Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended June 30, 2017

Q2 REPORT 2017

CONTENTS

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 June 30, 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
JULY 2017

The Q2 2017 AAERs: Highlights

- The L3 Communications release featured in Our Recommended Reading section demonstrates the importance of avoiding misleading legal phrases and advocacy on subjects that may be misunderstood for financial reporting purposes; certainly a useful read for litigation counsel.

- Notably, 76% of the AAERs in the second quarter of 2017 involved Rule 102(e) sanctions. We look into some trends and highlights among Rule 102(e) actions over the past 5 years in our Special Feature, including:
  - — What types of sanctions are most often administered?
  - — Who is receiving sanctions?
  - — When negotiating sanctions, are certain terms and provisions under the rules more favorable than others?

- Remarkably, the improper use of confidential information is not confined to Corporate America, as the SEC sanctioned one of its own employees for flouting ethics rules by trading prohibited securities and subsequently concealing such activity from the Commission.

- Finally, we continue to observe a lower volume of overall AAER activity compared to historical levels, an observation that may shift once the changes in the SEC's leadership are in place. The SEC named Stephanie Avakian and Steven Peikin Co-Directors of the Division of Enforcement on June 8, 2017.

Our Process and Methodology

The SEC identifies and discloses enforcement actions related to accounting and auditing 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.

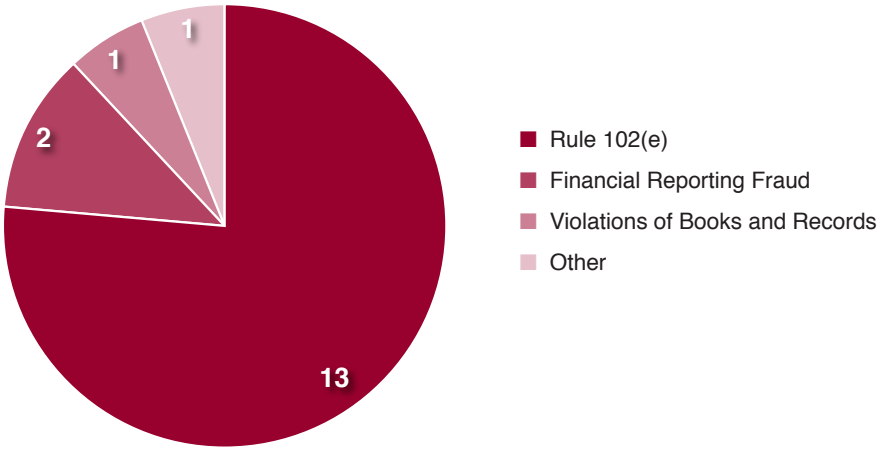
To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, www.sec.gov.

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 (e.g., 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 Q2 2017 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed seventeen AAERs during Q2 2017, with 102(e) actions representing 76% of the total releases.

Q2 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.

Rule 102(e) Actions

Rule 102(e) actions involve the censure or, on a temporary or permanent basis, the 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 or 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.

Fifteen individuals received Rule 102(e) sanctions. Fourteen 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:

- ***Two auditors were accused of failing to comply with PCAOB auditing standards during their audit of an investment company, which was allegedly engaged in a fraud involving the misappropriation of at least $16 million.*** Between 2013 and 2014, the investment company used investor funds to purchase small unsecured consumer loans, and allegedly generated profits through collection of interest payments on the loans. The SEC states that the company's managing partner used an intermediary to issue fictitious loans and in turn diverted the loan proceeds to his own bank accounts. Additionally, the investment company misappropriated funds that were purportedly used to purchase accounts receivable from Philippine companies as part of a factoring agreement.

"Our collective work benefits savers and workers, including teachers, factory workers, farmers, nurses, members of our military, and veterans, as well as many others. … From the SEC's perspective, working in the public interest has been integral to our three-part mission to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation."

Wesley Bricker
SEC Chief Accountant
New York, NY
May 4, 2017

Remarks before the 2017 Baruch College Financial Reporting Conference: "Advancing Our Capital Markets with High-Quality Information"

According to the release, the respondents failed to "act with due professional care and exercise professional skepticism," "obtain sufficient appropriate audit evidence," and "prepare proper audit documentation" during their 2014 fiscal year audit, and as a result, did not uncover these fraudulent acts.

- ***An SEC employee allegedly violated ethics standards by improperly trading options and other prohibited securities for his own benefit, as well as that of his family and friends.*** According to the SEC, the employee actively concealed this trade activity from the SEC's Ethics Office by not seeking pre-clearance for the trades and falsely reporting his security holdings. According to the release, the respondent made false representations on forms filed with broker-dealers and annual certifications of his trading activity to the SEC. In 2014, when confronted by the SEC's Office of Inspector General, the employee denied trading options or trading in his mother's brokerage account while employed at the SEC.

- ***A semiconductor manufacturing company based in South Korea and publicly traded in the U.S. was accused of violating the antifraud, books and records, and internal control provisions of federal securities laws.*** From 2011 to 2013, the company allegedly overstated its revenues and delayed or avoided expense recognition to meet publicly announced gross margin targets. The SEC claims that in one instance, certain employees engaged in "channel stuffing" by creating undisclosed agreements to incentivize customers to receive shipments of products before they originally wanted. The SEC also alleges that the company created false records indicating that unfinished inventory had been completed and shipped to customers, and also manipulated accounts receivable to make it appear as if customers were paying down their balances, when in fact they were not. According to the release, the company materially misstated its financial statements in its publicly filed reports, and also falsely stated that it had met its revenue and gross margin goals for the ten quarters following its IPO. The company's stock price rose nearly 70% over the relevant period and the company obtained more favorable interest rates based on these financial results. After the company self-reported certain revenue recognition issues, the stock price dropped nearly 50%.

- ***The SEC accepted settlement offers from the President, CAO, and Accounting Manager of two merged infrastructure service companies alleged to have improperly recognized revenue using a percentage of completion method in order to overstate earnings in public filings.*** According to the SEC, the three respondents requested premature invoices from subcontractors in order to recognize revenue on their long-term contracts prior to meeting revenue recognition requirements. The release states the company failed to prevent or detect this fraud due to a lack of sufficient internal accounting controls. The stock price dropped 50% from $3.01 per share to $1.52 per share when this issue was disclosed publicly. Per the release, the respondents committed or caused various violations of the antifraud, internal accounting controls, books-and-records, and reporting provisions of the federal securities laws.

- ***According to the SEC, an auditor engaged in improper professional conduct and aided, abetted, and caused violations of the federal securities laws in connection with audit engagements.*** The respondent allegedly failed to obtain Engagement Quality Reviews as required by the PCAOB auditing standards while conducting an audit of an issuer client and two broker-dealer clients. Then, according to the SEC, he falsely represented that the audits were conducted in accordance with PCAOB standards. Per the release, the respondent failed to comply with PCAOB auditing standards concerning, among other things, audit risk, related parties, the confirmation process, audit documentation, evaluating audit results, communication with audit committees, and due professional care in the performance of work. The SEC also claims that the respondent violated the Commission's auditor independence requirements.

"It is important to remember that different factors and influences can impact the risk of fraud. At its core, fraud is the result of decisions or actions by individuals. As such, management should carefully consider how the transition to new GAAP standards will affect opportunities, incentives, pressures, attitudes, and rationalizations in a manner that could drive changes to previously identified fraud risks. These considerations also play an important role in the design and effectiveness of internal controls that mitigate those risks."

Sylvia E. Alicea
Professional Accounting Fellow
Office of the Chief Accountant
Washington D.C.
May 8, 2017

Remarks before the
Bloomberg BNA Conference
on Revenue Recognition

- ***The SEC alleges that an escrow agent knowingly made material misrepresentations and omissions to individuals and businesses by misleading them about the use of their funds to purchase securities.*** According to the release, the respondent claimed to be able to arrange commercial loans for investors if they deposited 10% of the anticipated loans with the escrow agent. The SEC claims that the agent misled these individuals and businesses into believing that their money would be used to buy liquid, "government-backed" securities that the company would leverage in order to fund a loan. Instead, per the claim, the agent siphoned off escrow funds as payments to himself, his company, and others; and with the remainder, purchased volatile, illiquid securities derivatives that lacked any meaningful government guarantee. The respondent is alleged to have diverted to himself at least $105,000 of the escrow client funds, and at least an additional $490,000 of those funds to his company and its associates.

- ***An audit partner entered into a settlement with the SEC related to allegations of improper professional conduct.*** According to the release, the respondent repeatedly violated professional standards while performing an audit of an oil and gas investment fund by failing to conduct the audit in conformity with Generally Accepted Auditing Standards ("GAAS"). The claim states that the audit partner was aware of, but failed to adequately respond to the fact that the fund's financial statements failed to separately report the fair value of the investment in each oil and gas royalty interest, as required by Generally Accepted Accounting Principles ("GAAP"). In addition, the SEC alleges that the respondent knew that adequate procedures had not been performed in auditing the fair value of the investment and concealed this fact from other audit personnel. The release also states that the respondent did not perform adequate audit procedures on the fund's schedule of investments to obtain sufficient evidence for their fair value. The SEC also claims that the audit partner failed to adequately plan and assess the risk of the oil and gas investment fund audit before commencing field work for the audit.

"However, it's important for management to remember their responsibility to keep books, records, and accounts that accurately reflect their transactions and to maintain internal accounting controls designed to provide reasonable assurance that their transactions are recorded in conformity with GAAP."

Sylvia E. Alicea
Professional Accounting Fellow
Office of the Chief Accountant
Washington D.C.
May 8, 2017

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Violations of Books and Records

This quarter we categorized one AAER 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. This release resulted in over $1.5 million in total penalties as part of settlements with the United States Department of Justice.

- ***The CEO of a biopharmaceutical company allegedly arranged to have more than 100 internet articles published to promote the company.*** According to the SEC, the CEO hired two different firms to write favorably about the company on various investment websites without disclosing that the company had compensated the writers above and beyond what they would typically be paid by the websites to write the articles. The claim also states that the writers repeatedly lied about not receiving any payment from the company. Per the release, these omissions and misrepresentations were a violation of anti-fraud and anti-touting provisions of federal securities laws. The biopharmaceutical company also violated the periodic reporting and books and records provisions of federal securities laws by including stock options as part of the compensation paid to one of the firms that published the articles which, according to the SEC, constituted an unregistered transaction. Furthermore, upon exercise of the options, the biopharmaceutical company effectively sold shares to one of the two marketing firms which, again according to the SEC, constituted an unregistered, non-exempt transaction, and did not take "reasonable care to prevent further distribution of the shares." The SEC claims the company and its CEO misstated that the company had not issued unregistered securities during the relevant periods, and also failed to record the stock option expense in its income statement conduct that occurred over nearly a decade.

Financial Reporting Frauds

We categorized two AAERs as financial reporting frauds during the quarter, including this quarter's Recommended Reading and the following:

- ***According to the SEC, the CEO and CFO of a multinational freight forwarding and logistics company failed to include adequate information in the Management's Discussion & Analysis section of financial statements.*** Per the release, the omissions prevented investors from meaningfully assessing the company's financial condition and results of operations, particularly related to its future prospects. Specifically, the CEO and CFO allegedly failed to properly disclose that the company sought amendments or waivers of its debt covenants due to poor operating results and that customers were not being issued invoices in a timely fashion due to the implementation of a new system, resulting in historically low cash inflows. According to the claim, in public filings, the company violated the Exchange Act by attributing a material decrease of the company's liquidity to the seasonal nature of its business, rather than identifying the known trend.

The Q2 2017 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in Q2 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
Defalcation	Thefts of funds and assets
Intentional Misstatement of Expenses	Deceptive misclassifications and understatements of expenses
Insider Trading	Trading based on access to confidential information.
Manipulation of Reserves	Improperly created, maintained, and released restructuring reserves, general reserves, and other falsified accruals

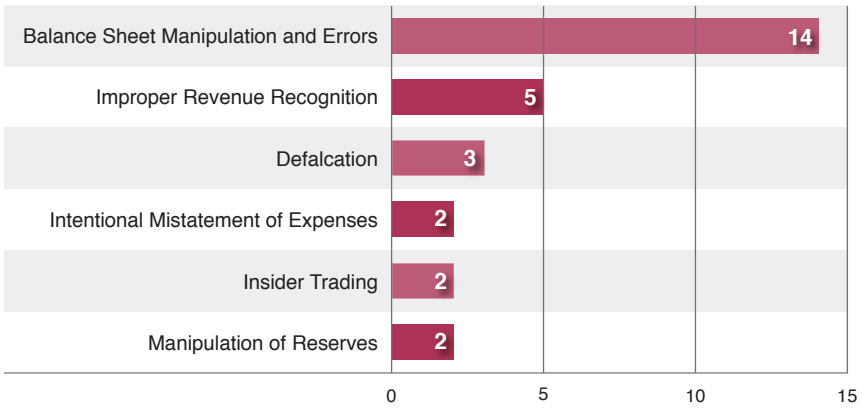
The chart on the next page illustrates the frequency of financial reporting issues by category among all AAERs issued during Q2 2017. Balance Sheet Manipulation and Errors continues to be the most frequent issue among violations with fourteen of the seventeen releases for the second quarter relating to this category. Notably, the only enforcement actions that did not overlap with Balance Sheet Manipulation and Errors were matters related to Insider Trading.

"The credibility of financial statements have a direct effect on a company's cost of capital, which is reflected in the price that investors are willing to pay for the company's securities. Accounting and auditing may not readily grab the general public's attention, but they are nonetheless important to the livelihoods of all Americans."

Wesley Bricker
Chief Accountant
Los Angeles, CA
June 8, 2017

Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: "Advancing the Role of Credible Financial Reporting in the Capital Markets"

Financial Reporting Issues Identified in Q2 2017 AAERs



Notable Q2 2017 AAERs for "Recommended Reading"

"Potential examples related to areas of judgment susceptible to management bias include the identification of performance obligations, the estimation of standalone selling price for distinct goods and services, as well as the estimation of variable consideration when determining the transaction price. It is important for management to consider whether new or changes in internal controls are warranted to reduce the risk associated with management bias."

Sylvia E. Alicea
Professional Accounting Fellow
Office of the Chief Accountant
Washington D.C.
May 8, 2017

Remarks before the
Bloomberg BNA Conference
on Revenue Recognition

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.

For this quarter, we selected one AAER to highlight.[1] For legal counsel, this matter makes evident the importance of avoiding misleading legal phrases and advocacy on subjects due to the financial reporting confusion it may cause for clients when forming assertions and determining proper applications of GAAP.

Accounting and Auditing Enforcement Release No. 3868 / April 28, 2017, Administrative Proceeding File No. 3-17950, In the Matter of David Pruitt, CPA

Imagine that you represent a company with a fixed-fee government contract and your client realizes that it may incur a loss on the contract. The client asks you, as legal counsel, to help find ways to charge the government more so that the company can avoid reporting a loss.

You review the contract, work with the company's finance team, craft legal arguments, and prepare a draft claim for additional amounts owed from the government. You also advise your client regarding the probability of success for each claim based on the company's history with similar government contract disputes.

While you use the phrase "legal entitlement" when describing the claims with your client, you have no responsibility for the financial reporting process and the judgments about the probability of collection and revenue recognition for the possible contract claim recoveries.

A similar scenario appears in a recent accounting and auditing enforcement release issued by the U.S. Securities and Exchange Commission concerning L3 Technologies' ("L3") improper recording of revenue in its Army Sustainment Division. L3 is a contractor for government agencies, including the Department of Defense.

[1] *This article has previously been published in* Massachusetts Lawyers Weekly.

The improperly recorded revenue arose from a fixed-price aircraft maintenance contract between L3's Army Sustainment Division and the U.S. Army, which is referred to as the C-12 contract. Per the release, L3 recognized revenue for the C-12 contract in excess of the contractual amount, and before any commitment to pay additional amounts from the Army was received.

Following an investigation, L3 settled with the SEC and accepted the entry of an order instituting cease-and-desist proceedings, as well as payment of a monetary penalty for internal control violations underlying the financial statement misstatement. Importantly, L3's cooperation and remediation favorably impacted the SEC's actions. In addition, the SEC took action against management and finance individuals involved in the improper recording of revenue. No action appears to have been taken with regard to legal counsel's involvement.

Understandably, it's not legal counsel's role to serve as an expert in revenue recognition. However, awareness of the rules and general requirements can help clients avoid similar problems, especially on matters for which counsel provides assistance.

Background Facts

Note that the following is a brief overview of the information contained in the release; a thorough reading of the release is recommended to appreciate the full context of the facts.

Starting in mid-2013, the Army Sustainment Division's finance team, the general counsel of ASD, and the general counsel of ASD's business segment worked together to estimate that they were "likely to recover" approximately $30 million of the total potential claims, which totaled approximately $50.6 million.

The recovery process would involve a request for equitable adjustment under the contract, and possibly a dispute with the Army if matters could not be resolved amicably.

Per the release, the "likely to recover" estimate was based on the results of the company's historical negotiations with the government, indicating the company had a history of revisiting contract terms and interpretations.

In December 2013, ASD produced a document titled "Army C-12 Contract Dispute Summary," which included a table containing 10 rows with separate claims categories adding up to the $50.6 million. A column on the table was titled "legal entitlement" and applied a discount of either 50 or 60 percent to each claim value comprising the $50.6 million. The presentation acknowledged that ASD planned to meet with the government to reach a resolution and that, "[a]fter the negotiations with the government, L3 is postured to immediately invoice and bill the government."

Before receiving approval for additional payments from the Army, a member of ASD management requested that invoices be generated in L3's accounting system for certain amounts among the potential claims categories, but not be delivered to the Army.

Needless to say, withholding the invoices produced from and recorded in the L3 accounting system was a significant internal control violation. As a result of generating the invoices, ASD recognized an additional $17.9 million in revenue. Of significance and raising management integrity concerns, that amount allowed ASD to meet management incentive bonus targets.

In fact, L3 never collected for the undelivered invoice amounts and never should have recognized revenue for them. To correct for the misstatement, on Oct. 10, 2014, L3 restated its financial statements for the fiscal year ended Dec. 31, 2013, and for the first quarter of 2014. Among other things, L3 disclosed that it was revising its financial statements to reverse amounts improperly recognized as revenue related to the C-12 contract.

"Even as individual firms continue to invest in their own proprietary systems, methods, and techniques, I also encourage firm leadership to remain focused on supporting and fostering an open approach to innovation through supporting professional standard setting activities, so that the audit profession as a whole is well-positioned to advance the role of audit in meeting the needs of investors and other stakeholders."

Wesley Bricker
Chief Accountant
Los Angeles, CA
June 8, 2017

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Legal Entitlement

The phrase "legal entitlement" is worthy of vetting for the financial reporting confusion it may cause when evaluating the revenue recognition standards.

Importantly, legal entitlement appears to be a misnomer when applied to the facts described in the release. An entitlement is defined generally as "the fact of having a right to something." Prefaced with "legal," the word "entitlement" implies the existence of a statutory or other right under the law. When dealing with contract recoveries and interpretations, especially a fixed-fee government contract, that creates a potentially misleading situation.

In contrast to the certainty the phrase portrays and its potential misunderstanding, the very existence of counsel's judgments on the probability of success for each claim would seem to negate the certainty of the amounts presented as legal conclusions regarding collectability when using the phrase "legal entitlement."

Based on the limited information in the release, the extent to which this phrase was relied on when making financial reporting judgments is unclear.

GAAP Standards

Putting aside the potential financial reporting misunderstanding from the phrase "legal entitlement," the facts presented in the L3 release raise interesting discussion points regarding the application of Generally Accepted Accounting Principles, or GAAP, and how L3 may have viewed its ability to recognize revenue.

For foundation, L3's revenue recognition policy is consistent with GAAP and sets forth four major requirements that must generally be met before revenue can be realized and earned: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the seller's price to the buyer is fixed or determinable; and (4) collectability is reasonably assured.

Of significance, per the release, L3 failed to deliver the invoices to the Army. Thus, there is little basis to debate that collectability could be reasonably assured as of year-end if the Army didn't have them.

In addition, collectability could not be reasonably assured for the claims that L3 was asserting against the Army, because no agreement to pay had been reached.

As of year-end, the claims appear to be gain contingencies under GAAP. Guidance on accounting for contingencies can be found in ASC 450, which addresses both loss and gain contingencies.

Many aspects of financial reporting are founded in the principle of conservatism. Perhaps the greatest example relates to contingencies, which are defined as events that cannot be predicted with certainty.

Notably, loss contingencies should be accrued when the loss is probable and may be reasonably estimated. If the loss is only possible, then while not accrued in the financial statements, disclosure in the footnotes may be appropriate and even required.

However, gain contingencies, such as recoveries from lawsuits, are not allowed to be accrued. In fact, the L3 claims for recovery from the C-12 contract have all the characteristics of a classic gain contingency. As such, under GAAP and as gain contingencies, the claims amounts should never be recorded before a commitment to pay arises or, if in the dispute process, a final judgment.

That said, if L3 didn't envision the need for a formal dispute process with the Army based on the history of their dealings, one could understand how L3 may have been analogizing

"Second, I have previously emphasized the importance of disclosures in the new revenue recognition standard. The new revenue disclosures may require the disclosure of different data and information than previously provided, potentially necessitating updates to existing processes and controls. I encourage companies to ensure they are dedicating the appropriate resources to planning for preparation of those disclosures."

Wesley Bricker
Chief Accountant
Los Angeles, CA
June 8, 2017

Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: "Advancing the Role of Credible Financial Reporting in the Capital Markets"

the recording of revenue to the GAAP guidance for sales with a right of return. That's not the proper treatment, but the facts in the release are sufficient to ponder if L3 envisioned that recording a revenue estimate was reasonable based on that approach.

For context, under GAAP, companies may recognize sales with a right of return if and only if a reasonable estimate may be established for sales returns based on historical experience with the sales of similar products. Following this approach, the company estimates the percentage that will be returned and reports the net amount that will not be returned as revenue.

If one analogized to those rules, the estimate for the claims for L3 would represent the sales volume amount, and the probability of success would represent the net reportable and assumed collectable amount, after estimating the historical rate of returns.

While seemingly analogous, there is an important distinction between L3's claims that are properly reported as gain contingencies and the guidance for sales with a right of return. The sale of product with a right of return is in fact a sale, whereas the claims amount is subject to negotiation and possible dispute resolution.

Identifying that distinction is vital to appreciate the lack of proper applicability for these rules to the L3 facts as presented in the release. And yet, from reading the release, one can see where L3, while aggressive, may have been trying to report a reasonable amount for revenue recognition taking this analogous posture.

Again, legal counsel is not responsible for the GAAP decisions that clients make. But sensitivity to how clients may use the advice, words and actions of counsel when forming financial statement assertions can significantly mitigate risks for improper applications of GAAP.

"Finally, companies should consider whether it would be beneficial to obtain insight into their other reporting processes from those outside of the finance and investor relations functions. Sometimes a fresh perspective can provide new insight into potential risks and ways to maintain the effective operation of essential controls and procedures."

Wesley Bricker
SEC Chief Accountant
New York, NY
May 4, 2017

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Special Feature

Dissecting the SEC's Favorite Weapon: Rule 102(e)

Approximately 76% of the SEC's Accounting and Auditing Enforcement Releases reported during the quarter ended June 30, 2017 are for Rule 102(e) sanctions against individuals; a quarterly percentage that reflects a record high for at least the prior five-year period.

While the percentage of Rule 102(e) actions among overall AAERs is impacted by the recent lower volume of AAERs, evaluating and understanding the facts and trends within the Rule 102(e) population remains key. Answers to the questions below can provide valuable insights for defense counsel and individuals involved in SEC enforcement investigations.

- What types of sanctions are most often administered?
- Who receives sanctions?
- When negotiating sanctions, are certain terms and provisions under the rules more favorable than others?

For background, under Rule 102(e), the SEC has the power to suspend and disbar professionals from appearing or practicing before the Commission on behalf of public registrants. Of note, there are three types of Rule 102(e) actions; simply denoted by section as (1), (2), and (3).

The first category, Rule 102(e)(1) actions, involves censuring a person or denying that person, temporarily or permanently, the "privilege of appearing or practicing" before the SEC based on findings that the individual:

- Does not possess the requisite qualifications to represent others;
- Is lacking in character or integrity or has engaged in unethical or improper professional conduct; or
- Has willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

Importantly, with respect to persons licensed to practice as accountants, "improper professional conduct" under Rule 102(e)(1)(ii) means:

- Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or
- Either of the following two types of negligent conduct:
  - A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
  - Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

The second category, Rule 102(e)(2) actions, is specifically for individuals who have had a professional license suspended or revoked, or have been disbarred by a court of the United States or of any State. Additionally, this category also includes any person who has been convicted of a felony or a misdemeanor involving moral turpitude.

Finally, the third category, Rule 102(e)(3) actions, is limited to temporary suspensions stemming from proceedings brought by the Commission in any court of competent jurisdiction.

As described above, Rule 102(e) actions represent a significant portion of total reported AAERs. Remarkably, over the last five years, more than 260 individuals have received Rule 102(e) sanctions, and such actions account for almost 50% of all AAERs during this period of time.

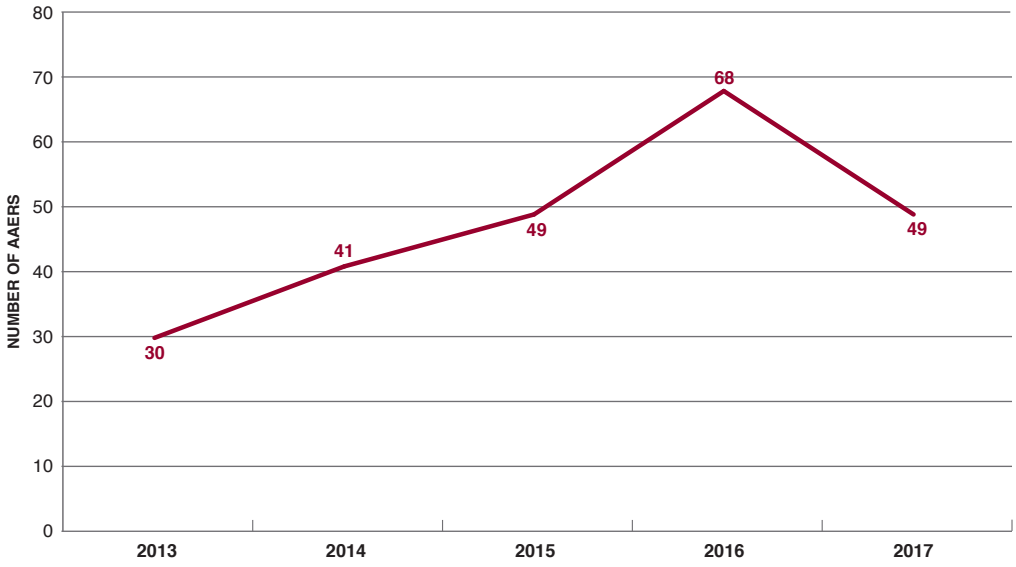
The chart below reflects the volume for Rule 102(e) actions annually, and many actions include sanctions for more than one individual.

"We often witness the devastation suffered by victims of securities fraud. Whether fraudsters cold-called their victims to peddle their fraudulent "investment opportunities", or sat beside them in church, the results were the same."

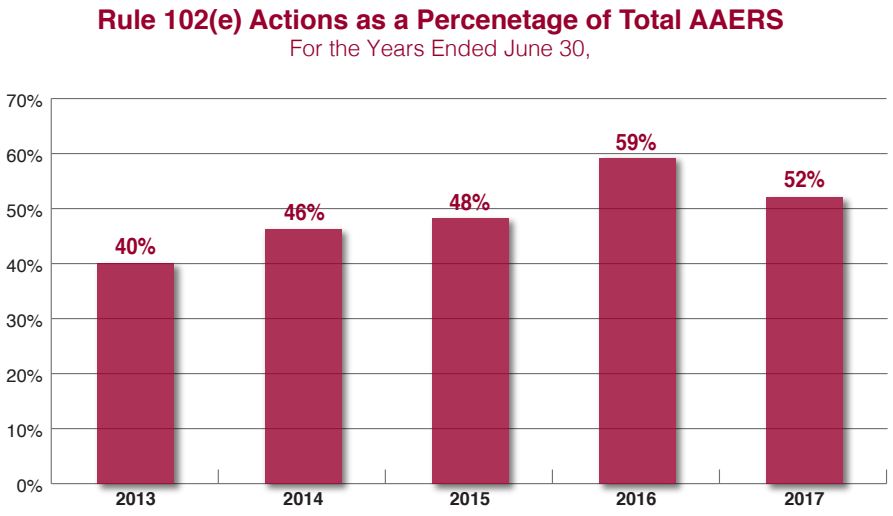
Kara M. Stein
SEC Commissioner
Washington D.C
May 9, 2017

Closing Remarks at
North American Securities
Administrators Association
Section 19(d) Conference

Total Rule 102(e) Actions by Year
For the Years Ended June 30,

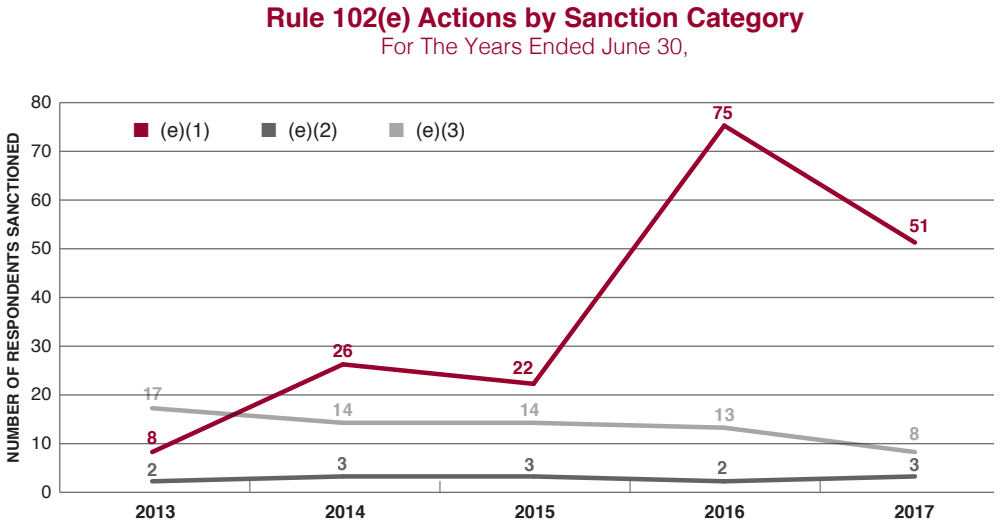


For this same period of time, Rule 102(e) actions as a percentage of total AAERs is as follows:



With this background for the rules and volume of recent Rule 102(e) actions, let's address the key questions raised above.

What types of sanctions are most often administered?
As illustrated below, the increase in Rule 102(e) actions in recent years is concentrated in sanctions that cite Rule 102(e)(1). Actions filed under the other two provisions remained relatively consistent over the same time period.



Who receives sanctions?
Among the population of individuals receiving Rule 102(e) sanctions from the SEC are "C" level executives, finance and accounting personnel, attorneys, auditors, and others. Auditors, however, stand out when observing trends among these groups.

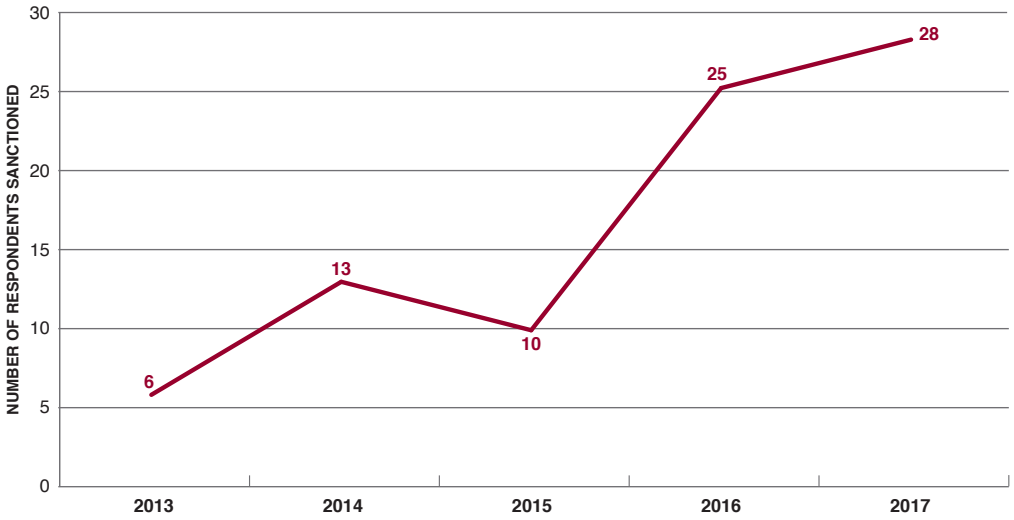
The chart on the next page reflects the increase in Rule 102(e) actions involving auditors. In fact, auditors received almost the same number of Rule 102(e) sanctions as corporate officers for the five years ended June 30, 2017, with an increasing volume for auditors in more recent years. Notably, sanctions for auditors exceeded those for corporate officers during the twelve months ended June 30, 2017 by a two to one margin.

"Similar to non-GAAP financial reporting, key operating metrics and forecasts may also be distorted via bias—for example, painting a potentially misleading picture—error, or fraud, all of which undermine the credibility of the reporting. Therefore, it is important that companies proactively and thoughtfully address risks to their reporting."

WWesley Bricker
SEC Chief Accountant
New York, NY
May 4, 2017

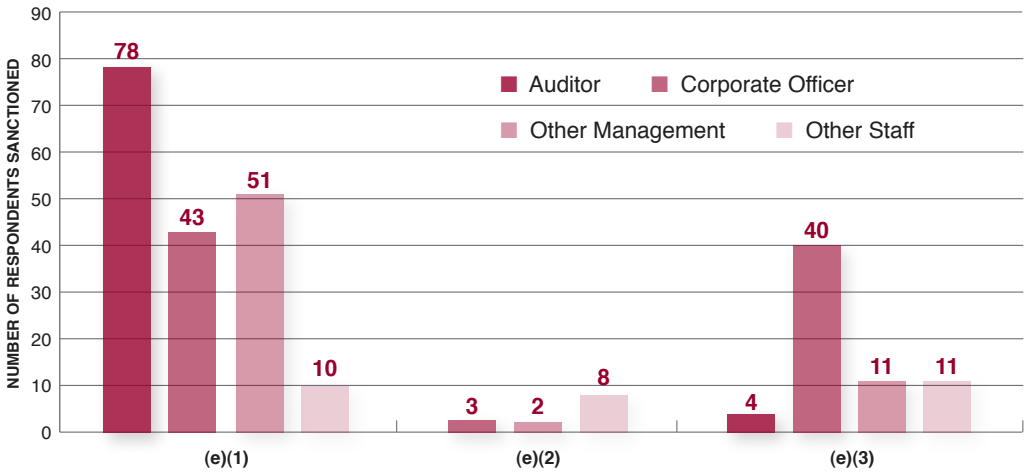
Remarks before the
2017 Baruch College Financial Reporting Conference:
'Advancing Our Capital Markets with High-Quality Information'

Rule 102(e) Actions Involving Auditors
For the Years Ended June 30,



The link between the increases in sanctions for auditors and Rule 102(e)(1) actions is demonstrated below. More auditors are being sanctioned, and more often than not, under Rule 102(e)(1). The following chart represents the five years ended June 30, 2017.

Rule 102(e) Actions by Respondent Role
For The Five Years Ended June 30, 2017



When negotiating sanctions, are certain terms and provisions more beneficial than others?

Facts and statistics can be very interesting, however they become even more valuable when used in a meaningful way. As described below, we analyzed the Rule 102(e) data to determine if any observations or trends exist that may be beneficial in negotiations with the SEC. Specifically, we sorted the data to assess the impact of various trends and types of Rule 102(e) sanctions on individuals with the potential to be reinstated to appear and practice before the SEC after receiving a Rule 102(e) sanction.

Our process involved compiling information about the individuals receiving sanctions during the five-year period ended June 30, 2017 and comparing the results to those being reinstated during the same period. The specific information we gathered for our comparison included the type of Rule 102(e) sanction and key terms and restrictions made in the sanction—notably the terms "denial of privilege," "suspension," and "cease and desist."

"While there is certainly an element of learning that comes with inspection experience that should inform auditors' future performance, the PCAOB cannot rely on inspections alone to fulfill its mission. Another important tool the PCAOB uses in fulfilling its mission is its enforcement program, which identifies issues that should be addressed through formal disciplinary proceedings. Additionally, the PCAOB fulfills its mission through the establishment and maintenance of rigorous high-quality auditing standards that keep pace with the evolution in financial reporting."

Wesley Bricker
Chief Accountant
Los Angeles, CA
June 8, 2017

Remarks before the 36th Annual SEC and Financial Reporting Institute Conference: "Advancing the Role of Credible Financial Reporting in the Capital Markets"

We further separated the first two categories into those requiring a time period prior to applying for reinstatement and those without a time period. Cease and desist orders do not deny an individual the privilege of appearing or practicing, therefore a waiting period is not applicable.

Importantly, for Rule 102(e)(1) and (3) sanctions, an individual may reapply at any time unless a specific waiting period is defined. For Rule 102(e)(2) sanctions, an individual may only reapply if there is a reversal of the conviction or termination of the underlying suspension, disbarment, or license revocation that gave rise to the sanctions.

The following summaries illustrates the results of our compilation:

Rule 102(e) Actions
For the Five Years Ended June 30, 2017

	"Denial of Privilege"		"Suspension"		"Cease and Desist"
	No Waiting Period	Waiting Period	No Waiting Period	Waiting Period	
(e)(1)	20	111	—	—	51
(e)(2)	—	—	13	—	—
(e)(3)	—	1	39	26	—
Total	**20**	**112**	**52**	**26**	**51**

Reinstatements from Rule 102(e) Actions
For the Five Years Ended June 30, 2017

	"Denial of Privilege"		"Suspension"		"Cease and Desist"
	No Waiting Period	Waiting Period	No Waiting Period	Waiting Period	
(e)(1)	—	12	—	—	—
(e)(2)	—	—	—	—	—
(e)(3)	—	—	—	16	—
Total	—	**12**	—	**16**	—

Based on this data, we made the following observations:

- Individuals receiving Rule 102(e)(3) sanctions are disproportionately more likely to be reinstated than those receiving Rule 102(e)(1) sanctions.
- No one sanctioned under Rule 102(e)(2) sanction received a reinstatement.
- Of significance, only individuals receiving a defined waiting period received a reinstatement.

Therefore, when assessing this information, receiving a Rule 102(e)(3) sanction with a defined waiting period would appear to be the preferred treatment if one wishes to return to practicing and appearing before the SEC at some point in the future.

Finally, one other very significant observation stood out while we reviewed the data—a gender imbalance problem. Notably, the SEC issued 13% of the Rule 102(e) sanctions for the five-year period to women, while none were reinstated during that time period. Unfortunately, the SEC reports who is sanctioned and who is reinstated but nothing is reported on who applies for reinstatement, leaving a list of open questions as to whether women are less apt to re-apply, or be reinstated after re-applying. In any case, it's a peculiar result.

"Well-run public companies have effective internal controls not just because internal controls are a first line of defense against preventing or detecting material errors or fraud in financial reporting, but also because strong internal controls contribute to better internal accountability and information flows, among many other things."

Wesley Bricker
Chief Accountant
Los Angeles, CA
June 8, 2017

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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.

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