Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended March 31, 2021

Q1 REPORT 2021

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Introduction and Our Objective

We are pleased to present you with our summary of the U.S. Securities and Exchange Commission, Division of Enforcement's Accounting and Auditing Enforcement Releases ("AAERs") for the quarter ended March 31, 2021.

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
APRIL 2021

Highlights:

- **The SEC released just six AAERs in Q1 2021, surpassing Q1 2020 for the lowest number of releases in a quarter since at least Q1 2007. Although the SEC has not commented on the historically low volumes, we suspect the COVID-19 crisis continues to play a role in the limited activity.**

- **We report on the WageWorks, Inc. case in our Recommended Reading section. The case involves allegations of false and misleading statements made by the former CEO and CFO. Allegedly, the former CEO and CFO disregarded a client's refusal to pay and made false and misleading statements to auditors and staff related to the client contract, which led to the improper recognition of revenue. We offer lessons learned and considerations for management and legal counsel to avoid similar problems.**

- **Finally, we evaluate the trends and provide observations on Rule 102(e) actions over the prior five years in our Special Feature section. We detail the types of sanctions most often administered, year-over-year trends, and the prominence of Rule 102(e)(1) actions against auditors. Of significance, Rule 102(e) actions involving auditors have dropped precipitously over the past five years, with only 13 auditors facing suspension or disbarment in 2020 as compared to 33 auditor suspensions/disbarments in 2016.**

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.

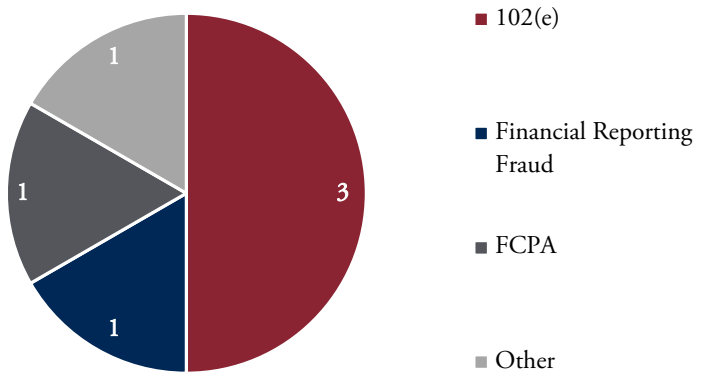
To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, www.sec.gov.

As part of our review, we gathered information and key facts, identified common attributes, and noted trends. 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 categorized the release by the most significant issue. Based on this process and methodology, we prepared a database of the key facts contained in each release.

The Q1 2021 AAERs: Summary by Category and Insights from the Releases

The SEC released six AAERs during Q1 2021, with SEC Rule 102(e) actions representing 50% of the total releases.

Q1 2021 AAERs by Category



"Over the years, Commissioners on both sides of the political aisle have agreed that a strong enforcement program incentivizes compliance with the securities laws, and that enforcement helps to promote a market that inspires investor confidence, creating a level playing field for market participants."

Commissioner Caroline A. Crenshaw
March 9, 2021
Moving Forward Together – Enforcement for Everyone

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

Three AAERs were related to Rule 102(e) actions during the quarter. Rule 102(e) actions involve the temporary or permanent censure and denial of the privilege of appearing or practicing before the SEC. Summaries of the actions reported in this quarter's Rule 102(e) releases are included below:

- ***The SEC suspended an engagement partner and a manager of an accounting firm for engaging in improper professional conduct.*** The complaint alleges that an accounting firm was retained to audit the financial statements of a college. According to the complaint, the controller of the college hid invoices and created improper and unsupported journal entries that overstated the college's assets by $33.8 million for fiscal year 2015. Per the complaint, the engagement partner and manager failed to obtain sufficient appropriate audit evidence, properly prepare audit documentation, properly examine journal entries for evidence of fraud due to management override, adequately assess the risk of material misstatement, communicate significant audit challenges to those charged with governance, and exercise due professional care and professional skepticism. These pervasive audit failures reduced the audit team's ability to detect the controller's fraud. Furthermore, the complaint alleges that despite the audit failures, the engagement team approved the issuance of an audit report stating the audit was performed in accordance with Generally Accepted Auditing Standards. The engagement partner and manager were denied the privilege of appearing or practicing before the Commission as accountants for three years and one year, respectively, due to this violation.

- ***A CPA was suspended for engaging in insider trading.*** According to the complaint, shortly after retiring, the CPA returned as a consultant to help his/her successor close the books for the quarter ending March 31, 2018. During this time, the CPA obtained material non-public information about the company's deteriorating financial condition. The complaint alleges the CPA then sold shares of the company and exercised his/her in-the-money stock options ahead of the public announcement of the company's financial position, avoiding losses and making an unjust profit of more than $85,000. As a result, the CPA was suspended from appearing or practicing before the Commission as an accountant.

FCPA Violations

There was one FCPA-related release in Q1 2021 resulting in criminal penalty, disgorgement, and prejudgment interest of approximately $123 million. Below is a summary of the release:

- ***A global financial services company was fined approximately $123 million and the SEC instituted cease-and-desist proceedings against the company for violating the books and records and internal accounting controls provisions of the FCPA.*** According to the complaint, between 2009 and 2016, the company improperly used third-party intermediaries, business development consultants, and finders to obtain and retain global business. Per the release, this practice was approved by the company's senior management and various regional committees. However, the complaint alleges the company lacked sufficient internal accounting controls related to the use and payment of consultants, which resulted in bribes and other payments for unknown, undocumented, or unauthorized services being passed off as legitimate business expenses. Per the complaint, these improperly recorded payments involved invoices and documentation falsified by company employees. As a result of these actions, the company improperly recorded approximately $7 million in payments as legitimate expenses, unjustly enriching the company by $35 million. The company was ordered to pay a criminal penalty of $79.6 million as well as disgorgement and prejudgment interest of $35.1 million and $8.2 million, respectively.

"Enforcement best advances our agency's goals when it concentrates the costs of harm with the person or entity who committed the violation. For these reasons, ensuring that the violator pays the price is key to a successful enforcement regime and to promoting fair and efficient markets more broadly."

Commissioner Caroline A. Crenshaw
March 9, 2021
Moving Forward Together – Enforcement for Everyone

Notable Q1 2021 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. 4202 / February 2, 2021, In the Matter of Joseph Jackson and Colm Callan

Stubbornness and Financial Reporting Don't Mix

The settlement by the United States Securities and Exchange Commission with the former CFO and CEO ("former officers") of WageWorks, Inc. ("WageWorks"), as described in Accounting and Auditing Enforcement Release No. 4202 ("release"), illustrates the financial reporting risks created by senior management who are too stubborn to acknowledge opposing viewpoints.

WageWorks is a corporation, headquartered in California, that administers flexible spending accounts for clients. Per the SEC, the former officers made false and misleading statements that resulted in WageWorks improperly recognizing revenue of $3.6 million in 2016 related to a contract with a large public-sector client (the "client").

What Went Wrong?

For starters, the former officers felt they were right and that their client was wrong about payment obligations under a contract for services. In fact, as described below, the former officers failed to even acknowledge the client's refusal to pay when allowing the company to report revenues earned for the amount in dispute. Making the situation worse, in an effort to avoid disclosing the disagreement with the client, the former officers also misrepresented information to the company's accounting staff and its external auditors.

Below is a discussion regarding the facts reported in the release, an overview of the major contract terms, the statements, omissions and misrepresentations made by the former officers, and most importantly, questions for legal counsel to consider to help their clients avoid similar financial reporting problems.

"The exchange of information and ideas, the goal of any conference, relates to one of our underlying democratic norms: that knowledge is empowering. That principle is also the basis of *shareholder* democracy: through clear and timely disclosure, we empower investors to hold the companies they own accountable."

Acting Chair Allison Herren Lee
March 17, 2021
Every Vote Counts: The Importance of Fund Voting and Disclosure

The Contract

WageWorks entered into the contract with the client to provide Flexible Spending Account ("FSA") benefits servicing on March 1, 2016. Between March 1 and September 1, 2016, WageWorks was responsible for development and transition services, so that the platform would be ready to process the client's employee claims by September 1, 2016. The client had a contract with a different service provider through September 1, 2016.

WageWorks would be paid for its services based on a fee on a per-account, per-month basis, meaning fees earned would equal the number of participant accounts multiplied by a fixed price. The start date for such payments is where the former officers and the client interpreted the contract differently: March 1st or September 1st, respectively.

On March 17, 2016, a WageWorks employee emailed the client regarding billing for the development and transition period. On March 29, a client employee responded that it was not obligated to pay for any services during the period prior to September 1, 2016. The former officers were aware of this email exchange.

Later, on June 10, 2016, during a telephone call between WageWorks project implementation employees and client employees, a client employee similarly stated that the client was not obligated to pay for services during the development and transition period. Again, the former officers were aware of this exchange.

Statements, Omissions and Misrepresentations

Despite the former officers' knowledge that the client had no intent to pay fees during the development and transition period, WageWorks began to recognize revenue under the contract during the second quarter of 2016. The accounting staff even prepared a memo that was reviewed by the former CFO which stated that the client agreed to pay fees starting on March 1, 2016 and that WageWorks was able to bill for fees during the development and transition phase. Similarly, WageWorks recognized revenue for the development and transition phase in Q3 2016.

Despite recognizing revenue for the development and transition services period in Q2 and Q3 2016, WageWorks sent its first invoice to the client on February 15, 2017: an invoice for the period of March 1, 2016 through December 31, 2016. The client rejected this invoice consistent with its earlier statements that it was under no obligation to pay for services prior to September 1, 2016.

Importantly, Generally Accepted Accounting Principles required that revenue should only have been recognized when: A) collectability is reasonably assured, B) services have been performed, C) persuasive evidence of an arrangement exists, and D) there is a fixed or determinable fee. Needless to say, collectability was not reasonably assured when the client repeatedly stated they would not pay.

Per the SEC, the former officers made numerous false statements and/or omissions of material facts to the WageWorks internal accounting staff and auditors, including for example,

- in Q3 2016 stating the client "had agreed to pay,"
- in Q1 2017 stating that WageWorks "was talking" to the client about payment and "was working on collection,"
- in Q2 2017, stating the client rejected WageWorks' invoice "because it had been submitted in the wrong format" and that WageWorks "expected to be paid after it resubmitted its invoice."

Even after submitting a "certified claim" to the client during Q3 2017, as a precursor to litigation, the former officers advised the company's auditors that WageWorks "would be paid by the end of the year" and that it "was going through a process to collect" the amounts owed. Even if this was arguably true and based on their contract interpretation, the omission of material facts in their disclosures to the auditors raises serious questions about the former officers' integrity.

It was not until January 10, 2018 that the former officers advised the company's accounting staff and auditors that the client denied that it owed any payment for services provided during the development and transition period. This disclosure led to WageWorks reversing the revenue previously recognized for the development and transition period and restating its financial results for Q2 and Q3 2016.

Avoiding Similar Financial Reporting Problems

The facts described in the WageWorks enforcement action raise questions and matters for legal counsel to discuss with their clients to avoid similar problems.

Can We Recognize Revenue Without Sending an Invoice to the Client?

Revenue should be recorded upon the completion of the earnings process which during this time period required the factors described above, including that collectability must be reasonably assured, services have been performed or a product delivered, persuasive evidence of an arrangement exists, and there is a fixed or determinable fee. After meeting these standards, the client owes monies for the services or products delivered, which is represented on the company's books and records as an account receivable in an amount equal to the revenue recorded. Consistent with owing monies, the client would record an account payable and an expense or asset for the delivery of services or a product.

The essential link in accounting between vendors, such as WageWorks, with their clients and customers is the invoice generated by the vendor and sent to the client or customer. Simply put, invoices evidence amounts due to the vendor from the client or customer.

The lack of a timely delivered invoice by the vendor is troubling as the accounting appears one-sided, and it indicates a problem regarding revenue recognition as collectability is not likely to be reasonably assured if the party obligated to pay does not have a payable recorded on its books and records.

"We know there is a temptation to spend money on operations at the expense of investing in compliance. To help deal with those misaligned incentives, the Commission was given civil penalty authority, allowing it to tailor remedies to misconduct and effectively deter malfeasance to promote a fair market. Fairness yields better results for everyone."

Commissioner Caroline A. Crenshaw
March 9, 2021
Moving Forward Together – Enforcement for Everyone

Rules can have exceptions, but for a company such as WageWorks, revenue should not be recorded in the ordinary course without invoicing for the services or products delivered. The WageWorks release does not provide any information regarding whether the former officers suppressed the invoice or how the revenue was reported without an invoice being sent to the client. Needless to say, the lack of a timely invoice being sent to the client should have raised concerns.

Does Our Accounting Staff Communicate Directly with Project Management?

Individuals overseeing the actual delivery of services or products to clients and customers generally know the most about the facts required to assess whether the earnings process is complete. For the project described above, the WageWorks team responsible for the development and transition services knew the client explicitly stated that it was not obligated to pay for services until September 1, 2016.

Per the release, project management shared this information with the former officers, but it is not clear whether the same individuals had any communication with the accounting staff or auditors.

To ensure the full and fair flow of necessary information from the project team to the financial reporting team, companies should implement processes to create and/or improve the sharing of periodic information. Checklists at the start of a contract describing its terms and regular updates shared directly to the accounting staff will provide favorable documentation for financial reporting estimates, judgments, and assumptions. Importantly, this type of process should eliminate the biases displayed by the former officers in controlling the flow of information in an unbalanced manner.

In addition to these subjects, other questions and matters for discussion based on the WageWorks problems include the existence of an ethics hotline, providing revenue recognition training for project personnel, and indicia of tone at the top suggesting overzealous senior management.

Most important, a full and fair vetting of all facts in an unfiltered manner is essential to fairly stated financial results, and strong internal controls represent the best tool to eliminate senior management biases or stubbornness which dismiss unfavorable facts they refuse to accept.

"If the penalties are sufficiently high to motivate the company to remediate problems, strengthen internal controls, clarify lines of responsibility, and prioritize individual accountability, those are all changes that likely lead to better future outcomes, and higher profits for shareholders."

Commissioner Caroline A. Crenshaw
March 9, 2021
Moving Forward Together – Enforcement for Everyone

Special Feature: Rule 102(e) Trends and Observations for the Five Year Period Ending December 31, 2020

Rule 102(e) actions have continuously accounted for the largest percentage of quarterly Accounting and Auditing Enforcement Releases over the last five years in all but two quarters. The consistent prominence of these releases drives us to evaluate the facts and trends within the Rule 102(e) population, so we can provide valuable insights for counsel and people involved in SEC enforcement investigations.

For background, under Rule 102(e), the SEC is authorized to suspend or disbar a person from appearing or practicing before the Commission on behalf of public registrants. Of note, there are three types of Rule 102(e) actions, each denoted by section as (1), (2), and (3). The first category, Rule 102(e)(1) actions, involves censuring or denying any person, temporarily or permanently, the "privilege of appearing or practicing" before the SEC based on findings that the respondent:

- 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 those 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, applies to individuals who have had a professional license suspended or revoked, or have been disbarred by a federal or state agency. This category also includes any individual who has been convicted of a felony or a misdemeanor involving moral turpitude.

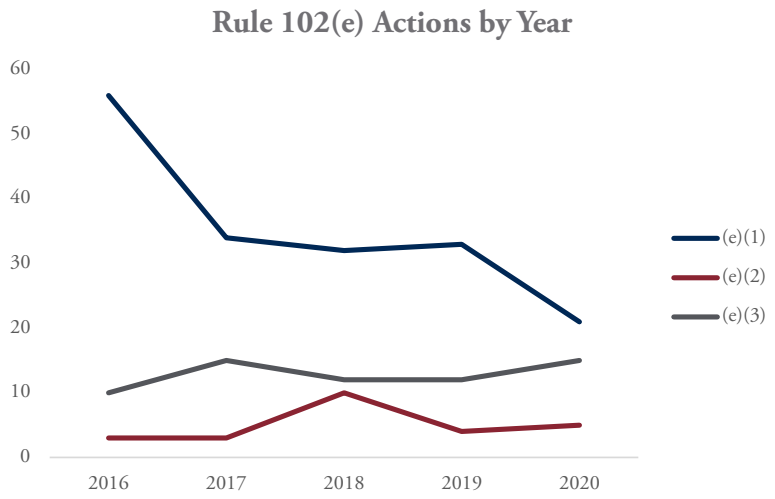
The final category, Rule 102(e)(3) actions, is limited to temporary suspensions stemming from proceedings brought by the Commission in any court of competent jurisdiction.

As noted above, Rule 102(e) actions represent a significant portion of total reported AAERs. In fact, during the five-year period between 2016 and 2020, the SEC released 225 AAERs[1] under Rule 102(e) which accounted for approximately 50 percent of all AAERs during that period. However, despite the prominence of Rule 102(e) releases as a percentage of total AAERs, the number of Rule 102(e) actions declined 41% over the five-year period, from 69 actions in 2016 to 41 actions in 2020. Interestingly, the prominence of actions imposed under Rule 102(e)(1) was unequivocal, as approximately two-thirds of all Rule 102(e) actions pursued were under section (1). Therefore, the downward trend in total 102(e) actions is directly attributable to a significant decline in the number of actions filed under Rule 102(e)(1), as seen in the chart below. Of note, Rule 102(e) actions filed under the other two sections remained relatively consistent across the five-year period.

"Any effective and fair regulatory framework has to start with a recognition and understanding of people."

Commissioner Hester M. Peirce
February 22, 2021
Atomic Trading – George Washington University Law School Regulating the Digital Economy Conference

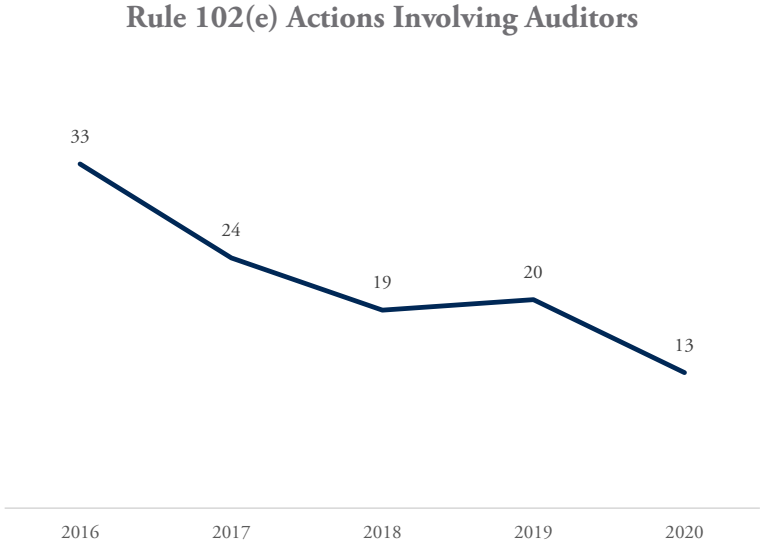
1 Please note, for the purposes of this analysis, we focused on the number of actions taken within these 225 AAERs, as the SEC often charges multiple individuals under a single AAER. In other words, our analysis focuses on the 265 Rule 102(e) actions filed within the 225 Rule 102(e) AAERs over the previous five years.



The decrease in Rule 102(e)(1) actions during this five-year period aligns with a similar trend in Rule 102(e) actions involving auditors, as 96% of auditor-related actions fall under Rule 102(e)(1). For the five-year period ending December 31, 2020, Rule 102(e) actions against auditors accounted for 41% of total Rule 102(e) actions. However, similar to the significant decrease in the number of Rule 102(e)(1) actions, we note a downward trend in enforcement actions against auditors. As detailed in the chart below, actions against auditors declined sharply between 2016 and 2017, as well as between 2019 and 2020.

"Aggressive but even-handed enforcement, without fear or favor, protects law-abiding corporate citizens. It also incentivizes everyone to behave fairly and focus on operations rather than on racing to the bottom."

Commissioner Caroline A. Crenshaw
March 9, 2021
Moving Forward Together – Enforcement for Everyone



Remarkably, contrary to the trends highlighted above, auditor reinstatements for Rule 102(e)(1) and (3) sanctions have increased consistently over the five-year period, with 16 auditors being granted reinstatement during the period.

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

Given the vast majority of auditors are sanctioned under Rule 102(e)(1), most have the opportunity to apply for reinstatement. Notably, during the five-year period, 48% of all individuals reinstated were auditors and auditor reinstatements nearly doubled between 2016 and 2020. Unfortunately, the SEC does not release data on the number of applications for reinstatement it receives, which would highlight the frequency in which the SEC grants reinstatements to auditors sanctioned under Rule 102(e), an important

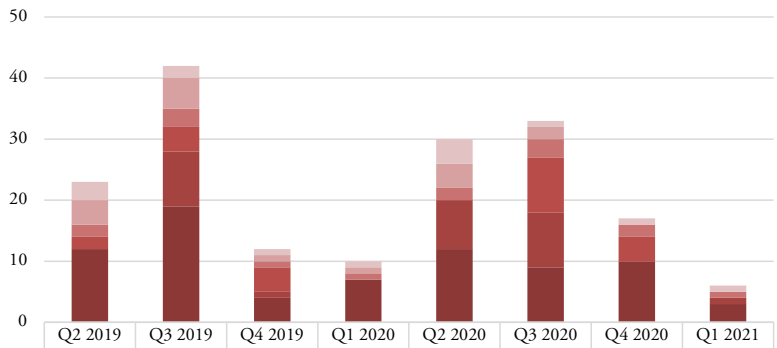
consideration if one wishes to return to practicing and appearing before the SEC. Nevertheless, the SEC's use of Rule 102(e) against auditors will be a trend we continue to follow closely, and it will be particularly intriguing to compare and contrast the number of actions brought under Rule 102(e), and the number of reinstatements, given the recent changes in SEC leadership roles.

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
Q2 2019 through Q1 2021



	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
Other	3	2	1	1	4	1	1	1
Reinstatement	4	5	1	1	4	2	0	0
FCPA	2	3	1	1	2	3	2	1
Violations of Books and Records	2	4	4	0	0	9	4	0
Financial Reporting Fraud	0	9	1	0	8	9	0	1
Rule 102(e)	12	19	4	7	12	9	10	3

Based on this data, we made the following observations:

- Rule 102(e) sanctions continue to be the most common category of release, on average accounting for 47% of total AAERs released each quarter over the prior two years. Of significance, the SEC has not released any AAERs categorized as reinstatements over the prior two quarters, a trend we will continue to watch closely given the influx of Rule 102(e) actions noted above.
- In Q1 2020, the SEC released the lowest number of AAERs in over 12 years, attributed, in part, to the COVID-19 pandemic. This trend continued in Q1 2021 as the SEC released just 6 AAERs. We are eager to see whether these trends continue throughout the remainder of the COVID-19 pandemic or shift with the change in administration.

"The enactment of prudent regulation changed that dynamic, as did the creation of an enforcement regime that has evolved over time to better address violations. The stability of our regulatory system has allowed our markets to prosper."

Commissioner Caroline A. Crenshaw
March 9, 2021
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ABOUT Floyd Advisory
Floyd Advisory is a consulting firm providing financial and accounting expertise in areas of SEC reporting, transaction advisory, investigations and compliance, litigation services, as well as business strategy and valuation.

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