



*Summary of Accounting and  
Auditing Enforcement Releases  
for the Year Ended  
December 31, 2018*

ANNUAL REPORT 2018

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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 year ended December 31, 2018.

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  
JANUARY 2019

# Highlights:

- SEC enforcement actions increased from 754 in Fiscal Year 2017 to 821 in Fiscal Year 2018, due in part to increased activity in Q3 2018, the final quarter of Fiscal Year 2018. Nearly half of the Fiscal Year's total enforcement actions, and over half of the Fiscal Year's AAERs, occurred during this quarter.
- 
- The SEC has demonstrated an increased focus on compliance with SEC rules and misleading financial disclosures based on the financial reporting issues identified in the 2018 AAER population. Defined as "SEC filing offenses and financial disclosure errors, omissions, or otherwise misleading representations," the majority of these issues deal with SEC filing requirement transgressions, non-GAAP measures, and other key performance indicators.
- 
- In 2018, the SEC awarded \$168 million to 13 whistleblowers under the Dodd-Frank Whistleblower Program, representing a 243% increase in award money from the \$49 million granted to 12 whistleblowers in 2017 and an increase in average reward from \$4.1 million to \$12.3 million. The SEC granted awards of \$50 million, \$39 million and \$33 million, the 3 largest individual amounts ever awarded under the program.
- 
- In our "Recommended Reading" section, we use the case involving Alliance One International, Inc. as an example of how material frauds can occur at immaterial subsidiaries. We discuss how legal counsel and audit committees with oversight responsibilities can adequately apply scrutiny to the design and operation of internal controls over financial reporting to avoid the types of problems Alliance encountered.

## 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](http://www.sec.gov).*

*As part of our review, we gathered information and key facts, identified common attributes, noted trends, and observed material events. Applying our professional judgment 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). 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. Based on this process and methodology, we prepared a database of the key facts in each release.*

# Highlights from the SEC Annual Report for the Twelve Months Ended September 30, 2018

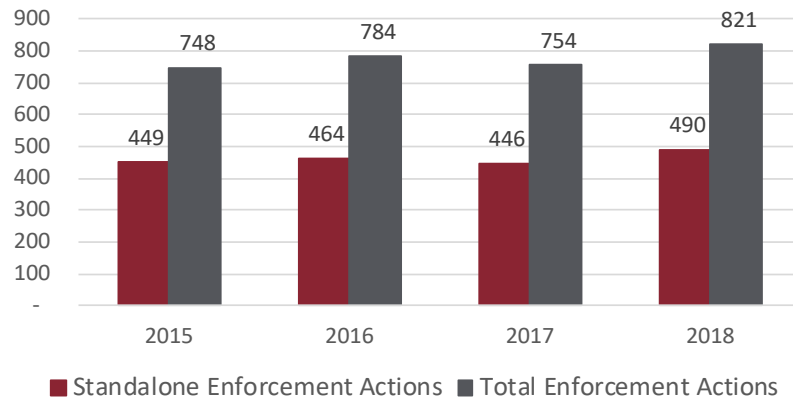
## *Enforcement Actions on the Rise, Driven by Significant Fiscal Year Q4 Activity*

2018 was the second year in a row that the Division of Enforcement used a revised methodology when reporting enforcement action statistics in their Annual Report. For Fiscal Year 2017, the new leadership at the SEC added a level of transparency when issuing the results that has effectively set a new standard for the types of cases that deserve recognition by removing actions associated with a voluntary self-reporting program. Of note, the 821 enforcement actions in Fiscal Year 2018 represents a record high for at least the last fourteen years, even when considering years prior to 2015 where the SEC has not provided revised enforcement action totals that remove the types of actions described above.

“The SEC’s actions over the past year illustrate the premium we place on establishing individual liability where appropriate. In FY 2018, the Commission charged individuals in more than 70% of the stand alone enforcement actions it brought. Those charged include individuals at the top of the corporate hierarchy, including numerous CEOs and CFOs, as well as accountants, auditors, and other gatekeepers.”

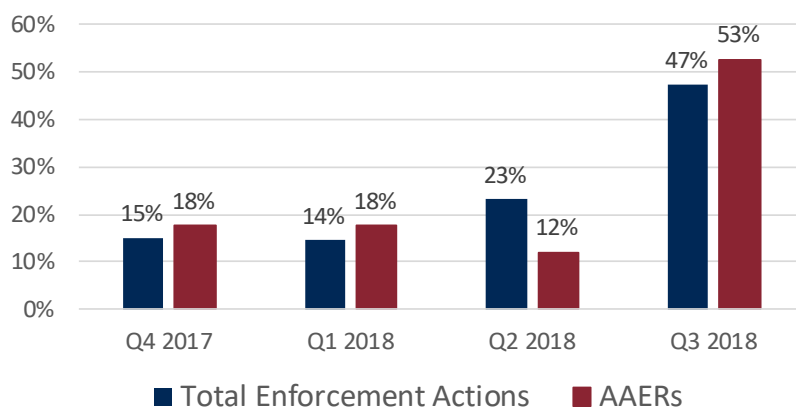
Division of Enforcement  
2018 Annual Report  
November 2, 2018

**Total SEC Enforcement Actions for the Years Ended September 30,**



When looking at the years in which the SEC reported enforcement statistics using this revised methodology, Fiscal Year 2018 saw record highs in both Standalone Enforcement Actions and Total Enforcement Actions. A significant portion of this increase can be attributed to the fourth quarter of Fiscal Year 2018, where 47% of the Fiscal Year’s Enforcement Actions and 53% of the Fiscal Year’s AAERs occurred. This appears to indicate a push by the SEC to bring open cases to closure prior to the end of the Fiscal Year.

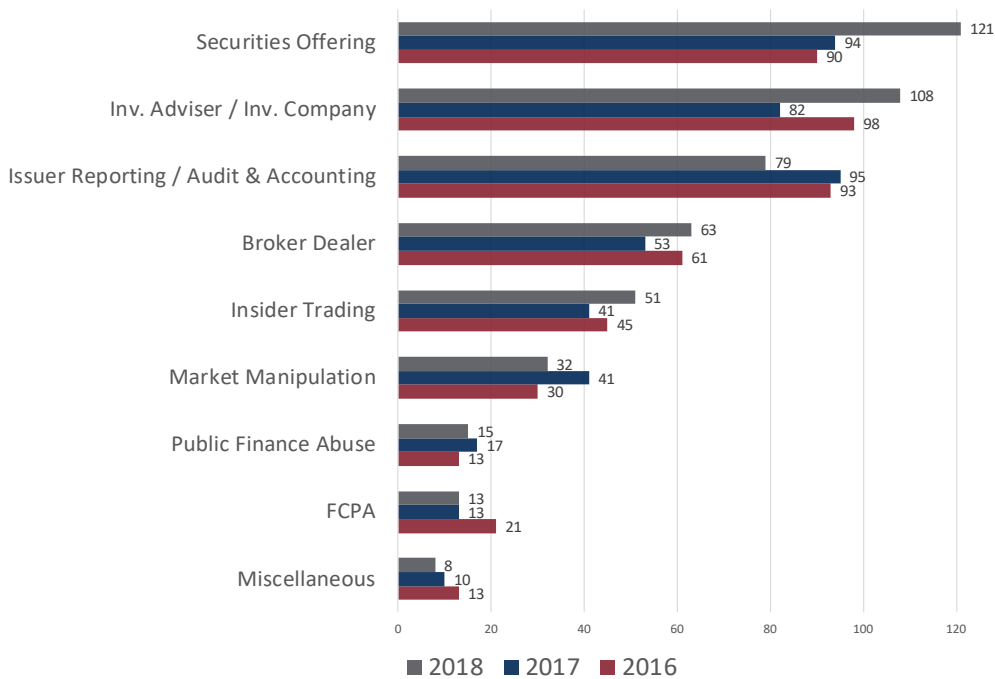
**Percentage of Total Fiscal Year 2018 Enforcement Actions by Quarter**



## Financial Reporting and Auditing Matters Decrease in the Rankings of Enforcement Categories

When reviewing the types of matters handled by the Division of Enforcement for Fiscal Year 2018, a few notable observations are evident. Issuer reporting and accounting and auditing cases fell from most common to third most common among all categories between Fiscal Years 2017 and 2018. The categories with the most significant increases were securities offerings cases and matters involving investment advisors and investment companies, which rose into the top two spots.<sup>1</sup> These two categories each experienced a 4% increase in their share of total enforcement actions between Fiscal Years 2017 and 2018, while the issuer reporting and accounting and auditing category experienced a 5% decrease in its share of the total across the same time period.

### Standalone Enforcement Actions by Classification Fiscal Years 2016 to 2018



“Bars and suspensions are the means by which the Commission prevents wrongdoers from serving as officers or directors of public companies, dealing in penny stocks, associating with registered entities such as broker-dealers and investment advisers, or appearing or practicing before the Commission as accountants or attorneys.”

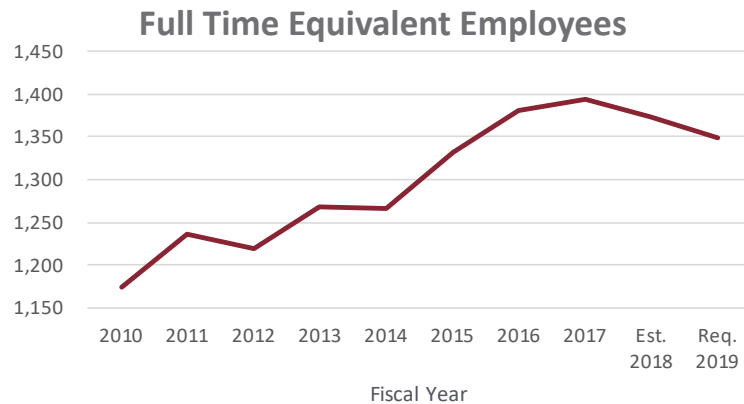
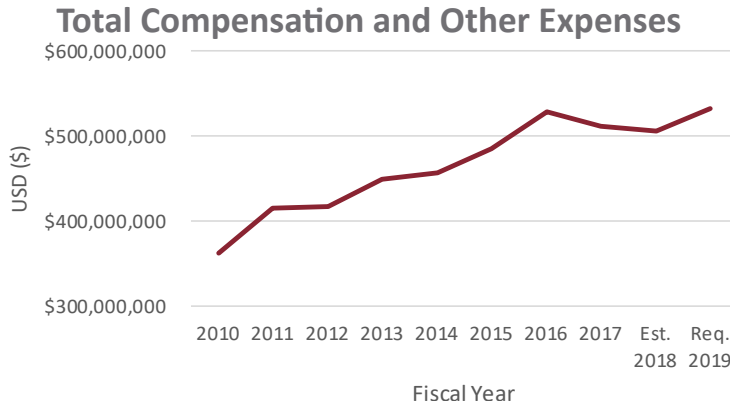
Division of Enforcement  
2018 Annual Report  
November 2, 2018

Standalone Enforcement Actions					
Classification	2018		2017		Difference
	#	%	#	%	
Inv. Adviser / Inv. Company	108	22%	82	18%	4%
Securities Offering	121	25%	94	21%	4%
Insider Trading	51	10%	41	9%	1%
Broker Dealer	63	13%	53	12%	1%
FCPA	13	3%	13	3%	0%
Miscellaneous	8	2%	10	2%	-1%
Public Finance Abuse	15	3%	17	4%	-1%
Market Manipulation	32	7%	41	9%	-3%
Issuer Reporting / Audit & Accounting	79	16%	95	21%	-5%
<b>Totals</b>	<b>490</b>	<b>100%</b>	<b>446</b>	<b>100%</b>	

<sup>1</sup> The “Miscellaneous” category refers to the summation of the following categories: SRO or Exchange, NSRO, Transfer Agent, and Miscellaneous.

### Division of Enforcement: Divergence in Forecasted Operating Metrics

The SEC’s Division of Enforcement also reflects lower estimated spending and personnel levels in Fiscal Year 2018 as compared to 2017. However, we observed a slight increase in the requested budget for Fiscal Year 2019, which suggests they are targeting a return to pre-2017 levels. Despite this, the Division of Enforcement is planning for a decrease in personnel from Fiscal Year 2018 to 2019, which signals a break from the trend of budget and personnel moving in tandem and suggests a change in the Division of Enforcement’s resource allocation.

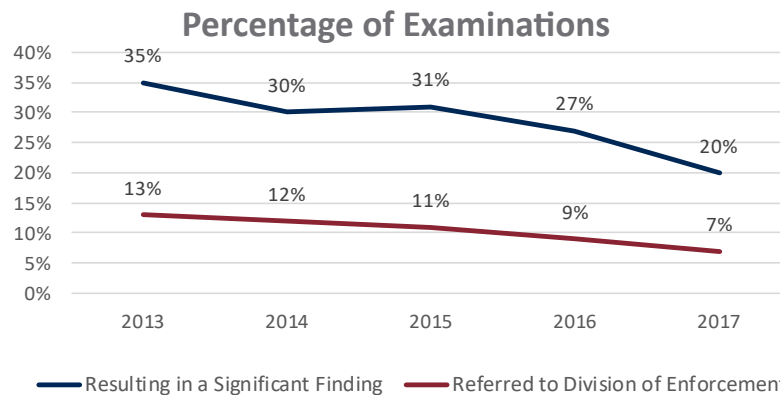


“The SEC oversees approximately \$90 trillion in annual securities trading, the disclosures of approximately 4,300 exchange-listed public companies valued at some \$32 trillion, and the activities of over 27,000 registered entities such as investment advisers, broker-dealers, and self-regulatory organizations. The SEC’s Enforcement Division has the daunting task of ferreting out misconduct and, where appropriate, recommending civil enforcement actions that variously seek injunctions or cease-and-desist orders, penalties, disgorgement of ill-gotten gains, suspensions and bars of bad actors, and the temporary suspension or delisting of securities.”

Steven Peikin  
Co-Director, Division of  
Enforcement  
Cambridge, MA  
December 3, 2018

### Examinations Reveal Improvements in Compliance

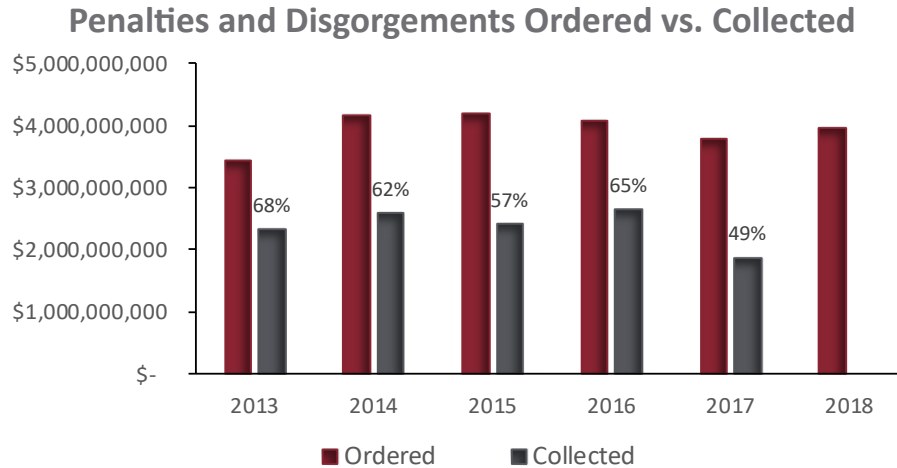
The SEC’s Office of Compliance Inspections and Examinations focuses its reviews on investment advisers, broker-dealers, national securities exchanges, and the PCAOB, among others. Inspections of SEC registrant filings continue to uncover fewer issues, implying improvements in the quality of financial reporting and disclosures. Of significance, for the five years ended September 30, 2017, the percentage of inspections identifying “significant findings”<sup>2</sup> dropped by 15 percentage points, and referrals to the Division of Enforcement dropped by 6 percentage points. Over that same time period, the number of inspections conducted increased by 78%.



<sup>2</sup> “Significant findings” are defined as those that may cause harm to customers or clients of a firm, have a high potential to cause harm, or reflect recidivist misconduct.

## Enforcement Penalties and Disgorgements Should be Reported Net

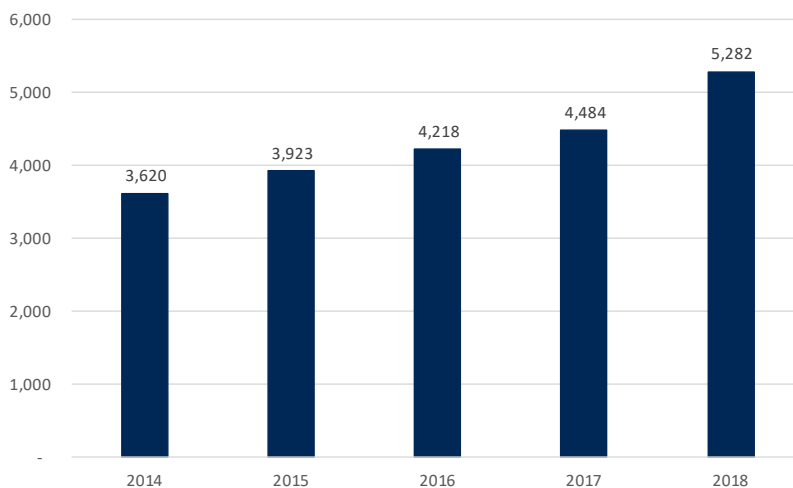
Based on the SEC's collection history for penalties and disgorgement orders, the SEC should consider estimating and disclosing a reserve for uncollectible amounts. The chart below reflects the SEC's ability to convert amounts due into cash over the previous five fiscal years, and indicates a five-year low point for collections in 2017. While the net amounts are substantial, reporting the gross amount alone may be misleading. The SEC has not released 2018 collection data.



## Whistleblower Awards Continue, but Questions Surround the Program's Effectiveness

In Fiscal Year 2018, the SEC's Office of the Whistleblower ("OWB") received a total of 5,282 allegations of wrongdoing. This is approximately 46% higher than the number of allegations received in Fiscal Year 2014. The chart below illustrates the growth in whistleblower allegations for the five years ended September 30, 2018.

### Whistleblower Allegations for the Years Ended September 30,



The OWB awarded over \$168 million to 13 whistleblowers during Fiscal Year 2018. This represents a dramatic increase in monetary awards distributed as compared to Fiscal Year 2017, and notably exceeds the total monetary awards distributed between 2012 and

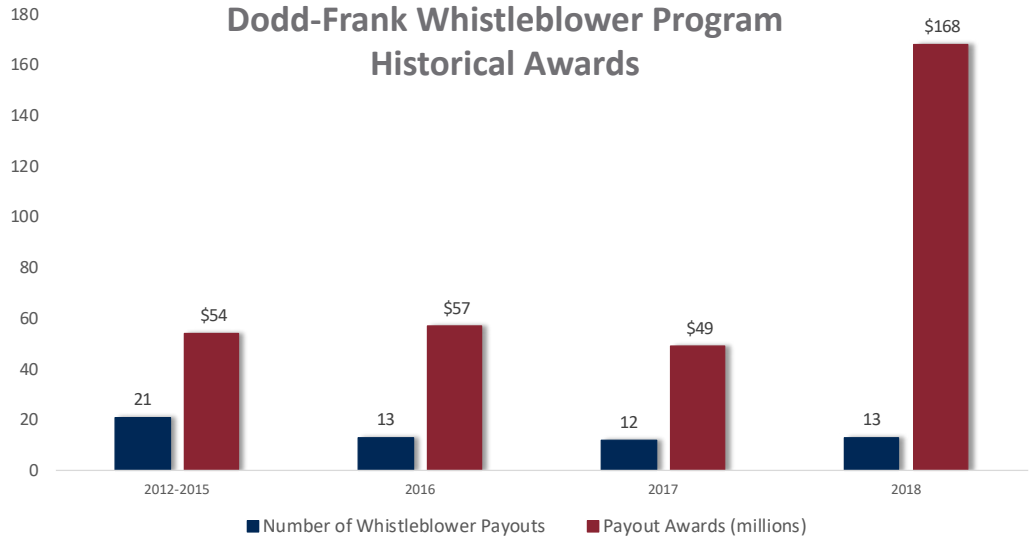
"How much did the SEC collect in penalties in fiscal year 2018? Even if the raw numbers do not tell us anything, surely the amount of penalties the SEC collects in a fiscal year is relevant to assessing how meaningful the cases were, right? Again, not so fast. ... In short, an assessment of the SEC's penalties for a given year is not an analysis of the effectiveness of our enforcement program but simply tells us whether we settled or concluded litigation in a handful of large-penalty cases."

Hester M. Peirce  
Commissioner  
Atlanta, Georgia  
Oct. 26, 2018

Lies and Statistics: Remarks at the  
26th Annual Securities Litigation  
and Regulatory Enforcement  
Seminar

2017. The SEC made two of its largest-ever whistleblower awards in Fiscal Year 2018: a total combined \$83 million award shared by three individuals and an award of almost \$54 million shared by two individuals.

The Dodd-Frank Act’s Whistleblower Program began in August of 2011 and has paid out over \$326 million to 59 whistleblowers since its inception. Of note, the total number of awards paid represents just 0.2% of the total allegations received by the OWB.



“Collaboration with international regulators and law enforcement is critical to the SEC’s civil law enforcement success. In today’s global, interconnected marketplace, fraudulent schemes and other misconduct often have cross-border elements, and the need for cooperation between the SEC’s Division of Enforcement and international law enforcement and regulatory counterparts has never been greater. Our investigations often involve witnesses and evidence in different countries, transactions that cross international boundaries, and the resulting application of multiple different legal systems.”

Any allegation that leads to an investigation resulting in an enforcement action and an award for the benefit of a shareholder is a success. That said, now that the Whistleblower Program has been in effect for several years, it may be time to evaluate the return on investment of the program by weighing the costs against the results.

### *The Globalization of Securities Enforcement Actions*

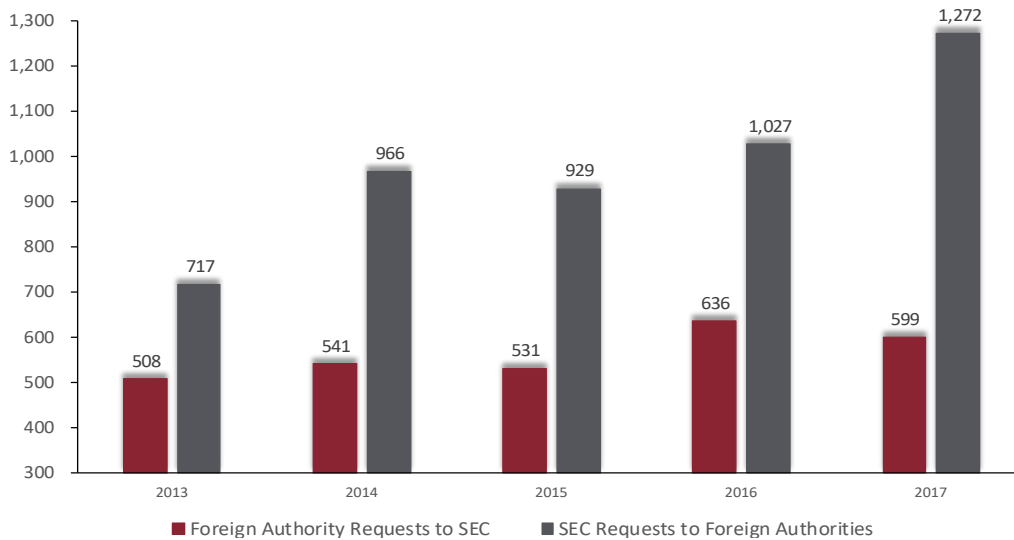
Cooperation among global regulators appears to be reaching new record levels. The SEC Office of International Affairs reported a slight decline in requests from foreign authorities for SEC assistance; however, SEC requests for assistance from foreign authorities saw a significant increase from 2016 to 2017.<sup>3</sup> The SEC has not released 2018 data regarding these requests. In an effort to facilitate this type of communication, the SEC entered into the Multilateral Memorandum of Understanding in 2002, negotiated through the International Organization of Securities Commissions (“IOSCO”), which encourages countries to allow regulators to cooperate with their foreign counterparts.

<sup>3</sup> Section 21(a)(2) of the Securities Exchange Act of 1934 authorizes the SEC to conduct investigations on behalf of foreign securities authorities and compel the production of documents and testimony from any person or entity, whether or not that person or entity is regulated by the SEC. Section 3(a)(50) of the Securities Exchange Act of 1934 defines a “foreign securities authority” as “any foreign government, or governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.” Section 21(a)(2) provides that on request from a foreign securities authority, the Commission may provide assistance if the requesting authority states that it is conducting an investigation necessary to determine whether any person has violated, is violating, or is about to violate any laws or rules relating to securities matters that the requesting authority administers or enforces. The Commission may, in its discretion, conduct such investigation as the Commission deems necessary to collect information and evidence pertinent to the request for assistance.

Steven Peikin  
Co-Director, Division of  
Enforcement  
Cambridge, MA  
December 3, 2018



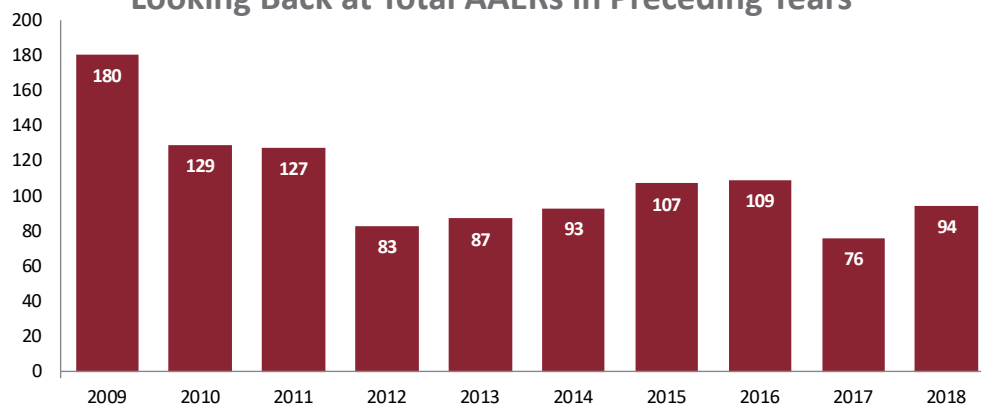
## SEC Requests to and from Foreign Authorities



## AAERs for Year Ended December 31, 2018: Major Observations and Insights

For the year ended December 31, 2018, the SEC issued 94 AAERs, representing a 24% increase in releases from 2017 to 2018.

### Looking Back at Total AAERs in Preceding Years



AAERs highlight enforcement actions related to auditing and accounting matters and the SEC determines whether each enforcement release is categorized as an AAER. In 2018, AAERs comprised 11% of all enforcement actions, a slight increase from 10% in 2017.

To evaluate the type of enforcement action behind each AAER issued in 2018, we sorted the releases into six major categories: Rule 102(e) Actions, Financial Reporting Frauds, Foreign Corrupt Practices Act violations (“FCPA”), Reinstatements to Appear and Practice

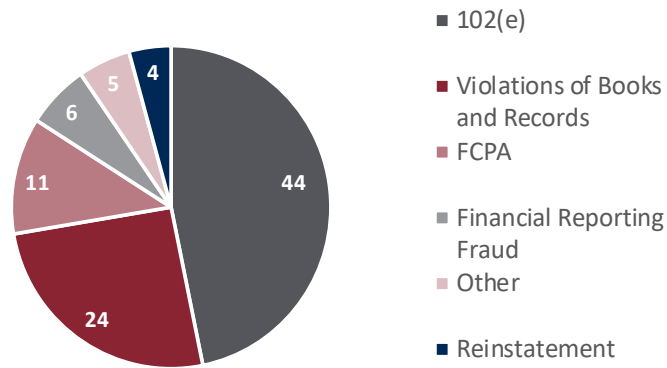
“Many of those who closely follow the work of the Enforcement Division tend to evaluate its effectiveness based on metrics such as the number of enforcement actions the Commission brings each year and the total amount of penalties and disgorgement ordered by the Commission or federal district courts. These quantitative metrics are of some value in assessing the work of the Division; they certainly provide a rough measure of our overall activity level. But statistics such as these do not provide a full and meaningful picture of the quality, nature, and effectiveness of our efforts.”

Steven Peikin, Co-Director, Division of Enforcement  
New York, NY  
October 3, 2018

“Remedies and Relief in SEC Enforcement Actions”

before the SEC, Violations of Books and Records, and Other. The chart below illustrates the number of AAERs in each category in 2018.

**2018 AAERs by Category**



Within the AAERs, nearly half of the actions brought forth by the SEC in 2018 were suspensions or disbarments from practicing before the SEC under SEC Rule of Practice 102(e). These can be temporary or permanent and can be levied against either an individual working at a firm or against the firm as a whole.

## The 2018 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in the 2018 AAERs, we identified the accounting problem(s) in each based on the classification definitions below.

Classification	Definition
<b>Intentional Misstatement of Expenses</b>	Deceptive misclassifications and misstatements of expenses
<b>Improper Revenue Recognition</b>	Overstated, premature, and fabricated revenue transactions reported in public filings
<b>Failure to Comply with SEC Rules</b>	SEC filing offenses and financial disclosure errors, omissions, or otherwise misleading representations
<b>Manipulation of Reserves</b>	Improperly created, maintained, or released reserves and other falsified accruals
<b>Balance Sheet Manipulation and Errors</b>	Misstatement and misrepresentation of asset balances and the recording of transactions inconsistent with their substance

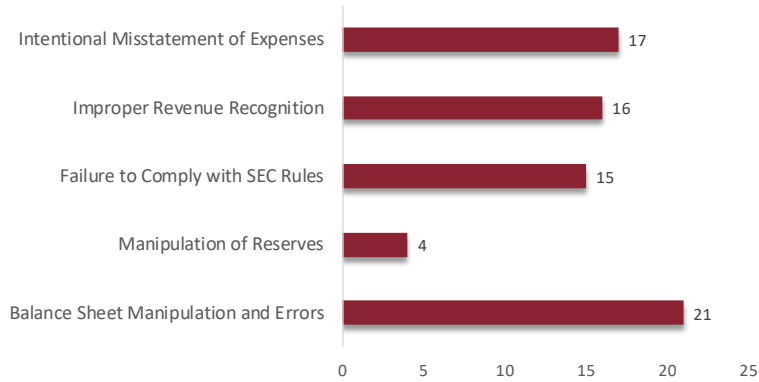
As shown below, intentional misstatement of expenses represents the most common financial reporting issue in the 2018 AAER population. Importantly, we record each accounting problem identified in a release as a separate item. Therefore, many actions that involve improper revenue recognition, manipulation of reserves, and the intentional misstatement of expenses also have a balance sheet impact. For this reason, we do not consider the category of balance sheet manipulation and errors in our ranking of issues.

“In addition to undertakings, the Commission can also seek or impose other forms of forward-looking or remedial relief, such as officer and director bars and associational bars and suspensions. Like undertakings, bars and suspensions are not a punishment. Rather, they serve a critical prophylactic function – preserving the integrity of our markets and protecting investors by limiting the activity of known bad actors by removing them from the industry or preventing them from serving as officers or directors at public companies.”

Steven Peikin, Co-Director, Division of Enforcement  
New York, NY  
October 3, 2018

“Remedies and Relief in SEC Enforcement Actions”

## Financial Reporting Issues Identified in 2018 AAERs

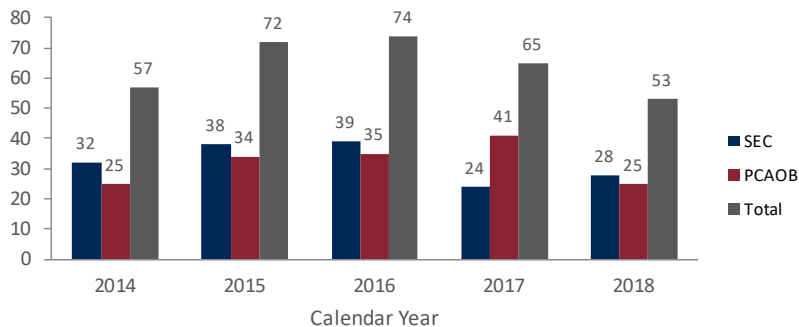


Failure to comply with SEC rules represents an issue of increasing prominence in 2018, constituting just under 25% of the financial reporting issues identified in the 2018 AAERs. The majority of these issues relate to public filings that were not reviewed by an independent public accounting firm, and therefore do not meet the SEC's filing requirements. Also included in this category are errors, omissions, and misstatements related to MD&A, non-GAAP measures, and key performance indicators in public filings and financial statements.

### *SEC and PCAOB Auditing-Related Enforcement and Disciplinary Actions*

The SEC and PCAOB share the responsibility of taking action against auditors who violate SEC codes and professional standards. In 2018, the PCAOB reported a year-over-year decrease in Auditor-Related Enforcement and Disciplinary Actions for the first time in five years. The SEC reported an increase in auditing-related enforcement actions from 2017 to 2018 after reporting its first year-over-year decrease since 2012 in 2017.

## SEC and PCAOB Auditor Enforcement and Disciplinary Actions

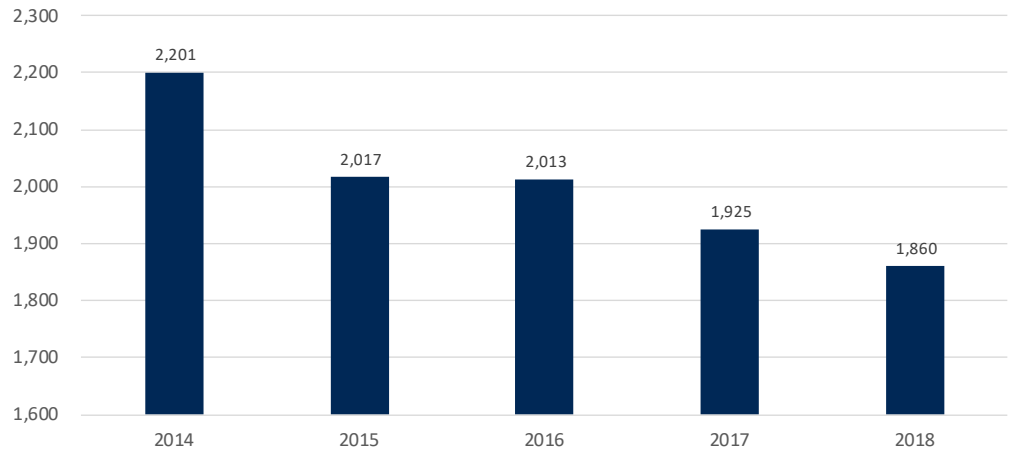


The number of firms registered with the PCAOB has dropped precipitously over the past 5 years, perhaps explaining the recent decrease in enforcement actions assessed by the PCAOB. Note that for 2018, the PCAOB reports that approximately 1,860 public accounting firms are registered with the PCAOB.

“In FY 2018, the Commission brought charges against ... 54 entities and 94 individuals in stand alone actions relating to issuer financial reporting and disclosures in the following categories: revenue and expense recognition problems; faulty valuation and impairment decisions; missing or insufficient disclosures; misappropriation through accounting misrepresentations; inadequate internal controls; and misconduct by financial reporting gatekeepers...”

Division of Enforcement  
2018 Annual Report  
November 2, 2018

## Firms Registered with the PCAOB by Year



“The PCAOB contributes to [investor’s] confidence through its role in overseeing the audits of public companies ... in the preparation of informative, accurate, and independent audit reports. The PCAOB’s responsibilities are broad as it pertains to the audit profession; they include standard-setting, registration and inspection, and investigation and enforcement authority. ... The Commission’s oversight of the PCAOB includes the appointment of its Board members, approval of PCAOB rules and standards, oversight of disputed inspection reports and enforcement actions, and approval of the PCAOB’s budget and accounting support fees.”

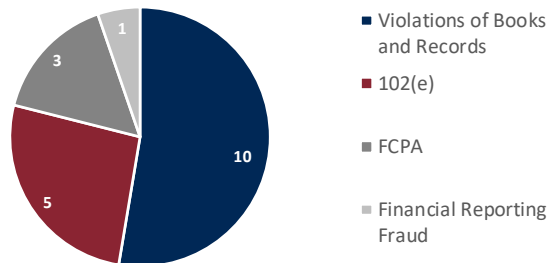
Wesley Bricker  
Chief Accountant  
Washington D.C.  
December 10, 2018

## Overview of Q4 2018 AAERs

As part of our annual report on AAER activity, we provide an abbreviated version of our quarterly reporting for the final quarter of the year.

The chart below illustrates the number of AAERs that fell into each category of violation during the fourth quarter of 2018. Violations of Books and Records led the releases in Q4, accounting for 53% of the total.

### Q4 2018 AAERs by Category



## Notable Q4 2018 AAER 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.

***Accounting and Auditing Enforcement Release No. 3993 / November 9, 2018, Administrative Proceeding File No. 3-18891, In the Matter of Pyxus International, Inc., Respondent.***

The United States Securities and Exchange Commission (“SEC”) recently issued an Accounting and Auditing Release (“AAER”) announcing the settlement of an action against Pyxus International, Inc. (“Pyxus”), a public registrant formerly known as Alliance One International, Inc. (herein referred to as “Alliance”).

Of significance, the Alliance AAER provides valuable insights regarding the risks that companies may encounter when establishing lesser financial reporting controls for remote and smaller business entities; including insights that legal counsel may use to help their clients avoid the problems encountered by Alliance.

Alliance is headquartered in Morrisville, North Carolina and purchases, processes, and sells tobacco leaf, domestically as well as globally. In May 2016, Alliance filed restated financial statements for the years ended March 31, 2015, 2014, and 2013 to correct for accounting irregularities in its Kenyan business unit, Alliance One Tobacco (Kenya) Ltd. (herein referred to as “Kenya”). At the same time, it reported that its internal controls over financial reporting had not been designed or operating effectively, and that material weaknesses existed in its internal control over financial reporting.

Alliance’s financial reporting errors, which occurred over several years, cumulatively decreased the reported amount of inventory by approximately \$32 million, decreased accounts receivable by approximately \$7 million, and decreased retained earnings by approximately \$39 million.

Insights regarding the causes for Alliance’s financial reporting problems may be found in the company’s restatement disclosures including:

The Company’s regional review of operations at African origins was ineffective due to the lack of adequate qualified resources to appropriately examine and investigate financial results. Although the financial information from the Kenya origin was reviewed on a timely basis, the regional review did not incorporate the qualitative and operational context needed to perform an adequate review, which allowed the misstated balances to build up over extended periods of time.

While not stated specifically, presumably Alliance management deemed the Kenya business as lower risk and less material to Alliance’s overall business, thereby providing a lesser level of oversight and scrutiny than its larger business operations.

Alliance is not alone in setting a lower standard for the financial reporting controls at smaller locations. In fact, many companies subject remote locations and/or smaller subsidiaries to a lesser standard of scrutiny over its financial reporting. Even auditors have this mindset when prioritizing their efforts as reflected in the Public Company Accounting Standard Board’s guidance in paragraph 11 of Auditing Standard No. 9, *Audit Planning*, which states:

In an audit of the financial statements of a company with operations in multiple locations or business units, the auditor should determine the extent to which audit procedures should be performed at selected locations or business units to obtain sufficient appropriate evidence to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. This includes determining the locations or business units at which to perform audit procedures, as well as the nature, timing, and extent of the procedures to be performed at those individual locations or business units. The auditor should assess the risks of material misstatement to the consolidated financial statements associated with the location or

**“We have spoken about the importance of identifying and communicating material weaknesses before they manifest in the form of a financial statement restatement. ... However, we encourage ongoing attention, including audit committee participation and training as needed, regarding the adequacy of and basis for a company’s effectiveness assessment, particularly where there are close calls in the assessment of whether a deficiency is a significant deficiency (and reported to the audit committee) or a material weakness (and reported also to investors).”**

Wesley Bricker  
Chief Accountant  
Washington D.C.  
December 10, 2018

Statement in Connection with the  
2018 AICPA Conference on Current  
SEC and PCAOB Developments

business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk of material misstatement associated with that location or business unit.

Taken literally, the standard makes sense; focus the testing where the risks most likely exist. However, when lowering the scrutiny for smaller and/or “immaterial” locations, the process to assess such risks has to be very thorough to avoid oversights and problems; especially if such locations are disregarded for long periods of time.

Below we will provide an overview for Alliance’s business, a summary of the facts reported in the SEC’s release regarding the problems that occurred, and provide recommended questions and considerations for legal counsel to public registrants and audit committees to help assess and avoid similar situations.

Alliance is a global company with approximately \$2 billion in annual revenue. The company has production facilities in nine countries, purchases tobacco in thirty-five countries, and ships products to approximately ninety countries. Based on publicly available information, the Africa division, as a continent, represents less than 5% of the overall business, and the operation in Kenya would therefore presumably represent less than that amount. Alliance grows tobacco in Kenya, which it sells primarily to one customer, making the operation relatively autonomous.

Notably, the Africa division’s oversight of the Kenya business appeared to be limited to inquiry and the receipt of representations, including for the accounts that ultimately proved fraudulent. Of significance, Alliance’s problems occurred over many years and went undetected, thereby resulting in financial irregularities that were material to the overall company.

An overview of the relevant facts from the SEC’s AAER include:

- In June 2015, Alliance announced that it was restructuring its Kenya operations, and not long thereafter terminated the majority of the Kenyan management team.
- During October 2015, Alliance’s African regional management identified discrepancies in the Kenya business’ physical inventory and the major customer disputed the outstanding accounts receivable balance due.
- In November 2015, Alliance announced that the financial statements contained errors including inventory and accounts receivable overstatements, the errors may date back to 2008 or earlier, and could reach approximately \$40 million in aggregate.
- Alliance’s misstated financial statements resulted from improper accounting practices at the Kenya operation including recording fictitious sales, improper revenue recognition, overstating inventory, and understating costs.

As noted by the SEC, the material weaknesses in its internal control over financial reporting included (1) an ineffective regional review of operations in Africa due to the lack of adequate qualified resources to appropriately examine and investigate financial results and (2) Alliance’s fraud risk assessment was not adequately designed or implemented to address the risks of fraud in certain regions. The failures all relate to a flawed assumption that such a material fraud may not occur at a subsidiary, such as the smaller size and presumed simplicity of the Kenyan operation.

“...the managers and employees at the firms for which you work are the first line of defense. In doing their jobs, these employees and executives should strive to act in a manner that is consistent with the securities laws and should encourage compliance by the employees they supervise. ... You, as compliance professionals, are the second-line of defense. You help your firms and their employees to comply by developing a deep knowledge of the rules, conducting training, monitoring conduct, and speaking up boldly for ethical business practices.”

Hester M. Peirce  
Commissioner  
Atlanta, Georgia  
Oct. 30, 2018

Costumes, Candy, and Compliance:  
Remarks at the National  
Membership Conference of the  
National Society of Compliance  
Professionals

For legal counsel that advise companies and audit committees with oversight responsibilities for similar risk assessments in the design and operation of internal controls over financial reporting, understanding how similar judgments are made and what level of scrutiny should be applied to remote and less material operations is critical to avoid the types of problems experienced by Alliance. Suggested questions to address include:

- Which entities on the company organization chart are deemed less material to the overall business?
- How often is the assessment revisited?
- How is the assessment made and who approves it?
- Are the less material entities autonomous?
- Does management for these entities have personal financial incentives that may create risks?
- How comfortable is the finance department accepting results from these entities?
- Should internal audit periodically inspect the records; annually or on a rotational basis with other similarly situated entities?
- Do the entities have adequate resources to meet the segregation of duties control? For example, treasury functions that are separate from record keeping.
- Are there ways to mitigate the risks further through compensating controls or centralization of reporting functions?
- How do the external auditors assess the situation?
- On what basis do the external auditors limit their procedures for certain entities?
- Would the external auditors like to do more work annually or on a rotational basis for less material entities?

By being well informed on these matters, the company as well as the audit committee is able to apply the appropriate professional judgment to ensure that all of the various locations have proper and adequate oversight. Also of significance, once a division or subsidiary is deemed to present lower risks for financial reporting and fraud, it does not mean it will always remain at that level. Rather, the inquiries should be performed regularly as businesses evolve and change, so may the judgments regarding managing risks.

Also of use to registrants that may encounter financial reporting problems and have to work with the SEC, the AAER discussed several actions taken by Alliance that favorably influenced the settlement including the following:

- Retained an independent outside counsel and a forensic accounting firm to conduct an investigation;
- Kept the SEC informed throughout the internal investigation, which reduced the time and resources necessary for the SEC;
- Restated its financial statements impacted by the improper and erroneous accounting uncovered by the investigation;
- Hired new accounting control positions within the African region; and
- Implemented new internal accounting control procedures and policies.

While legal counsel may not have direct responsibility for their companies' or client's financial reporting, they do play a major role in helping identify risks, avoiding problems, and helping resolve difficult issues when they arise. Lessons from the Alliance discussion above, as well as reported in many of the SEC's AAERs, are quite informative and useful for legal counsel's awareness and communications with their clients.

**“As a foundational point, controls should address the identified risks to reliable financial reporting, including the nature and extent of any changes in those risks. A vital step in management’s evaluation of whether the operation of the control is effective, is the consideration of whether the control has operated as it was designed.”**

Emily L. Fitts  
Professional Accounting Fellow,  
Office of the Chief Accountant  
Washington D.C.  
Dec. 10, 2018

Remarks before the 2018 AICPA  
Conference on Current SEC and  
PCAOB Developments

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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, Transaction Analysis, and Litigation Services.

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