



*Summary of Accounting and
Auditing Enforcement Releases
for the Quarter Ended
September 30, 2020*

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

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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 September 30, 2020.

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 continue 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 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
OCTOBER 2020

Highlights:

- We report on the Valeant Pharmaceuticals International, Inc. case in our Recommended Reading section. This case involves allegations of inadequate internal accounting controls which resulted in material misstatements and omissions in earnings presentations and filings. Notably, the company approved credit increases for a related-party customer without proper justification and improperly recognized revenue from sales to this client. We offer lessons learned and considerations for audit committees of public registrants to help avoid similar problems.
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- September 30th marks the end of the SEC's fiscal year and, as we've noted in prior reports, release activity normally spikes in Q3, possibly indicating the SEC's willingness to settle violations prior to "closing their books" and releasing results on the year's enforcement actions. To that end, we categorized nine releases as Financial Reporting Fraud this quarter, which doubled the number of releases in this category for the twelve-month period ending September 30, 2020.
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- Following two consecutive quarters with no releases classified as Violations of Books and Records, the SEC released nine AAERs this quarter that fall into this category. Notably, these violations included allegations of material misstatements and omissions in quarterly earnings presentations and quarterly and annual filings, a failure to estimate an "incurred but not reported" liability, and a failure to maintain adequate internal controls over financial reporting ("ICFR").

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. The disclosed AAERs are intended to highlight certain actions and are not meant to be a complete and exhaustive compilation of all actions that may fit into the definition above.

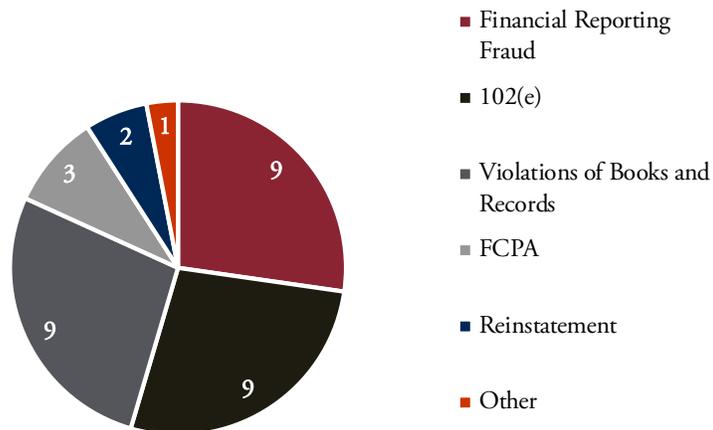
To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, www.sec.gov.

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). 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.

The Q3 2020 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed 33 AAERs during Q3 2020, with SEC Rule 102(e) actions representing 27% of the total releases.

Q3 2020 AAERs by Category



“U.S. public companies are not only subject to enforcement by the SEC and other federal agencies as well as state authorities for material misstatements and omissions, they also must draft disclosure with the awareness that the law provides a private right of action for misstatements and omissions in SEC filings. These companies are on the hook—to a lot of different people—for everything they do (or do not) disclose in their filings.”

Commissioner Elad L. Roisman
July 7, 2020
Keynote Speech at the Society for Corporate Governance National Conference

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 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.

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

- **A CPA pled guilty to falsifying investor account records.** According to the complaint, from at least the mid-1990s through late 2008, the CPA falsified books and records of the accounts of several of his clients. The complaint alleges the CPA created inaccurate trade confirmations and other records relating to fabricated trades, which were falsely reflected in the firm’s ledgers and related books and records. Per the complaint, the CPA understood the trades were backdated and improper, yet the CPA continued to manufacture records that falsely reflected assets and liabilities, and income, expense and capital accounts. The CPA pled guilty to three federal felony charges and agreed to a permanent injunction.

- ***The SEC suspended the engagement partner of an accounting firm for engaging in improper professional conduct.*** A former PCAOB registered audit firm was retained to audit the financial statements of a Dallas-based oil and gas company. According to the complaint, during the audit, the accounting firm and the engagement partner engaged in improper professional conduct and failed to take appropriate steps in relation to potential illegal activity by the oil and gas company and its management. Per the complaint, the engagement partner, despite being aware that illegal acts may have occurred, failed to determine whether the illegal acts likely occurred. The engagement partner was denied the privilege of appearing or practicing before the Commission as an accountant and may request that the Commission consider his reinstatement after a year of this order.
- ***A CPA was sentenced to imprisonment for devising a scheme to defraud investors and the IRS.*** The complaint alleges the CPA, who was the president and founder of a financial services company, solicited more than 70 investors to invest over \$10 million in various securities offerings by willfully making false representations. The complaint further alleges that part of the scheme involved passing and falsely attributing business expenses to clients, which allowed clients to offset their tax owed from IRA withdrawals. Per the complaint, a judgment of conviction was entered against the CPA, finding him guilty of tax evasion, securities fraud and wire fraud. The CPA was suspended from appearing or practicing before the Commission as an accountant, sentenced to 72 months of imprisonment and ordered to pay \$12 million in restitution.

Financial Reporting Fraud

We categorized 9 AAERs as Financial Reporting Fraud during the quarter. The following are examples of releases within this category:

- ***The SEC charged a former CEO with aiding and abetting a car-rental company in its filings of inaccurate financial statements and disclosures.*** According to the Commission's complaint, the car rental company's financial results fell short of its forecasts throughout 2013 and the company's CEO pressured subordinates to "find money" by reanalyzing reserve accounts, causing the staff to make improper accounting entries that rendered the financial reports materially inaccurate. The complaint further alleges that the CEO directed the company to hold rental cars in its fleet for longer periods, thus lowering depreciation expenses, without disclosing the change and associated risks to investors. Lastly, the complaint alleges the CEO approved reaffirming the company's earnings guidance, despite internal calculations projecting lower EPS figures. The CEO agreed to settle the charges and repay the company nearly \$2 million in incentive-based compensation and the company agreed to pay \$16 million to settle related fraud and other charges brought by the SEC.
- ***The Commission instituted cease-and-desist proceedings against an industrial equipment manufacturer for engaging in accounting fraud.*** The complaint alleges former executives fraudulently inflated the company's revenues in order to meet the company's prior revenue guidance and analysts' revenue expectations. According to the complaint, as a result of the fraud, the company issued materially misstated financial statements in its public filings and overstated its revenues by almost \$25 million. Per the complaint, executives fraudulently recognized revenue for purported sales of products that the customer had not yet accepted and for transactions with undisclosed side agreements, including contingencies such as product return rights and special financing and payment terms. The executives also misled certain members of the company's accounting department to ensure the company recognized revenue from the transactions in question, despite not being entitled to report revenue from those transactions at the time. The company was ordered to pay a \$1.7 million civil penalty as a result of this violation.

"We put a sharp focus on financial fraud and issuer disclosure. Integrity and accuracy in financial statements and issuer disclosures are critical to the functioning of our capital markets. Over the past three years, the Commission has brought hundreds of enforcement actions involving virtually all aspects of the financial reporting process."

Stephanie Avakian, Director
Division of Enforcement
September 17, 2020
Protecting Everyday Investors and
Preserving Market Integrity: The
SEC's Division of Enforcement

- ***The SEC imposed additional sanctions against a CEO for engaging in a \$12.2 million fraudulent scheme.*** According to the complaint, the CEO, who was also the president and sole director of a containers company, utilized backdated convertible notes and preferred stock to fraudulently recognize revenue. The complaint alleges the company falsely claimed stock sale proceeds as revenue and that the CEO reported and disclosed these fictitious revenues in press releases and financial reports, which in turn maintained and/or increased the company's stock price and volume, allowing an undisclosed de facto officer and control person to sell his stock into the market. As a result of these actions, the DOJ sentenced the CEO to sixty months of imprisonment and he was ordered to forfeit \$921,094 and pay a money judgment of \$1.16 million.

FCPA Violations

There were 3 FCPA-related releases in Q3 2020 resulting in more than \$166 million in civil money penalties, disgorgement, and prejudgment interest. Below is an example of a release within this category:

- ***A global nutrition and weight management company was fined over \$123 million and was issued a cease-and-desist order for violating the books and records and internal accounting controls provisions of the FCPA.*** According to the complaint, from 2006 to 2016, the company's Chinese subsidiaries engaged in a scheme to offer corrupt payments and other improper benefits to Chinese government officials. The complaint alleges the improper benefits included cash, gifts, travel, alcohol, meals and entertainment. Per the complaint, the company's executives received reports of high travel and entertainment spending in China but failed to detect and prevent the improper payments and the falsifications of expense reports. As alleged in the release, the improper benefits provided by the Chinese subsidiaries were not accurately reflected in the company's books and records, and the company failed to devise and maintain a sufficient system of internal accounting controls. The company's remedial actions included terminating employees involved, hiring a dedicated CCO, enhancing internal accounting controls and compliance functions, and adopting a new compliance structure.

Violations of Books and Records

This quarter we categorized 9 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. Below are examples of releases within this category:

- ***The Commission instituted cease-and-desist proceedings against a financial holding company for departing from its stated valuation practices.*** The complaint alleges the company made material misrepresentations and omissions in its public filings and failed to maintain accurate books and records and sufficient internal accounting controls. Per the complaint, the company's public filings inaccurately described the process that the company used to value its mortgage servicing rights ("MSR") asset and determine its corresponding valuation allowance. According to the complaint, the company departed from its stated valuation practices and maintained a \$1.3 million MSR valuation allowance that was not supported by its publicly disclosed MSR valuation process. The company then belatedly reversed the allowance in the following quarter, increasing its EPS by a penny at a time when it otherwise would have fallen short of analyst consensus expectations. The SEC ordered the company to pay a \$1.5 million civil penalty.

"We should not place capital formation over investor protection – nor vice versa. Instead we should seek balance. Investors in our capital markets should be able to take on risks – risk transfer is, after all, a centerpiece of the capital markets. At the same time, we must ensure that when investors take on risk, they do so having received appropriate disclosure."

Dalia Blass, Director, Division of
Investment Management
September 24, 2020
Keynote Address: Regulating with
our Eyes on the Future

- ***A technology company failed to disclose material information regarding its print supplies channel inventory management and sales practices.*** According to the Commission's complaint, certain regional managers at the company undertook undisclosed sales practices to increase quarterly operating profit, which led to an erosion of profit margin and an increase in channel inventory, while failing to disclose known trends and associated uncertainties. Per the complaint, the managers used a variety of incentives to accelerate, or "pull-in," sales that they otherwise expected to materialize in later quarters. The complaint alleges the company failed to disclose the known trend of increased quarter-end discounting leading to profit margin erosion and an increase in channel inventory, and the unfavorable impact this trend would have on sales and income from continuing operations. The company was ordered to pay a \$6 million civil penalty due to this violation.

Reinstatements

There were 2 releases in Q3 2020 related to reinstatement of CPAs to practice before the SEC. The following is a summary of one release within this category:

- ***A CPA was reinstated to appear and practice before the Commission as an accountant.*** The complaint alleges the CPA, while serving as a manager on the audit of a private investment fund, engaged in improper professional conduct. Specifically, as alleged in the complaint, the CPA failed to comply with AICPA audit standards by failing to obtain sufficient appropriate audit evidence about the existence of certain fund assets, exercise appropriate professional judgment and professional skepticism, and properly supervise the audit. The Commission reinstated the CPA for good cause shown.

Other

We categorized 1 release in Q3 2020 as Other. Below is a summary of this release:

- ***The SEC instituted administrative and cease-and-desist proceedings against an investment adviser for violating the Advisers Act.*** According to the complaint, a company, registered with the Commission as an investment adviser, failed to timely distribute annual audited financial statements to the investors of two private funds the company advised, in violation of the "custody rule." The complaint further alleges the company also failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. The company was charged with a civil penalty of \$75,000 due to this violation.

"We have pursued charges against individuals for misconduct across the spectrum of the securities markets, including registered individuals, executives at all levels of the corporate hierarchy, including CEOs, CFOs and other high-ranking executives, as well as gatekeepers such as accountants, auditors, and attorneys."

Stephanie Avakian, Director
Division of Enforcement
September 17, 2020
Protecting Everyday Investors and
Preserving Market Integrity: The
SEC's Division of Enforcement

Notable Q3 2020 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. For this quarter, we selected the following AAER to highlight.

Accounting and Auditing Enforcement Release No. 4153 / July 31, 2020, In the Matter of Valeant Pharmaceuticals International, Inc., n/k/a Bausch Health Companies, Inc.

Complex Accounting Expertise or Common Sense?

As legal counsel to a public registrant, imagine your client asking for your advice on the following questions:

- Can we help fund the startup of a new distribution customer that will buy more of our products? If so, can we set the customer up so that we charge higher than usual prices and have control over what they buy?
- In addition, would there be a problem if we increase credit limits for the customer so that we can continue making sales, even when the customer has past due accounts receivable balances?
- Finally, we have decided to acquire the customer, but don't want anyone to know. Can we change our disclosure policies to avoid having to say anything in our public filings about this relationship?

As farfetched as these questions appear, they are based on the actual facts in the recent Accounting and Auditing Enforcement Release issued by the United States Securities and Exchange Commission related to a settlement with Valeant Pharmaceuticals International, Inc. ("Valeant").

Valeant is a publicly traded global pharmaceutical and medical device company that develops, manufactures, and markets a broad range of branded, generic and branded generic pharmaceuticals, over-the-counter products, and medical devices. The customer referenced above is a mail order pharmacy, Philidor Rx Services LLC ("Philidor").

Answering the questions raised above involves an appreciation for the applicable Generally Accepted Accounting Principles ("GAAP") and SEC reporting requirements for public registrants. Below we address each question and discuss the considerations and concerns that counsel should raise if asked to advise on these subjects. While aspects of technical and complex accounting matters may be involved, common sense may be equally or more useful when advising a client on these topics.

Before addressing the questions, we will highlight several key facts reported in the release about Valeant and Philidor's relationship, including:

- In 2013, Valeant "helped establish" Philidor with an advance of \$2 million and entered into agreements with Philidor to dispense Valeant's products.
- Approximately 95% of the product dispensed by Philidor and its affiliated pharmacies consisted of Valeant branded drugs.
- Toward the end of Q3 of 2014, Valeant received a \$75 million order from Philidor, which was put on hold because it exceeded Philidor's credit limit. Valeant approved a \$70 million credit increase to process this order and did so without proper justification.
- In Q4 of 2014, Valeant received an additional \$130 million order from Philidor. Once again, Valeant approved Philidor's credit increase, and also granted extended payment terms, without proper justification. At this time, Philidor's accounts receivable balance was approximately \$78 million, of which approximately \$41 million was past due.

"However, if your desire to devote yourself to your company or your bank is motivated by a selfish scheming for personal benefit, or your decision to increase a dividend payment is driven by the fact that you yourself are a shareholder and want to enrich yourself, that's a problem."

Commissioner Hester M. Peirce
August 27, 2020
Markets, Morality, and Mobsters:
Remarks at the 18th Annual
Corporate Governance Conference

- Of significance, the \$130 million order included one-time special pricing in which Philidor paid 4% over the wholesale cost.
- The \$130 million order was also unique because Valeant was out of stock for a specific product and requested Philidor to accept a substitute product.
- The \$130 million order, with its one-time pricing and product substitution, occurred less than two weeks before the December 15, 2014 date when Valeant acquired the option to purchase Philidor for \$100 million in cash and would begin consolidating Philidor in its financial statements.
- Upon the closing of the option agreement, Valeant determined that it would consolidate Philidor in its financial statements and that it would have to wait to recognize the Philidor revenue until Philidor sold the product through to patients.
- Valeant erroneously recognized revenue for the \$130 million when the product was delivered to Philidor. Valeant later restated the revenue from this order.
- Next, Valeant evaluated its disclosure obligations in light of the option agreement. As of December 1, 2014, Valeant's disclosure thresholds required Valeant to disclose details about transactions the size of the Philidor transaction, including mentioning the acquiree by name, in its annual report on Form 10-K for 2014.
- On December 10, 2014, Valeant increased its thresholds in an amount that exceeded the anticipated total option purchase price for Philidor such that Valeant would no longer disclose transactions of Philidor's size by name in the 2014 Form 10-K.
- Management informed the board of directors' audit and risk committees about the increased disclosure threshold, including its impact on disclosure of the Philidor option transaction.
- Valeant reported misstatements in its restated financial statements filed on April 29, 2016, reducing previously reported fiscal year 2014 revenue by approximately \$58 million, and net income by approximately \$33 million. These amounts reflect permanent reductions to Valeant's previously reported financial results.

While numerous parties understood Valeant's relationship and dealings with Philidor, certain facts were concealed. In fact, two executives, one from Valeant and one from Philidor, were convicted for self-dealing and a kickback scheme connected to the option agreement. Even recognizing this conduct, there still appears to have been a lack of proper skepticism and judgment applied by members of Valeant's management team and others with corporate governance responsibilities.

Returning to the questions raised above, below are considerations and concerns that counsel should raise if ever asked to advise on similar subjects.

Can we help fund the startup of a new distribution customer that will buy more of our products?

Generally, the answer is no if the company wants its sales to meet the revenue recognition standards. If the new customer lacks funds and isn't adequately capitalized, then they also likely will not have the financial capacity, independent of the funding, for sales to meet the collectability standard for a valid sales transaction under GAAP. The general revenue recognition criteria under GAAP includes evidence of an arrangement, delivery, pricing that is fixed and determinable and collectability for the receivable.

"Best practices in corporate governance are usually the result of many years of private ordering experimentation and experience. Also, governance reform focuses on the company itself and what is best for its optimal operation as well as its shareholders."

Commissioner Elad L. Roisman
July 7, 2020
Keynote Speech at the Society for
Corporate Governance National
Conference

Also of concern, if the funds are used by the customer to pay the company for the product, then the funding isn't a loan or equity investment but, in substance, is still an account receivable and not likely collectable, which thereby defers the recognition of revenue until the product is sold to an end customer.

Questions and comments about charging the customer higher than usual prices and having control over what the customer buys should immediately raise concerns about the integrity of this overall relationship. These matters are perfect examples of using common sense to ask your client: is there something else going on here?

Would there be a problem if we increase credit limits for the customer so that we can continue making sales, even when the customer has past due accounts receivable balances?

This question should trigger two reactions: why would you want to do that and are you sure you will be able to collect the receivable timely (if at all)? Hearing that the need to increase the credit limit is arising while prior receivables are unpaid and aging just adds to concerns.

Putting the company at risk of delivering a product for which payment may not be ultimately collectable or may require the customer to sell in order to pay the receivable, raises obvious revenue recognition concerns and potential harm to the business's liquidity by potentially wasting valuable assets.

In sum, yes, this is a problem, and also raises concerns and questions about revenue pressures and company culture to achieve targets and goals.

Finally, we have decided to acquire the customer, but don't want anyone to know. Can we change our disclosure policies to avoid having to say anything in our public filings?

With an appreciation for the facts surrounding Philidor, it's difficult to understand how the Valeant audit committee agreed to change its disclosure rules to avoid making more information about the transactions and the relationship available to the public.

For counsel advising on a question like this, one should ask the obvious question: What is it about this deal that warrants changing the established disclosure rules and practices for the company? If the answer is the avoidance to make information public, then a refresher lesson on the purpose of the company's disclosure process for material events is needed. Changing company policies and practices for the convenience or avoidance of specific events or transactions creates a control environment with no standards, and likely a failure to comply with SEC disclosure requirements.

Legal counsel advising on questions such as these would have adequate grounds to advise the company regarding a need for an independent investigation and inquiry into the transactions and the pressures giving rise to the conduct.

While the Valeant and Philidor relationship undeniably involves aspects of technical and complex accounting matters, common sense may be equally or more useful in assessing what the right answers are and whether the parties involved were engaging in proper conduct or playing games to achieve a financial reporting result.

"The most obvious tool in the SEC's toolkit is disclosure. This gets investors the information they need to make investment decisions based on their own judgment of what indicators matter for long-term value."

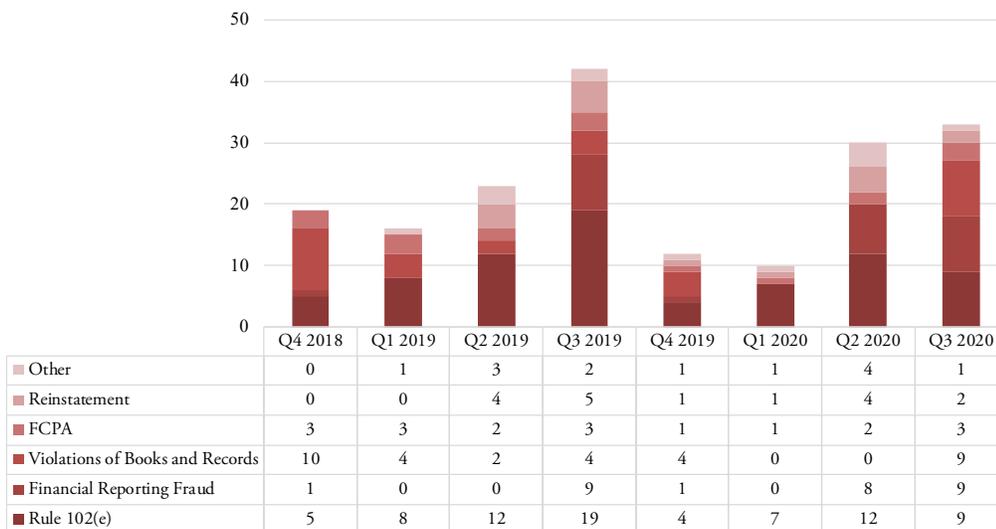
Commissioner Allison Herren Lee
September 22, 2020
Diversity Matters, Disclosure Works, and the SEC Can Do
More: Remarks at the Council of Institutional Investors Fall 2020 Conference

Prior Period Comparison: Quarter to Quarter

As described in the section titled “Our Process and Methodology,” AAERs are intended to highlight certain actions and they do not represent an exhaustive and complete compilation of all actions that fit into the definitions provided by the SEC for the various AAER classifications. That said, comparisons of the number of AAERs between periods can be a useful gauge of the SEC’s activities.

The following chart maps quarterly totals for each category over the past eight quarters.

Quarter to Quarter AAER Comparison
Q4 2018 through Q3 2020



Based on this data, we made the following observations:

- While Rule 102(e) sanctions have been the most common category in recent periods, accounting for 70% and 40% of total AAERs in Q1 & Q2 2020, respectively, Financial Reporting Fraud and Violations of Books and Records sanctions combined to account for 55% of this quarter’s releases.
- The number of releases (33) in this quarter, which coincides with the SEC’s fiscal year-end, fell sharply when compared to releases issued in prior third quarters (48 and 42 in 2018 and 2019, respectively). It will be interesting to see whether this decrease in activity can be attributed, in part, to the COVID-19 pandemic.
- Following four reinstatements last quarter, the SEC reinstated two CPAs this quarter. For the twelve-month period ending September 30, 2020, the SEC reinstated eight CPAs to appear and practice before the Commission as accountants, similar to the nine CPAs reinstated during the twelve-month period ending September 30, 2019.

“However, analyzing past dislocations should not be the only drivers of regulatory review and changes. Instead we also need to be forward-looking with a fresh eye, focusing on how to create a flexible framework that will interact smoothly with future market innovations, different market conditions, and investor reactions that we may not have already experienced.”

Dalia Blass, Director, Division of Investment Management
September 24, 2020
Keynote Address: Regulating with our Eyes on the Future

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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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