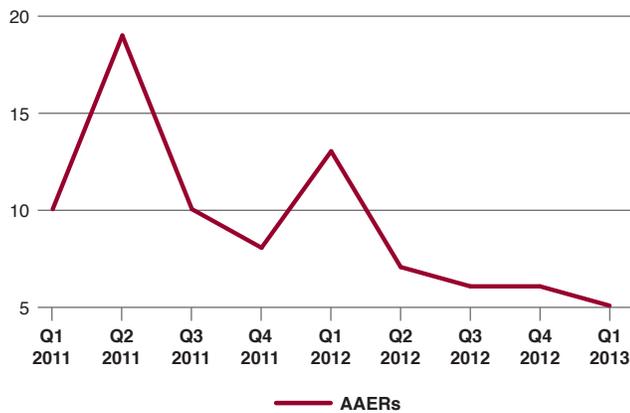
- The U.S. District Court for the Southern District of Florida entered a final judgment by default against the former CFO (who also was a CPA) of a security corporation.*** The SEC's complaint alleged that from April through June 2009, the former CFO and others engaged in a fraudulent scheme involving illicit kickbacks to induce the purchase of the security company's stock. Specifically, according to the complaint, the former CFO's participated in paying illegal kickbacks to a purported trustee of an employee pension fund so the trustee would purchase 133 million restricted shares of the company's stock. The former CFO and the other defendants attempted to conceal the kickbacks by entering into a sham consulting agreement between the security company and a purported consulting company created to receive the kickbacks.

While these individuals were penalized, others were reinstated having satisfactorily served their suspension and penalty period for inappropriate conduct. There were three releases during the first quarter of 2013 for individuals, each having held a CPA license, that were reinstated to practice before the SEC after having completed a satisfactory Rule 102(e) suspension period.

### *Financial Reporting Frauds*

We identified five AAERs reported during Q1 2013 as financial reporting frauds. Notably this tally is the lowest number of such releases in over two years. The chart below reflects the financial reporting fraud releases from Q1 2012 through Q1 2013. The diminishing number of financial reporting fraud releases is similar to the overall trend in AAERs during the same period as described later in our report.

**Financial Reporting Fraud AAERs**



We identified five AAERs reported during Q1 2013 as financial reporting frauds. Notably this tally is the lowest number of such releases in over two years.

Examples of actions related to financial reporting frauds described in the Q1 2013 releases include:



According to the SEC, internal practice deviated materially from what the investing public was told, and the management team avoided recording proper reserves and write downs for assets.

- ***The SEC charged three former bank executives for understating millions of dollars in losses and masking the true health of the bank's loan portfolio at the height of the financial crisis.*** The SEC alleged the bank's former CEO, CFO and Commercial Loan Officer understated the bank's loan-related losses as well as losses on real estate repossessed by the bank (other real estate owned). The SEC's complaint alleges that, from in or about November 2008 through August 2010, the consistent message in the bank's SEC filings and public statements, was that its portfolio of loans, which comprised the majority of the bank's assets was conservatively managed according to strict underwriting standards aimed at keeping the bank's reserved losses low during a time of unprecedented economic turmoil. According to the SEC, internal practice deviated materially from what the investing public was told, and the management team avoided recording proper reserves and write downs for assets. The SEC's complaint alleges that the three individuals knew of the deteriorating state of the loan portfolio, were involved in hiding the deterioration of many of the loans at issue in various ways and were responsible for misleading public statements, in particular those in earnings releases.
- ***The SEC filed civil injunctive complaints in the U.S. District Court for the Southern District of New York in connection with alleged improper accounting at an information technology company located in New York, New York.*** The SEC alleges that the former CFO participated in a scheme to materially overstate revenue. The complaint alleges that for the fourth quarter and fiscal year ended October 28, 2007, the former CFO signed and filed financial statements reporting \$7.55 million of revenue that had not been earned and was not recognizable under U.S. GAAP, resulting in a material overstatement of the company's net income in its fourth quarter and fiscal year ended October 28, 2007. The complaint further alleges that the scheme relied on fabricated paperwork purporting to be a contract related to the sale of software to a customer. Allegedly the former CFO knew that any sale of the software was impossible because the company intended to lease the same software to the same customer the following year. Nevertheless, the former CFO allegedly authorized that the \$7.55 million in improper revenue be included in the company's consolidated income statement for 2007, which were included in several public filings and statements. In addition, the complaint alleges that the former CFO misled the company's external auditors, and then signed one or more certifications required by Section 302 of the Sarbanes Oxley Act that were false and misleading.

- ***The U.S. District Court for the Southern District of New York entered a settled final judgment against the former Controller and Vice President, Finance, for a now-defunct Internet portal.*** The SEC's amended complaint charged violations of the federal securities laws by eight former executives, alleging, in relevant part, that for fiscal year 2000 and the first two quarters of fiscal year 2001, the company's books and records misstated the company's revenue. The SEC had previously settled with six other defendants. In addition, on October 26, 2012, the court granted one defendant motion for summary judgment and ordered that the clerk terminate her as a defendant from the case.

## *FCPA Violations*

Remarkably, for the second consecutive quarter, the SEC did not report an AAER related to FCPA violations. The lack of any FCPA release is notable as well when one considers that the number of published FCPA enforcement actions as well as AAERs had already dropped by approximately 33% and 35% from 2011 to 2012, respectively.

It's difficult to accurately gauge the reasons for the lack of recent FCPA actions but the competing thoughts relate to possible improved controls by global businesses negating the occurrences for violations, a shift in the focus of the SEC's efforts, or a change in business conduct abroad (albeit not likely).

Remarkably, for the second consecutive quarter, the SEC did not report an AAER related to FCPA violations. The lack of any FCPA release is notable as well when one considers that the number of published FCPA enforcement actions as well as AAERs had already dropped by approximately 33% and 35% from 2011 to 2012 respectively.

# The Q1 2013 AAERs: Summary of Financial Reporting Issues



To report on the frequency of financial reporting issues involved in Q1 2013 AAERs, we identified the accounting problem(s) in each AAER based on the classification definitions below:

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

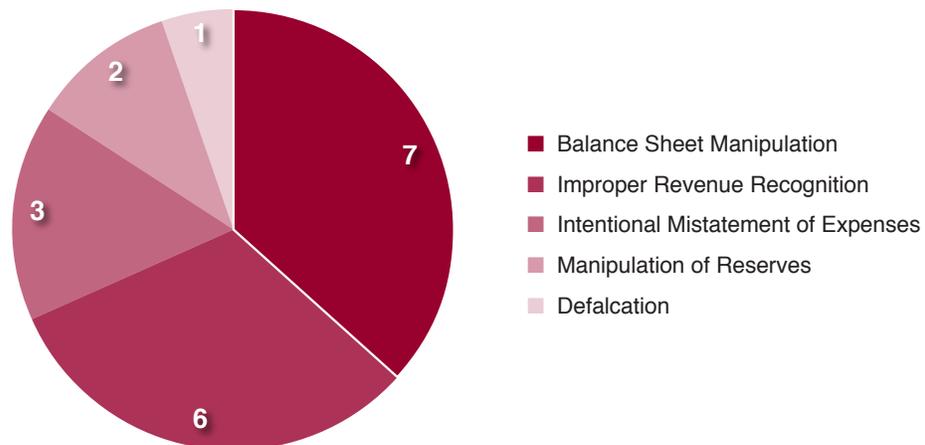
## PRIVATE EQUITY ENFORCEMENT CONCERNS

“By its nature, fraud is hidden and our ability to detect anomalies — a fee calculated in an odd way, a unique valuation methodology, an incomplete disclosure made to investors — has helped us to better allocate resources.”

Bruce Karpati  
Chief, SEC Enforcement Division's  
Asset Management Unit  
U.S. Securities and  
Exchange Commission  
Private Equity  
International Conference  
New York, N.Y.  
January 23, 2013

The following chart provides the results of our financial reporting issue analysis for the Q1 2013 AAER's.

**AAERs by Financial Reporting Issue**



# Notable Q1 2013 AAERs for “Recommended Reading”

While reviewing all of the SEC’s AAERs may prove insightful, certain releases present information that is 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.

Below is an AAER related to a financial reporting fraud that arose at Keyuan Petrochemicals, Inc., a China based entity formed through a reverse merger in April 2010. The AAER contains many interesting aspects but the diversion of cash to an off-balance sheet cash account stands out as unique and worthy of highlighting.

## ***Securities and Exchange Commission v. Keyuan Petrochemicals, Inc. and Aichun Li, Civil Action No. 13-cv-00263 (D.D.C.)***

The SEC charged Keyuan Petrochemicals, Inc. (“Keyuan”) with violations of the anti-fraud, reporting, books and records, and internal control provisions of the federal securities laws. The SEC also charged the former CFO with aiding and abetting Keyuan’s reporting and books and records violations and for failing to implement internal accounting controls. Keyuan and the former CFO have agreed to settle the SEC’s claims against them.

According to the SEC’s complaint, between May 2010 and January 2011, in what was its first year as a U.S. public company, Keyuan failed to disclose in its SEC filings numerous material related party transactions, as required by U.S. GAAP and SEC rules and regulations. The related parties included the company’s three founding and controlling shareholders, including its CEO, entities controlled by or affiliated with these persons, and entities controlled by Keyuan’s management or their family members. The related party transactions included sales of products, purchases of raw materials, loan guarantees, and short term financing.

From at least July 2008 and continuing through March 2011, Keyuan also maintained an off-balance sheet cash account that was kept off the company’s books by the former Vice President of Accounting. Total amounts funded to and disbursed from the account were approximately \$1 million.

According to the complaint, the off-balance sheet cash account was funded, in part, through proceeds from the sale of promissory notes, scrap metal and construction materials. The off-balance sheet cash account was also funded through the use of fictitious reimbursement claims that were submitted by Keyuan employees as a means to withdraw cash from the company’s cash accounts for use in the off-balance sheet cash account.

This AAER contains many interesting aspects but the diversion of cash to an off-balance sheet cash account stands out as unique and worthy of highlighting.



**According to the release, “once the account was discovered”, personnel at the company continued to conceal the true scope of the account and provided only a partial accounting of the off-balance account to the company’s auditors.**

The diversion of cash by selling assets and not remitting the cash is a form of theft referred to as skimming. Suspicious activity for this conduct generally relates to transactions outside of the normal course of business, which the scrap metal and construction materials sales may represent. The sale of the promissory notes as a form of diversion appears highly unusual and more obvious to detect as presumably the proceeds from the sale would be less than the face value of the notes, requiring a discount to be recorded and amortized to interest expense over time.

The falsification of accounting documents to steal cash is referred to as cash larceny. Structuring the theft as an employee expense reimbursement may be among the more difficult maneuvers to detect. It’s not a payment to a vendor that would be subject selection for testing, nor is it a false employee payment which also would be frequently subject to testing.

The account was used to pay for various items, including cash bonuses for senior officers and reimbursements to the CEO for business expenses, including travel, entertainment, and rent for an apartment. The account was also used to fund gifts—both cash and non-cash—for Chinese government officials, typically around the Chinese New Year. Among the recipients of the gifts were officials from the local environmental, port, police, and fire departments. Gifts ranged from household goods (such as beddings and linens) to “red envelope” gifts, in which cash was directly gifted to the recipients.

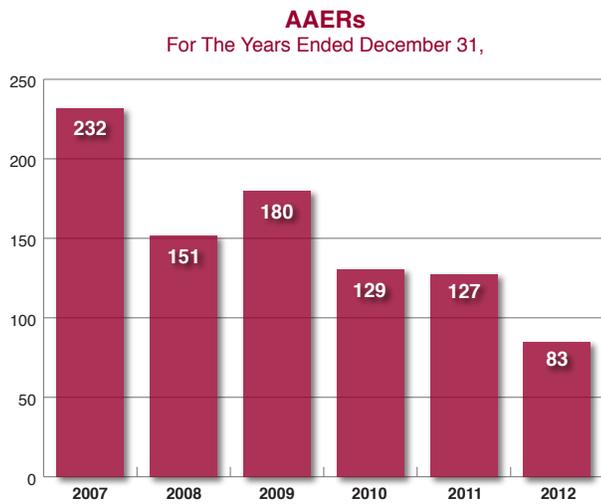
By failing to properly record these transactions on the company’s books and records, the company misstated its reported balances for cash, receivables, construction-in-progress, interest income, other income, and general and administrative expenses in its financial statements filed with the SEC.

The off-balance sheet cash account was concealed from the company’s auditors in connection with the 2010 audit. According to the release, “once the account was discovered”, personnel at the company continued to conceal the true scope of the account and provided only a partial accounting of the off-balance account to the company’s auditors.

Needless to say, the words “once the account was discovered” raise many questions as to how anything about it could be concealed, prospectively noting the improper off-balance sheet nature of the account and if one observed any of the activities described above. The combination of these factors would be catastrophic to any reliance on management integrity from that point forward.

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

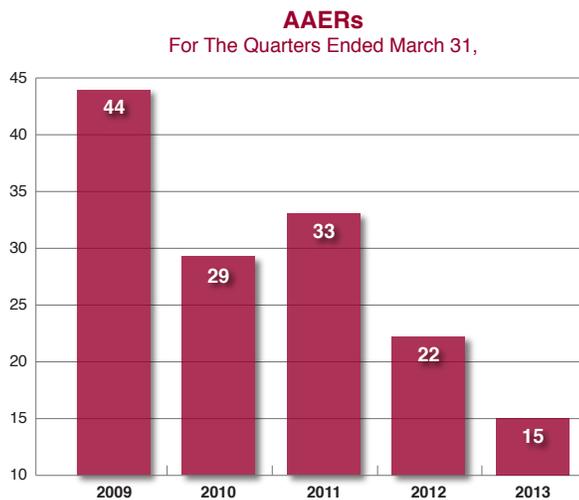
As described in “Our Process and Methodology” section, AAERs are intended to highlight certain actions and are not meant to be a complete and exhaustive compilation of all of the actions that may fit into the definition the SEC provides for the classification. That said, comparisons of the number of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



For the year ended December 31, 2012, the SEC issued 83 AAERs, remarkably the lowest number of AAERs reported over the last six years. For comparison, the average for the periods 2007 through 2012 was approximately 150 releases, with the greatest number of releases issued in 2007.

**AAERs reported for  
Year Ended  
December 31, 2012:**  
83

**AAER population  
issued for The  
Quarters Ended  
March 31, 2013:**  
15



When analyzing the AAER population issued during the first quarter for the years 2009 through 2013, the 2013 result reflects a decrease of approximately 32% from 2012, and a material drop from prior years as reflected below.

[www.floydadvisory.com](http://www.floydadvisory.com)

#### **ACKNOWLEDGEMENT**

We wish to acknowledge the valuable contribution to this analysis by Liz Klyuchnikova, Meghan Arsenault and Sarah Floyd.

#### **ABOUT Floyd Advisory**

Floyd Advisory LLC is an independent business advisory and forensic accounting 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.

#### **New York**

555 Fifth Avenue, 6th Floor  
New York, NY 10017  
212.867.5848

#### **Boston**

155 Federal Street, 14th Floor  
Boston, MA 02110  
617.586.1040