Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended March 31, 2017

Q1 REPORT 2017

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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, 2017.

As an independent consulting firm with financial and accounting expertise, 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 related to "accounting and auditing" 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 requests for any additional analysis you would find helpful.

Floyd Advisory
APRIL 2017

The Q1 2017 AAERs: Highlights

- Nine individuals received Rule 102(e) sanctions with eight of these individuals neither admitting nor denying the charges.

- The twenty-three AAERs in the first quarter of 2017 resulted in fines, penalties, and disgorgements totaling $51 million with an FCPA case generating the largest fine of approximately $13 million.

- Our Recommended Readings highlight two cases. The first case involves General Motors' failure to consider facts known by its legal counsel and others when assessing a contingent liability. The second case involves a software company and the creation of contract documentation inconsistent with substance of the transactions.

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"). 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.

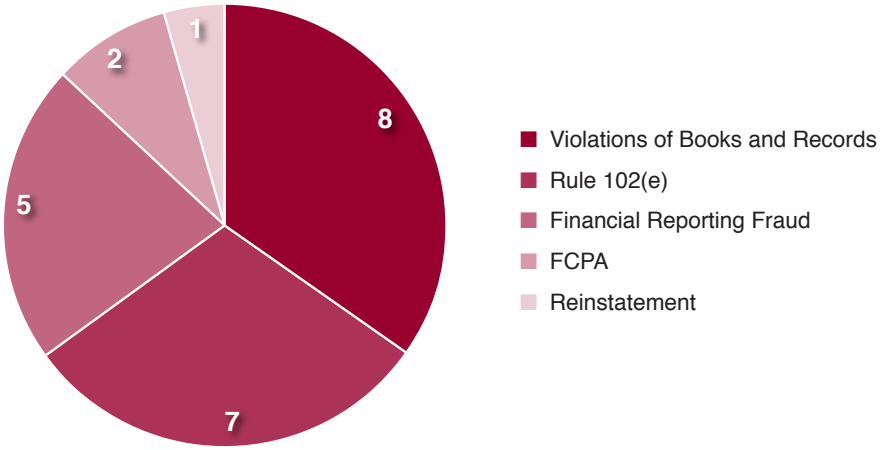
To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, www.sec.gov.

As part of our review, we gathered information and key facts, identified common attributes, noted trends, and observed material events. Applying our professional judgment to the information provided by the SEC, we sorted the releases into major categories (i.e., Rule 102(e) Actions, Financial Reporting Frauds, Foreign Corrupt Practices Act violations ("FCPA"), Reinstatements to Appear and Practice before the SEC, Violations of Books and Records, and Other), and classifications of the financial reporting issues involved (i.e., Improper Revenue Recognition, Manipulation of Reserves, Intentional Misstatement of Expenses, Balance Sheet Manipulation and Errors, 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.

The Q1 2017 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed twenty-three AAERs during Q1 2017, with Violations of Books and Records actions representing 35% of the total releases.

Q1 2017 AAERs by Category



While our categorical breakdown is analytically useful, a closer look at specific cases for each category provides a clearer understanding of the SEC's areas of focus as an enforcement agency.

"I am often asked for my reflections on this period of my public service. My most frequent response is 'never a dull moment.' My less irreverent observation is how proud I am of what the agency has accomplished for investors and the markets in the last four years."

Chair Mary Jo White
U.S. Securities and Exchange Commission
New York, NY
January 17, 2017

"The SEC after the Financial Crisis: Protecting Investors, Preserving Markets"

Rule 102(e) Actions

Rule 102(e) actions involve the temporary or permanent censure and denial 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.

Nine individuals received Rule 102(e) sanctions. Eight of these individuals neither admitted nor denied the charges.

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

- ***The Chief Financial Officer of a medical device company was accused of purposefully compromising the accuracy of the company's books and records over a three-year period.*** The alleged scheme revolved around improper revenue recognition resulting in material errors in its public filings.

More specifically, the SEC claims there were three transactions involving one of the company's largest international distributors in which they did not meet the "fixed and determinable" revenue recognition criteria. The company restated its financial statements for Q1 2013, both quarterly and annual filings for 2012 and 2011, and the annual results for fiscal year 2010. Further, the claim states that in fiscal year 2012 the respondent, after signing the management representation letter, failed to disclose certain transactions to the company's independent auditor.

- ***According to the SEC, a certified public accountant provided insider trading information related to an acquisition to an outside source about a public company for which she was providing professional tax services.*** Throughout the time in which the respondent was serving as a tax professional to a long-term assisted living facility, she learned of a potential merger involving her client. It is alleged that she revealed this information to a close acquaintance who subsequently bought stock in the company prior to the announcement of the acquisition. The commission also issued a cease-and-desist proceeding against the acquaintance. Further, the respondent was contacted by the Financial Industry Regulatory Authority ("FINRA") regarding her knowledge of any people using the confidential merger information. The SEC claims she falsely responded by saying she was not aware of any of the parties who were using this information.

- ***Partners at a public accounting firm were charged with failing to conduct and review the 2012 annual audit of a public energy company in accordance with PCAOB Audit Standards.*** It is alleged that the respondents failed to plan, conduct, and oversee the 2012 annual audit related to financial statements that included a 40% overstatement of inventory balances. Further, as part of its business, the company stores petroleum products (i.e. diesel and gas) at various fuel depot storage facilities in several Chinese cities. According to the claim, the company was measuring and recording its inventory in two separate manners. Inventory units were being measured in weight (metric tons), rather than volume (cubic meters) which the company allegedly used to report its inventory thereby requiring different conversion formulas to be applied to inventory held at these storage facilities. According to the SEC, the respondents failed to question this accounting practice, resulting in a lack of sufficient testing procedures performed over the company's inventory levels.

Violations of Books and Records

This quarter we categorized eight AAERs under Violations of Books and Records, a category that includes alleged improper accounting treatments and internal control problems deemed worthy of an enforcement action but not meriting financial reporting fraud allegations. These eight releases combined to result in $17.7 million in civil penalties as part of settlements with the United States Department of Justice. Examples of this quarter's releases include the following:

- ***The SEC alleged that a subsidiary of a U.S.-based food company failed to properly monitor payments relating to permits and licenses for a factory in India.*** The U.S. based SEC registrant acquired a company based in the U.K. in February 2010. The acquired company was a U.K. based confectionary and snack beverage company that had securities registered with the SEC at the time of the acquisition. An India-based subsidiary of the U.K. division retained an agent to handle interactions with the Indian government which were necessary to obtain licenses and other approvals for a factory to operate in Northern India.

"The Commission has always guarded its independence fiercely, a proud history that I have defended from my very first days as Chair. Not all of our actions and views have been uniformly praised. They never have been. At the core of being a good steward of the mission of the SEC is acting independently from the executive and legislative branches of government, fighting for that independence whenever necessary, and withstanding the inevitable criticism and pressure to change that follows."

Chair Mary Jo White
U.S. Securities and Exchange Commission
New York, NY
January 17, 2017

"The SEC after the Financial Crisis: Protecting Investors, Preserving Markets"

There was an inherent risk that the failure to monitor the activities of this agent could create the opportunity for improper or unauthorized use of funds paid to the agent. The SEC alleged that the nature of the agent's services was not accurately reflected in the U.K. company's books and records and that the company lacked sufficient internal accounting controls that would have detected and prevented the misuse of payments unauthorized by company management.

- ***The SEC has charged the former President and Vice President of Global Sales of a segment of a medical device company with violations of the reporting, internal accounting controls, and books-and-records provisions of federal securities laws.*** Throughout the period in question, the company had a practice that required contractual or payment modifications with international distributors to be approved by the CFO of the company's largest segment. The SEC claims that during the period in question, the respondents in this case agreed to terms on two transactions without the CFO's approval. On two other separate occasions, the respondents provided concessions on transactions, once again circumventing the CFO and the internal approval process. Additionally, the Vice President of Global Sales allegedly provided an inaccurate representation in response to a 2012 audit being conducted by the company's independent auditors.

- ***A public marketing firm allegedly violated federal securities laws relating to providing additional benefits to an executive and using non-GAAP financial measures for its disclosures.*** The first charge by the SEC relates to the former Chairman and CEO of the company receiving personal benefits that were paid by the company outside the normal course of business. The SEC claims these benefits included, but were not limited to, private aircraft usage, expenses related to a yacht and sports car, personal family medical expenses, and vacation and personal travel expenses. According to the claim, the company failed to disclose these benefits provided to the former executive in its proxy statements during this time, resulting in an alleged understatement of $1.9 million of the executive's compensation. Upon resignation, the Chairman and CEO agreed to pay back the company his cash bonus awards of approximately $10.6 million and reimburse $11.3 million of personal expenses received throughout the five-year period. The second violation relates to the company's alleged failure to disclose non-GAAP financial measures items under Regulation S-K in its quarterly earnings releases for a period of seven quarters. Rules under 10(e)(1)(i)(A) of Regulation S-K for a public company require a reconciliation or comparable financial measure that is calculated in accordance with GAAP. The company allegedly failed to reconcile its "organic revenue growth," a non-GAAP financial metric, to revenue calculated in accordance with GAAP.

"Nothing will drive away investors from your capital markets faster than fraud. If investors perceive that the issuers are cooking their books, or that the market is rigged with manipulation and insider trading, or that their brokers are not held accountable for unauthorized trades, then investors will demand a higher cost of capital, if they do not pull out altogether. All of these frauds, by the way, have a lack of full disclosure at their core."

Acting Chairman Michael Piwowar
U.S. Securities and Exchange Commission
Washington D.C
March 27, 2017

Remarks Before the 27th International Institute for Securities Market Growth and Development

Financial Reporting Frauds

There were five AAERs that we categorized as financial reporting frauds during the quarter, including but not limited to the following:

- ***A medical device company allegedly overstated revenue as a result of internal pressures to meet sales numbers for a period of approximately two years.*** The SEC alleges that the company, which has multiple operating segments, improperly recognized revenue related to several transactions with its largest international distributor in its largest operating segment. It entered into contingent sales with the aforementioned distributor and allegedly recognized revenue for product sales even in cases when the product could not be resold. In addition, per the SEC's claim, the company improperly accounted for certain transactions by consistently treating discounts as expenses as opposed to revenue reductions and recognizing revenue on products that could be returned or exchanged. It was alleged the company also improperly recognized revenue related to extra-contractual agreements at its Brazilian subsidiary. The underlying basis of

the company's multiple instances of alleged misconduct was inadequate internal controls over revenue recognition combined with a culture of aggressive sales targets and internal pressures to meet those targets. This led the company to restate over three years' worth of financial statements due to improper revenue recognition.

- ***An oil tanker company was charged with understating its federal income tax liability in financial statements over the course of 2001 through 2011.*** The company allegedly failed to record its income tax liability from its controlled foreign subsidiaries as required under Section 956 of the Internal Revenue Code ("IRC") which relates to the timing of income received from controlled foreign subsidiaries of a US corporation. According to the SEC's claims, the company had credit agreements in which its foreign subsidiaries were named liable for the company's debt, thereby creating a tax liability for the amounts borrowed and deferred tax liabilities for amounts not yet borrowed but still accessible under the agreement. In 2011, the cumulative effect of allegedly failing to record the current and deferred portion of the tax liability resulted in the understatement of income tax liabilities by $512 million or approximately 17% of its total liabilities. According to the SEC, after 2011, the company discovered this issue and filed for bankruptcy protection. Furthermore, the SEC alleged the company's CFO was aware of the tax implications from the credit agreements that were not disclosed to the auditors, thereby making misrepresentations regarding the impact of the credit agreements on the company's financial statements.

- ***A Mexico based construction company is charged with overstating revenue by approximately $3.3 billion (or 355%) throughout a three-year period.*** Per the SEC, the company allegedly participated in various fraudulent schemes relating to overstating revenue. Some of these schemes included certain employees working at the headquarters entering false information into the company's accounting system to include revenue from homes that were neither sold nor built. Further, they also entered false corresponding entries to cost of sales and inventory to make it look like a true revenue transaction had taken place. Another scheme the SEC alleges took place involved factoring its receivables (approximately $7.5 billion) by entering into agreements with at least thirteen Mexican banks. This included executing written agreements in which the banks would make discounted payments to the company in exchange for future revenue from the specified accounts receivable. These agreements were executed by the CEO and CFO. By entering into these agreements, the company became the guarantor and was required to refund the bank for any uncollectible accounts receivable. As such, a liability should have been recorded to account for these transactions, but they were not, which subsequently had a material impact on the financial statements. The SEC alleges that both the CEO and CFO signed representation letters in conjunction with filing 20-F, the annual report for companies following the International Financial Reporting Standards ("IFRS") saying they have reviewed the financial statements and they accurately reflected the financial status, including results and cash flows of the company. Due to these actions, in April 2014, the company filed in Mexico what is similar to the US form of bankruptcy after defaulting on its payments related to one of its debt offerings in 2013. Its securities were subsequently delisted from the NYSE in May 2014.

FCPA Violations

There were two FCPA-related releases in Q1 2017, resulting in almost $20 million in disgorgement, interest, and penalties. The two releases from this quarter include:

- ***A medical device company was charged with violating the internal controls and recordkeeping provisions of the Foreign Corrupt Practices Act.*** The alleged violations occurred at the company's Brazil-based subsidiary between 2011 and 2013. According to the SEC, several senior level employees from the Brazil

"Requiring banks to comply with the disclosure-oriented focus of market based regulation would provide better protection to the international financial system than what we have now."

Acting Chairman Michael Piwowar
U.S. Securities and Exchange Commission
Washington D.C
March 27, 2017

Remarks Before the 27th International Institute for Securities Market Growth and Development

subsidiary engaged in transactions with third-party distributors involving improper payments made to doctors at hospitals to persuade them to use Orthofix products and increase the company's sales. These payments were recorded as expenses and generated close to $3 million in profits to the company. The company lacked a sufficient structure of internal accounting controls and anti-corruption compliance program which could have detected and/or prevented this type of conduct. The respondent's settlement involved an admission to the commission's findings and total monetary penalties over $6 million.

- ***The SEC charged a global medical device company with violations of the books and records and internal controls provisions of the Foreign Corrupt Practices Act.*** The alleged violations occurred at various subsidiaries of the company including subsidiaries located in Mexico and Brazil. For a period of five years, a subsidiary company allegedly engaged a third-party broker from Texas, for whom a written contract or fee schedule did not exist, to import unregistered products into Mexico obtaining over $2.7 million in profits from these specified transactions. The SEC states that this third-party broker was subsequently replaced by a broker from Mexico, again, without any written contract or fee schedule. To get these products into Mexico, the company's subsidiary allegedly bribed Mexican custom officials using cash to ensure the products could get over the border without going through customs. The claim states that the company's payments totaled over $1.5 million to the Mexican broker and lacked supporting documentation. Furthermore, for a period of four years, another of the company's subsidiaries located in Brazil allegedly engaged in transactions with a banned distributor who was previously found guilty of making improper payments to Brazilian doctors to obtain sales of the company's products. The company improperly recorded these transactions in its books and records and continued the relationship until a whistleblower complaint was received by the SEC at the end of 2013. The company allegedly received over $3 million in profits related to transactions with this particular Brazilian supplier. Overall, the SEC claims the company lacked adequate internal accounting controls to detect and prevent these improper payments. The respondent consented to the Commission's order and was ordered to pay monetary penalties in excess of $13 million including disgorgement, prejudgment interest, and a civil penalty.

"Our work as regulators is not a "zero sum game." A rising tide lifts all boats. Adopting high quality regulatory standards and cooperative relationships create what economists call a virtuous circle—a positive feedback loop in which everyone benefits. At the SEC, every day we rely on working with regulatory and law enforcement authorities throughout the world."

Acting Chairman Michael Piwowar
U.S. Securities and Exchange Commission
Washington D.C
March 27, 2017

Remarks Before the 27th International Institute for Securities Market Growth and Development

Reinstatement

- ***The SEC reinstated the former CFO of global trading and collectibles network after being found guilty of violating the antifraud and reporting provisions of federal securities laws.*** During his tenure as CFO, the SEC had alleged that the respondent committed violations related to federal securities laws through a series of events including: 1) failing to disclose the related-party relationship between the company and its subsidiary which the company had control over; 2) falsely reporting that the company sold stamps to its former parent company at prices determined by an independent party when in reality the former CEO set the prices; and 3) improperly recording the sale of certain antiques.

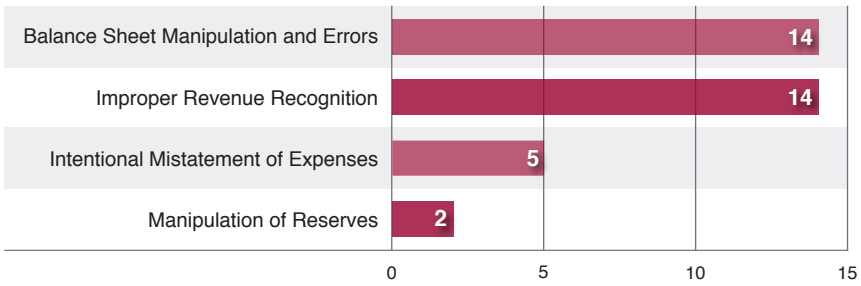
The Q1 2017 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in Q1 2017 AAERs, we identified the accounting problem(s) in each AAER based on the classification definitions below:

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

The chart below illustrates the frequency of financial reporting issues by category among all AAERs issued during Q1 2017. Balance Sheet Manipulation and Errors remains one of the top categories for the sixth straight quarter, although there has been an increase in the instances of improper revenue recognition this quarter compared to the previous four quarters. Notably, many enforcement actions with incidents of wrongdoing related to reserve accounting and expense misstatement also impact company balance sheet.

Financial Reporting Issues Identified in Q1 2017 AAERs



Notable Q1 2017 AAERs for "Recommended Reading"

While reviewing all of the SEC's AAERs would prove insightful, certain releases present information that is especially worthy of 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.

"Revenue is one of the single most important measures used by investors in assessing a company's performance and prospects, regardless of a company's industry, the nature of its securities, or the capital markets it accesses. Revenue impacts key analytical ratios and bottom line earnings. Companies cannot afford to get the accounting wrong—it deserves close attention by preparers, audit committees and auditors."

Wesley Bricker,
Chief Accountant
Philadelphia, PA
March 21, 2017

Remarks before the Annual Life Sciences Accounting & Reporting Congress: "Advancing Effective Internal Control and Credible Financial Reporting"

For this quarter, we selected two AAERs to highlight[1]. The first case involves a failure by General Motors to consider facts known by its legal counsel and others when assessing a contingent liability. The second case involves a software company and the creation of contract documentation inconsistent with substance of the transactions.

Accounting and Auditing Enforcement Release No. 3850 / January 18, 2017, Administrative Proceeding File No. 3-17797, In the Matter of General Motors Company, Respondent.

Accounting for many financial statement items requires open communications between company legal counsel and the accounting group, with accounting for litigation loss contingencies possibly requiring the most communication. Litigation loss contingencies involve complicated judgments and predictions about future events. In addition to the complexity of estimating future events, the process is made more difficult by the sensitivity and importance of maintaining attorney work product privilege and not disrupting legal strategy. That said, legal counsel is generally in the best position to provide facts and objective information to their clients' accounting departments so that proper financial reporting judgments may be made. If that communication doesn't happen, or material facts aren't shared, then problems like the ones General Motors Co. recently experienced can occur.

"As a matter of background, since 1977, U.S. public companies have been required to devise and maintain a system of internal accounting controls to provide ''reasonable assurances" that "transactions are recorded as necessary to permit preparation of financial statements" in conformity with GAAP."

Wesley Bricker
Chief Accountant
Philadelphia, PA
March 21, 2017

Remarks before the Annual Life Sciences Accounting & Reporting Congress: "Advancing Effective Internal Control and Credible Financial Reporting"

In January, GM settled an action with the Securities and Exchange Commission related to deficiencies in its financial reporting process for product liability and recall obligations. In particular, the SEC action arose out of GM's failure to comply with GAAP for potential losses related to a defective ignition switch that resulted in auto accident claims and a product recall. GM's settlement with the SEC involved accepting a cease-and-desist order, pursuant to Section 21C of the Securities Exchange Act of 1934, and paying a $1 million fine.

Of concern, company attorneys and others in early 2012 were aware of material facts that would indicate GM might incur significant liabilities from the defective switch. However, no one informed GM's accounting department about the facts or the problem until the end of 2013, at which time GM recorded a $41 million accrual.

Per the SEC, had the facts and information that the attorneys possessed been properly evaluated, GM would have at a minimum disclosed a liability to its investors for the defective ignition switch sooner. Accounting rules require the disclosure of even "reasonably possible" losses that may be reasonably estimated, and the accrual of a charge for losses that are "probable" and similarly may be reasonably estimated.

In contrast, defense counsel's job is to argue zealously that no liability exists and to pursue every argument available to minimize the ultimate obligation. Needless to say, making a public admission that a loss is even possible, leaving aside that it could be probable, is generally not consistent with most legal defense strategies and attorney work product privilege.

The GM case demonstrates the importance of legal counsel making sure their clients have sufficient information about litigation and other legal issues to make proper financial reporting judgments for loss contingencies. Importantly, in-house counsel, as part of management, bears direct responsibility for helping fulfill the financial reporting requirements.

[1] *These articles have previously been published in* Massachusetts Lawyers Weekly.

Remote, reasonably possible or probable?

Most attorneys are familiar with the American Bar Association Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information, which provides guidance on what to say and not to say about litigation matters to auditors. Of note, the guidance states that "[i]n view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either 'probable' or 'remote.'" The guidance describes "probable" as a situation in which the client not succeeding is "extremely doubtful and the prospects for success by the client in its defense are judged to be slight," a standard quite different than the GAAP definition for "probable," which is likely to occur.

Note that the "reasonably possible" level, which is a GAAP required level of assessment for financial reporting, is not a consideration in the ABA guidance. Without question, the ABA rules for auditor communications are very limiting, as well as not consistent with the GAAP standards. That said, the open exchange of facts and information that impact a client's financial statement judgments is essential for fairly stated financial statements to be presented.

Below is an overview of the relevant financial reporting guidance, background information on GM's product recall, and a discussion regarding the flaws in timely informing the accounting department of the problem. Under GAAP, a loss contingency, such as for a product recall or litigation matter, is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an entity that ultimately will be resolved when one or more future events occur or fail to occur. Preparers of financial statements must assess the likelihood of whether a loss or impairment is remote, reasonably possible or probable, and there are defined financial reporting steps for each classification. "Probable" means the future event (or events) is likely to occur. A loss is considered "reasonably possible" when the chance of the future event or events occurring is more than remote but less than likely. A loss is considered "remote" when the chance of the future event or events occurring is slight.

Importantly, when a loss is deemed probable and the amount of the loss can be reasonably estimated, GAAP requires that the estimated loss be recorded in the financial statements of the company. If a loss is probable but a reasonable estimate of the amount of the loss cannot be made, a company is required to disclose the nature of the contingency and provide an estimate of the loss or range of loss or a statement that such an estimate cannot be made. GAAP also requires that a loss contingency that is reasonably possible should be disclosed in the notes to financial statements. The reasonably possible category may be the hardest to assess, and easiest to second guess when the benefit of hindsight arises.

Finally, neither accrual nor disclosure is required if the loss contingency is remote. In order to properly apply the accounting rules, company management must have a system in place to gather relevant information, including from legal counsel. Pursuant to 13(b)(2)(B) of the Exchange Act, issuers must devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions, including loss contingencies, are recorded as necessary to permit preparation of financial statements in conformity with GAAP.

What went wrong at GM

With this background, let's review what went wrong at GM, and specifically the instances when legal counsel could have alerted the accounting group about specific facts and the need to assess the accounting treatment for the defective switch product liability.

"The beauty and efficiency of enforcement is that it focuses our limited resources on a risk based approach to addressing the problems in the market, in contrast to burdensome and ultimately futile attempts to regulate away the problems."

Acting Chairman Michael Piwowar
U.S. Securities and
Exchange Commission
Washington D.C
March 27, 2017

Remarks Before the
27th International Institute
for Securities Market
Growth and Development

According to the SEC, in early 2012, GM engineers had knowledge of airbag nondeployment problems in certain vehicles and claims that had occurred over several years. Per the release, by April 2012, a GM engineer determined that a probable cause of the airbag nondeployment problem was a defective switch involved in the ignition process. The information was immediately reported to an individual on one of GM's product liability committees and to a GM attorney. Those facts, even without the benefit of hindsight, should have triggered a financial reporting review for a loss contingency.

Also per the release, in April 2013, during a deposition in a case arising from a crash of a GM vehicle with the defective switch, the plaintiff's attorney produced evidence that a component of the defective switch differed from the same component in an earlier model year. A couple of months later, in July 2013, an expert retained by GM confirmed that certain model years did have a different ignition switch, and in October 2013, GM received documentary confirmation from the supplier of the ignition switch that there had been a part change in the defective switch. At that time, the engineers initiated GM's formal product liability and recall process.

According to the SEC release, it actually wasn't until November 2013 that the warranty group in the accounting department received information about a potential recall related to the defective switch. The following month, the defective switch was placed on the "emerging issues list" (which served as the company record for probable losses), and the warranty group accrued approximately $41 million for estimated costs of recalling three models with the defective switch.

By that point, GM attorneys had known about the product problem for over a year and a half, and GM had issued several financial statements to investors that lacked consideration of the obligations arising out of the defective switch. Certainly, based on the facts presented by the SEC, the possible loss threshold had been met, and perhaps even as of early 2012.

Under GM's system of internal accounting controls in place in 2012 and into 2014, only product liability and recall losses that met the probable and reasonably estimable standard were reported to the warranty group within the accounting department. As such, the warranty group received information only about vehicle issues at the point at which a recall was considered likely.

Indeed, GM lacked any formal consideration or communication process to send information to the accountants for loss contingencies that met the possible standard. The warranty group therefore had no knowledge or ability to assess whether losses related to potential product liability and recall campaigns were reasonably possible and should be considered for disclosure, as required by GAAP.

Needless to say, it's essential for there to be an open communication process between legal counsel and their client's accounting and financial reporting professionals. GM's failures arose because of a flawed process, as well as the lack of adequate information flow to ensure the key facts obtained by counsel were being properly considered for financial reporting assertions and judgments.

"Audit committees also play a critical role in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company's culture and internal control over financial reporting ("ICFR"), the quality of financial reporting, and the quality of audits performed on behalf of investors. The importance of the audit committees' work cannot be overstated."

Wesley R. Bricker
Chief Accountant
Office of the Chief Accountant
Knoxville, TN
March 24, 2017

Remarks before the University of Tennessee's C. Warren Neel Corporate Governance Center: "Advancing the Role and Effectiveness of Audit Committees"

Accounting and Auditing Enforcement Release No. 3858 / February 3, 2017, Administrative Proceeding File No. 3-17825, In the Matter of Ixia and Victor Alston, Respondents.

The recent Ixia settlement with the United States Securities and Exchange Commission ("SEC") provides significant insights for attorneys who advise clients on drafting and structuring contracts for transactions that are ultimately reported in financial statements.

Ixia's problems arose out of how it structured customer contract documentation in an attempt to obtain a more favorable revenue recognition result. Ixia however, failed to consider that Generally Accepted Accounting Principles ("GAAP") mandate reporting based on the substance of economic events and transactions, no matter how one describes or presents the transaction documentation. In the accounting literature, this is referred to as "faithful representation," which according to Financial Accounting Concept Statement No. 8, is the requirement that states "financial information represents the substance of an economic phenomenon rather than merely representing the legal form."

According to the SEC's release dated February 3, 2017, the former CEO of Ixia led an initiative to create documentation to circumvent GAAP and improperly accelerate the timing for Ixia's revenue recognition with major customers. The company referred to the plan as "Split POs." Before describing the "split POs" plan, a brief discussion of the software revenue recognition rules will provide context for the CEO's actions and the accounting standards that Ixia allegedly sought to circumvent.

As a software company, Ixia generally sells a combination of its products and services to customers in bundled transactions. In accounting parlance, sales that include several items are referred to as "multiple-element arrangements." Importantly, the different elements may not be delivered or provided during the same accounting period which raises timing issues for proper revenue recognition treatment.

Significantly, under GAAP, revenue from a multiple-element arrangement involving software products and services must be allocated to each element based on the fair value of each element (e.g., dollar value established through evidence of a consistent price paid by customers for the same or similar element), as measured by vendor-specific objective evidence of fair value ("VSOE").

Now for the problem that can frustrate certain management teams: if VSOE does not exist for certain elements of the transaction, then per GAAP, any software revenue from the multiple-element arrangement must be deferred until either the point in time when all elements have been delivered to the customer, or when VSOE does exist for each undelivered individual element, whichever occurs earlier. Alternatively, the revenue for the entire contract may be recognized ratably over the contract life.

Consistent with GAAP, Ixia's internal revenue recognition policy provided that:

> If evidence of fair value (or VSOE) cannot be established for an undelivered element within the software group or software arrangement, we defer revenue on the entire order until the earlier of (i) delivery of all elements or (ii) establishment of VSOE of the undelivered element. We have not been able to establish VSOE for our Professional Services, therefore, if the only undelivered element is Professional Services, the entire order or group is recognized as revenue over the service term or when the service is completed, depending on the arrangement.

Historically, Ixia never established VSOE for its professional services, so deferral of revenue and ratable revenue recognition were frequent occurrences for Ixia. This can happen when professional services are not sold as a stand-alone service by a company and there is no independent evidence for the fair value of the services.

Accordingly, the former CEO knew that whenever Ixia sold a combination of software and professional services in a multiple-element arrangement, Ixia could not recognize revenue from its sale of the software element until the professional services element of the transaction was fully delivered, or they could recognize prorated revenue over the contract's service term. When under pressure to meet quarterly revenue targets, either outcome can be difficult to accept.

"The disclosures required by the new standard are designed to allow an investor to understand the revenue arrangement and the registrant's role in it. The pertinent facts and related judgments related to a principal versus agent assessment should be disclosed so that investors can understand the arrangement."

Wesley Bricker
Chief Accountant
Philadelphia, PA
March 21, 2017

Remarks before the Annual Life Sciences Accounting & Reporting Congress: "Advancing Effective Internal Control and Credible Financial Reporting"

For Ixia, frustration with the accounting for multiple-element sales appears to have reached its apex in late September 2012, when Ixia closed a significant sale to a large technology company. The transaction was a multiple-element arrangement comprised of software, along with a nominal amount of hardware and professional services.

Although the value of the deal was substantial, under GAAP, Ixia could not recognize any of the revenue from the software licensed in the transaction in the third quarter of 2012 because the professional services sold to Ixia's customer would not be delivered before quarter-end. Adding to Ixia's frustration, the sale's revenue recognition would be deferred even further because Ixia's customer had decided that it wanted delivery of the professional services to be completed in 2013, rather than during fourth quarter 2012.

As a result, according to the SEC, under the leadership of the former CEO, Ixia crafted a creative idea to alter the contract documentation and recognize a significant amount of revenue from the sale. Specifically, Ixia asked its customer to "split" its original purchase order into two purchase orders. One purchase order would refer to software and already completed professional services. The other purchase order would reference the uncompleted professional services previously negotiated and agreed to by the customer.

Ixia's customer agreed to the request to submit new purchase orders. Now, under the guise of two separate customer orders, Ixia prematurely recognized approximately $530,000 of software revenue in its financial statements for the year ended December 31, 2012 as reported in its Form 10-K. The terms of the original negotiation and customer agreement were in substance unchanged, but based on Ixia's "Spilt POs" plan, the company documented two separate sales and achieved the recognition of revenue that it desired.

Per the SEC, it was the sale to the large technology company that focused the former CEO and others on the impact of professional services on Ixia's inability to immediately recognize revenue. As a result, the former CEO and others at the company fundamentally changed the way Ixia documented its sales transactions by instructing his team to separate all professional services from software sales.

Importantly, Ixia's sales practices didn't change and still involved negotiating and packaging the sale of products and services as a bundled offering to potential customers. However, when it came to contract documentation, Ixia began to submit two quotes to a potential customer where one quote reflected professional services and the other reflected all the remaining components of the sale. Following Ixia's new "Split POs" practice, it would then request that its customers submit two separate purchase orders, matching the paperwork for the two quotes, thereby creating a paper trail reflecting the purchase of professional services as an independent transaction.

The former CEO sent an email on April 21, 2013 to Ixia management that stated:

> Team
> Carrier deals that involve services need to be quoted with [professional services] on a separate quote.
> We cannot have [hardware/software] and Services quoted on the same order. That includes [professional services,] RE, or any other custom work.
> Ixia cannot deliver the quarter or meet revenue recognition any longer if we continue to book orders in this manner …
> Its [sic] not a business choice. It's a business reality …

Ixia hoped to achieve two important goals with its "Split POs" plan. First, in sales that included both software and professional services, Ixia could recognize the revenue from software immediately because professional services had been excised from the sale. Second, Ixia planned to separately establish VSOE for professional services through the misleading "Split POs" as if they reflected the substance of a stand-alone negotiation.

"The SEC has one of the strongest civil and administrative enforcement programs in the world. While we have no criminal authority, we have tremendous investigative powers. As you will hear, we routinely compel production of bank records, emails, cell phones and take testimony under oath."

Acting Chairman Michael Piwowar
U.S. Securities and Exchange Commission
Washington D.C
March 27, 2017

Remarks Before the 27th International Institute for Securities Market Growth and Development

Both notable goals, but both resulting from structure and form that had no basis in the substance of the negotiation, packaging, and delivery of Ixia's products and services.

Per the SEC, using "Split POs" violated Ixia's revenue recognition policy and circumvented Ixia's internal accounting controls. "Split POs" also created a trail of sales documentation, including sales quotes, purchase orders, and invoices that did not accurately reflect the true nature and substance of the sale.

Interestingly, Ixia's audit committee identified the "Split POs" plan after learning about integrity problem's with the company's former CEO and conducting an investigation into company practices. The former CEO apparently lied about his undergraduate and graduate degrees when he was hired as a salesperson for the company, many years before becoming the CEO. This case serves as another example as to why management integrity is essential in general, and to, financial reporting.

Needless to say, there are a plethora of areas where law and accounting overlap and work in unison to support and report the economic events and transactions that a business experiences and conducts. Examples include customer contracts such as described above with Ixia, leases, licenses, related party transactions, employment contracts, and many more. Indeed, there are many ways to be creative in crafting legal structures and contracts, but reporting substance when making financial statement assertions and judgments must always control for the statements to be fairly stated, free from material misstatement, and importantly, not misleading to the user of the information.

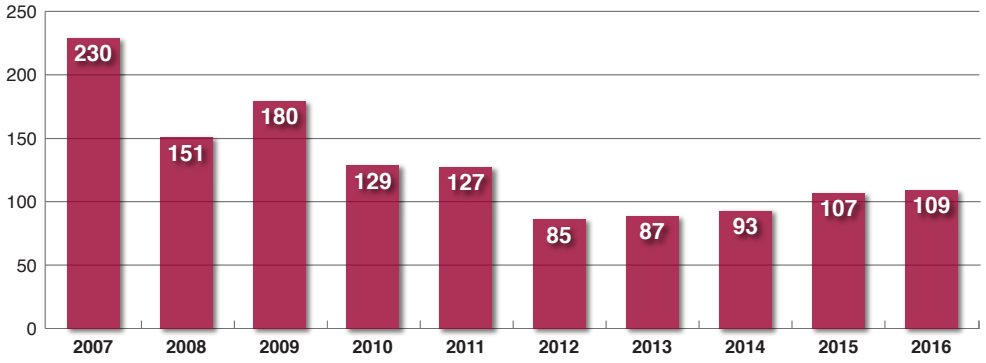
As one can observe from the Ixia case, it is imperative that companies report their activities in a manner consistent with the substance of their business operations as required by GAAP.

Prior Period Comparisons: Year over Year Statistics

As described in the section titled "Our Process and Methodology," AAERs are intended to highlight certain actions and are not meant to be a complete and exhaustive compilation of all 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.

Looking Back at Total AAERs in Preceding Years

For The Periods January 1 – December 31,



"As part of considering management's disclosure controls and procedures it is important for audit committees to understand corporate policies in this area and if such a policy does not exist to understand the reasons why. It can also be useful to understand who is responsible for administering the policy—how many times have they approved changes in reporting, why, and should the change be communicated to investors through disclosure."

Wesley R. Bricker
Chief Accountant
Office of the Chief Accountant
Knoxville, TN
March 24, 2017

Remarks before the University of Tennessee's C. Warren Neel Corporate Governance Center: "Advancing the Role and Effectiveness of Audit Committees"

www.floydadvisory.com

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For more information, please contact Joseph J. Floyd at 212.867.5848.

ABOUT Floyd Advisory
Floyd Advisory is a consulting firm providing financial and accounting expertise in areas of Business Strategy, Valuation, SEC Reporting, and Transaction Analysis.

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