Floyd Advisory

BUSINESS ADVISORY | FORENSIC ACCOUNTING

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended June 30, 2012

Q2 REPORT 2012

CONTENTS

Introduction and Our Objective

We are pleased to present you with our summary of the U.S. Securities and Exchange Commission, Division of Enforcement's Accounting and Auditing Enforcement Releases ("AAERs") for the quarter ended June 30, 2012.

As an independent business advisory and forensic accounting firm, 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 "accounting and auditing" related, 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 any additional analysis you would find helpful.

Floyd Advisory LLC
JULY 2012

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

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

As part of our review, we gathered information and key facts, identified common attributes, noted trends, and observed material events. Applying our professional judgment, which is based solely on publicly disclosed information, we sorted the releases into major categories (notably: Rule 102(e) Actions, Financial Reporting Frauds, Foreign Corrupt Practices Act violations ("FCPA"), Reinstatements to Appear and Practice before the SEC and Other) and classifications of the financial reporting issues involved (notably: Improper Revenue Recognition, Manipulation of Reserves, Intentional Misstatement of Expenses, Balance Sheet Manipulation, Options Backdating and Defalcations). Do note, when a release included more than one allegation, admission or violation, we placed the release into the category which represented the most significant issue. For our summary of financial reporting issues, we recorded each accounting problem identified as a separate item. Based on this process and methodology, we prepared a database of the key facts in each release.

REVIEW PROCESS

- Gathered information and key facts
- Identified common attributes
- Noted trends
- Observed material events
- Sorted the releases into major categories
- Prepared a database of the key facts

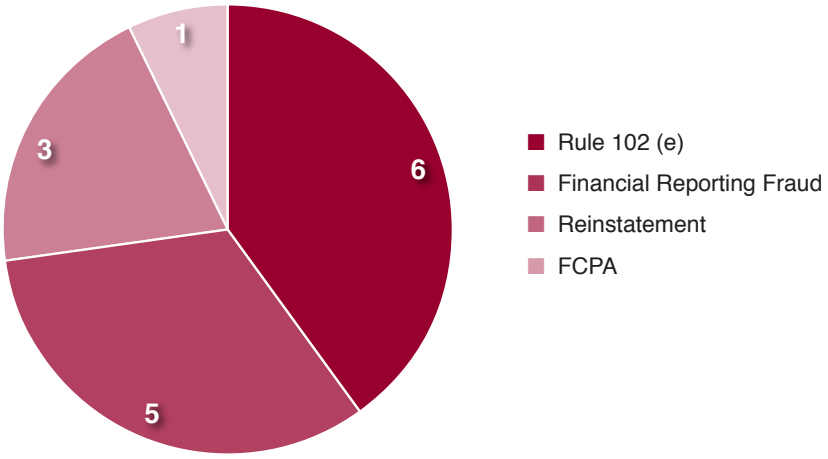
The Q2 2012 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed fifteen AAERs during Q2 2012 which we have sorted into the following categories as shown in the pie chart. Notably, individual sanctions dominated this quarter's results, with 40% of the releases being Rule 102(e) sanctions. Of note when removing reinstatements from the population the Rule 102(e) sanctions actually account for 50% of the AAERs in the quarter. While seeing the categorical breakdown is analytically useful, a closer look into each category provides a clearer understanding of the SEC's actions.

AAERs reported for Quarter Ended June 30, 2012:

15

AAERs by Category



Financial Reporting Frauds

As reflected in the chart above, there were five AAERs that we categorized as financial reporting frauds during the quarter. Two of the releases are discussed in detail below in the "Recommended Reading" section. Other actions related to financial reporting frauds described in the releases this quarter include:

- The SEC announced final judgments against three former officers and managers of Phoenix-based CSK Auto Corporation ("CSK"). In 2009 SEC alleged that from 2002 to 2004, CSK's former chief financial officer, senior vice president and treasurer, CSK's former controller, and CSK's former director of credit and receivables, engaged in a scheme to materially overstate CSK's income by aggressively recognizing vendor allowances and failing to write off vendor allowance receivables when management knew the receivables were uncollectible. At the time of the fraud, CSK was one of the nation's largest auto parts retailers with over 1000 stores located throughout the western United States. In a related criminal action, the CFO was sentenced to two years' imprisonment. The controller and director of credit and receivables both pled guilty to obstruction of justice in connection with the SEC's investigation by providing false information to CSK's counsel, knowing that the results of CSK's internal investigation would be disclosed to the SEC staff, in violation of 18 U.S.C. §1505 and were sentenced to three years' probation, and ordered to pay a fine.

- The SEC charged that FalconStor Software, Inc. ("FalconStor"), a Long Island, N.Y., data storage company, misled investors about bribes it paid to obtain business with a subsidiary of J.P. Morgan Chase & Co. FalconStor has agreed to pay a $2.9 million civil penalty to settle the case. The SEC alleged that the Company's co-founder and then-chief executive officer, president and chairman, who is now deceased (the "CEO'), ordered the bribes, which were paid to three executives of the subsidiary, JPMorgan Chase Bank, National Association, and their relatives. The bribes given and offered included grants of FalconStor options and restricted stock, direct cash payments, gift cards, payment of golf club fees, and entertainment. SEC charged FalconStor with violating the books-and-records and internal controls provisions of the Securities Exchange Act of 1934, Sections 13(b)(2)(A) and 13(b)(2)(B), and the offering registration provisions and certain antifraud provisions of the Securities Act of 1933, Sections 5(a), 5(c), and 17(a)(2) and (3).

Individual sanctions dominated for Quarter Ended June 30, 2012:

40%

Rule 102 (e) Actions

Rule 102(e) actions involve the censure and denial, temporarily or permanently, 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. Notably, of the six individuals receiving Rule 102(e) sanctions during Q2 2012, five were certified public accountants. One of these individuals was penalized for making false statements to the SEC during investigative testimony, whereas another for taking part in the insider trading scheme while the remaining three were penalized for involvement in financial reporting fraudulent schemes. The following releases are worth highlighting:

Notably, of the six individuals receiving Rule 102(e) sanctions during Q2 2012, five were certified public accountants.

- ***The SEC alleged that a tax manager at Deloitte Tax LLP ("Deloitte") acquired nonpublic information concerning the acquisition of a client while providing tax services to the client.*** *The SEC also alleged that in violation of Deloitte's policies and his employment agreement, the manager traded in the shares of the acquiree shortly before the announcement of the transaction. In addition, even though Deloitte required the manager to self-report his securities transactions, the manager did not report these trades, and was terminated for cause in January 2010.*

- ***The United States District Court for the Southern District of New York entered a final judgment against an audit firm partner, permanently enjoining him from future violations of securities laws.*** *The SEC alleged the CPA together with a co-defendant, offered and sold what purported to be the common stock and promissory notes of an entity, owned by an audit client. The stock and notes were fictitious. In fact the entity had been inoperative for over a decade. The CPA falsely held himself out to be an officer of the company and fraudulently obtained more than $2.1 million from at least thirteen investors, including audit clients.*

- ***The SEC sanctioned a retired Arthur Andersen LLP ("Arthur Andersen") partner for engaging in insider trading by tipping his son regarding the impending acquisition of a company for which he was an audit committee member and instructing his son to purchase securities in the company for his daughter.*** *The retired partner and audit committee member pled guilty to one count of securities fraud and one count of conspiracy to commit securities fraud.*

Reinstatements

During Q2 2012, three certified public accountants (or the Canadian equivalent) were reinstated to appear and practice before the SEC. Of note, the SEC reinstated the Arthur Andersen partner who had allegedly engaged in improper professional conduct in connection with the audit of the financial statements of WorldCom, Inc. ("WorldCom") for its fiscal year ended December 31, 2001. During 2001, WorldCom improperly removed approximately $3 billion in line cost expenses from its income statement by improperly and fraudulently characterizing these expenses as "assets" on its balance sheet. In his reinstated capacity as a preparer or reviewer, or as a person responsible for the preparation or review, of financial statements of a public company to be filed with the SEC, the former audit partner agreed that he will undertake to have his work reviewed by the independent audit committee of any company for which he works, or in some other manner acceptable to the SEC, while practicing before the SEC in this capacity. The former audit partner did not seek reinstatement as an independent accountant.

FCPA Violations

The only FCPA related release in Q2 2012 involved charges against a former executive at Morgan Stanley & Co., Inc. ("Morgan Stanley") for violating the FCPA as well as securities laws for investment advisers by secretly acquiring millions of dollars worth of real estate investments for himself and an influential Chinese official for a state-owned entity who in turn steered business to Morgan Stanley's funds. Morgan Stanley partnered with the Chinese state owned entity on a number of significant Chinese real estate investments. At the same time, the Morgan Stanley individual and the Chinese official expanded their personal business dealings both in a real estate interest secretly acquired from Morgan Stanley as well as by investing together in Chinese franchises of well-known U.S. fast food restaurants. The Morgan Stanley individual failed to include these investments in annual disclosures required as part of his employment. The SEC alleged that a Morgan Stanley compliance officer specifically informed the Morgan Stanley individual in 2004 that employees of the Chinese state-owned entity, were government officials for purposes of the FCPA. The Morgan Stanley individual also received at least 35 FCPA compliance reminders from Morgan Stanley, but nonetheless committed the FCPA violations.

REMARKS AT THE 37TH ANNUAL INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS ANNUAL CONFERENCE

"The highest quality accounting and auditing standards, and the most comprehensive anti-fraud laws, are meaningless if those standards and laws are not enforced."

Commissioner Elisse B. Walter
Bejing, China
May 16, 2012

The Q2 2012 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in Q2 2012 AAERs, we identified the accounting problem(s) in each AAER based on the classification definitions below:

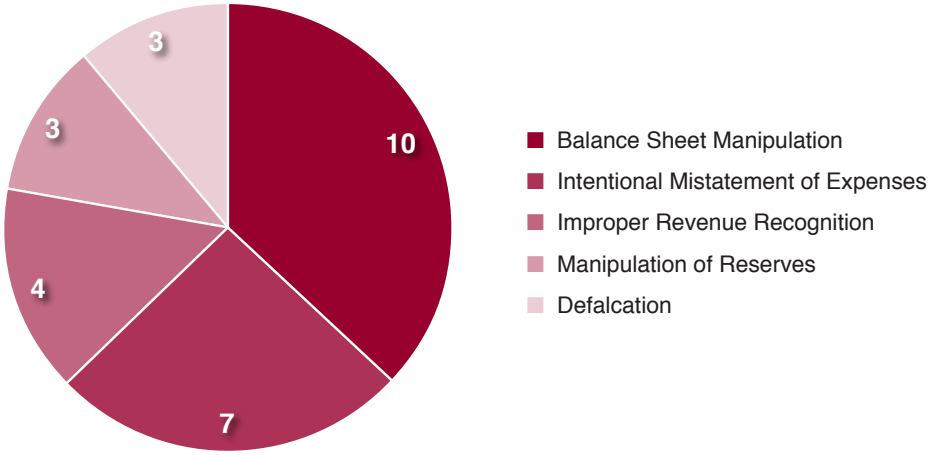
Classification	Definition
Improper Revenue Recognition	Overstated, premature and fabricated revenue transactions reported in public filings
Manipulation of Reserves	Improperly created, maintained and released restructuring reserves, general reserves and other falsified accruals
Intentional Misstatement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

Balance Sheet Manipulation was the most prevalent problem in the quarter.

Interestingly, Improper Revenue Recognition which was the dominant category in 2011 slipped to the third position in Q2 2012.

The following chart provides the results of our financial reporting issue analysis for the Q2 2012 AAERs. Balance Sheet Manipulation was the most prevalent problem in the quarter. Interestingly, Improper Revenue Recognition which was the dominant category in 2011 slipped to the third position in Q2 2012.

AAERs by Financial Reporting Issue



Notable Q2 2012 AAERs for "Recommended Reading"

While reviewing all of the SEC's AAERs may prove insightful, certain releases present information that is worth 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.

Among the Q2 2012 AAERs, two releases warrant such special attention. First, the release describing the improper related party transactions at China Natural Gas Inc. ("China Natural Gas") and second, the case involving manipulation of performing versus non-performing loans at Franklin Bank Corporation ("Franklin").

SEC v. China Natural Gas, Inc. and Qinan Ji, United States District Court for the Southern District of New York (Civil Action No. 12-cv-3824 (PGG))

The SEC filed suit in U.S. District Court for the Southern District of New York against China-based China Natural Gas, Inc. and its chairman and former CEO for defrauding investors by secretly loaning company funds to benefit the former CEO's son and nephew while failing to disclose the true nature of the loans.

The SEC alleged that the former CEO coordinated two short-term loans totaling more than $14 million in January 2010. One loan went to a real estate firm co-owned by the son and nephew through a sham borrower. The other loan went to a business partner of the real estate firm. Of significance, the company's SEC filings falsely stated that the loans were made to unrelated third parties. The former CEO then lied about the true borrower to China Natural Gas's board, investors, and auditors, as well as during the company's internal investigation.

In February 2012 Public Company Accounting Oversight Board ("PCAOB") issued for public comment a proposed updated auditing standard, *Related Parties*. "The Board is considering these changes because related party transactions and significant unusual transactions have played a recurring role in financial failures, from those that led to the Sarbanes-Oxley Act to those recently alleged in companies in certain emerging markets," said PCAOB Chairman James R. Doty.

The proposed standard would improve the auditor's evaluation of a public company's identification of, accounting for, and disclosure about its relationships and transactions with related parties. Specifically it would strengthen existing audit procedures for identifying, assessing, and responding to the risks of material misstatement associated with a company's related party transactions.

In February 2012 Public Company Accounting Oversight Board ("PCAOB") issued for public comment a proposed auditing standard, Related Parties. "The Board is considering these changes because related party transactions and significant unusual transactions have played a recurring role in financial failures, from those that led to the Sarbanes-Oxley Act to those recently alleged in companies in certain emerging markets," said PCAOB Chairman James R. Doty.

In addition, the PCAOB is proposing other amendments to the auditing standards designed to further complement its proposals regarding related parties and significant unusual transactions. One such amendment would address the auditor's consideration of the financial relationships and transactions between a company and its executive officers. Executive officers are in a unique position to commit financial statement fraud or asset misappropriation through their ability to manipulate accounting records and present fraudulent financial information (e.g., through override of controls). Further, a company's financial relationships and transactions with its executive officers might create incentives and pressures that could create risks of material misstatement of the financial statements.

COMPLIANCE AND THE AUDIT: RELEVANCE AND INVESTOR PROTECTION

"The relevance, credibility, and transparency of the financial audit are rooted in the core values of independence, objectivity and skepticism. These core values must be monitored, protected and enhanced in order to serve the public interest and protect investors in an ever more complex global business environment."

James R. Doty
Compliance
Washington, D.C.
Week of June 4, 2012

SEC v. Anthony J. Nocella and J. Russell McCann, Case No. 4:12-cv-1051 in the United States District Court for the Southern District of Texas.

The SEC charged the former CEO and CFO of Franklin Bank Corp. for their involvement in a financial reporting fraud related to improper loan modification programs during the 3rd and 4th quarters of 2007 for non-performing assets which artificially inflated Franklin's net income and earnings.

According to SEC the former officers knew that the delinquencies and non-performing loans in Franklin's single family and residential construction loan portfolios increased significantly during the summer of 2007. The SEC alleged that they implemented three loan modification schemes that caused Franklin to mask delinquent and non-performing loans as performing: (i) Fresh Start; (ii) Strathmore; and (iii) Great News. By the end of September 2007 the loan modification programs concealed from shareholders over $11 million in non-performing single family residential loans and $13.5 million in non-performing residential construction loans.

- ***Fresh Start.*** *Pursuant to the loan modification program known as "Fresh Start," Franklin unilaterally sent letters to delinquent and severely delinquent borrowers – all of whom were four or more payments past due and had failed to demonstrate the ability to pay under the terms of their loans. The letters advised the severely delinquent borrowers that the Bank would consider their loans current if the borrowers: (i) contacted the Bank by October 1, 2007; (ii) agreed to make one payment; (iii) agreed to move all past due amounts to the end of the loan due at the maturity of the loan; and (iv) made a payment on or before October 13, 2007 under the terms of the original loan. Through the end of the third quarter of 2007, an Executive Vice President and Managing Director of the Bank's mortgage banking division, regularly updated the former CEO and CFO about the dollar amount of loans that had been modified under the Fresh Start program. Ultimately, Franklin modified millions of dollars of loans through the Fresh Start program, including $4 million in loans that were previously classified by the Bank as nonperforming. Furthermore, in Franklin's third quarter 10-Q, the former CEO and CFO removed the non-performing loans that were modified pursuant to the Fresh Start program from the Bank's disclosures of nonperforming loans and non-performing assets.*

- ***Strathmore Modifications.*** *Because he understood that Fresh Start was not enough to "polish the apple," a phrase used at the bank for this process, the CEO tasked Franklin's General Counsel with reducing the growing delinquencies in Franklin's residential builder construction loan portfolio. The CEO was particularly concerned about four troubled loans totaling $13.5 million to Strathmore Finance Co. and its subsidiaries for four construction projects in the Detroit area (the "Strathmore loans"). By the summer of 2007, Strathmore could not repay the loans and asked Franklin for a loan modification. In fact, Strathmore's financial condition was so dire that it requested an interest reserve as part of the modification. An "interest reserve" allows a lender to advance loan funds to pay interest charges on the outstanding balance of the loan. The interest is capitalized and added to the loan balance. The Credit Committee, including the CEO and CFO, agreed to modify the Strathmore loans by approving an interest reserve sufficient to cover the next 12 months' interest payments. By September 28, 2007, the Strathmore loans were over four payments past due, and therefore, non-performing. Moreover, because the Strathmore borrower was insolvent, it could not demonstrate that it had the ability to make payments on the loan. Accordingly, the Strathmore loans, consistent with the Bank's publicly stated policies relating to non-performing loans, should have been reflected as non-performing in Franklin's third quarter 10-Q, and the Bank should have impaired the Strathmore loans. However, neither action was taken.*

- ***Great News.*** *On or about October 5, 2007, the CEO reviewed and approved the modification letter that became known as the "Great News letter," and directed that the letter be sent to 28 single-family borrowers whose loans were classified as non-performing. Although these loans were severely delinquent—between 119 and 545 days past due—the Great News letter advised the borrowers that their loans were now current and that, to remain current, borrowers only needed to make their next scheduled payment. After the Great News letters were mailed, a senior loan officer of the bank instructed the employee responsible for updating the loan servicing system to reflect the Great News loans as current in Franklin's accounting system. By the end of the third quarter of 2007, the Great News loans were significantly over four payments past due, and therefore, non-performing. Moreover, none of the Great News borrowers made payments; therefore, none of the Great News borrowers could have demonstrated the ability to make payments on the loan. Such treatment for delinquent loans was inconsistent with the Bank's internal Asset Classification Policies and Procedures and publicly disclosed policy on non-performing assets, which required the borrowers to make three payments and otherwise "demonstrate ability to repay the loan" before the loan could be reclassified as performing.*

Importantly, because all of the modified loans were part of troubled debt restructurings ("TDR") under GAAP, Franklin should have impaired them pursuant to FASB ASC 310 Receivables.

Importantly, because all of the modified loans were part of troubled debt restructurings ("TDR") under GAAP, Franklin should have impaired them pursuant to FASB ASC 310 Receivables, which states:

> *A loan is impaired when based on current information and events it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due to contractual terms means that both the contractual interest payments and contractual principal payments of a loan will be collected as scheduled in the loan agreement.*

In addition, FASB ASC 310 requires creditors to measure impairment based on the present value of expected future cash flows or an observable fair value of the collateral (i.e., an appraisal) if the loan is collateral dependent. If that present value is less than the recorded investment in the loan, the impairment should be added to reserves and expensed against income.

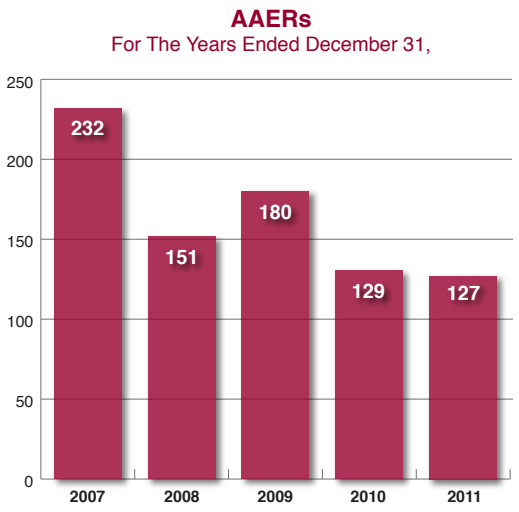
ADVOCATING FOR GREATER FEDERAL AND STATE SECURITIES REGULATORY COOPERATION AND COLLABORATION

"Investors' voices and concerns have to be priorities in the current regulatory landscape, and investors have to be part of the debate. This has not been the case—and this has to change."

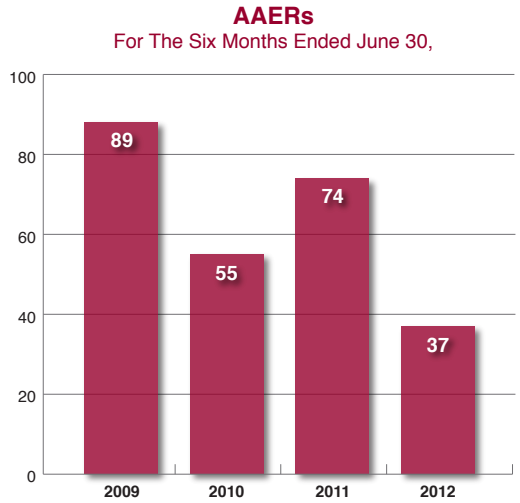
Commissioner Luis A. Aguilar

Prior Period Comparisons: Year over Year and Quarter over Quarter Statistics

As described in "Our Process and Methodology" section, 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 the SEC provides for the classification. That said, comparisons of the number of AAER's between periods may be a useful gauge of the SEC's activities.



For the year ended December 31, 2011, the SEC issued 127 AAERs, remarkably the lowest number of AAERs reported over the last five years. For comparison, the average for the periods 2007 through 2011 was approximately 164 releases, with the greatest number of releases issued in 2007



When analyzing the AAER population issued during the first six months of 2009 through 2012, the 2012 results show a decrease of approximately 55% from 2011. Needless to say, a remarkably low tally.

AAERs reported for Year Ended December 31, 2011:

127

AAER population issued for The Six Months Ended June 30, 2012:

37

www.floydadvisory.com

ACKNOWLEDGEMENT
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ABOUT FloydAdvisory
Floyd Advisory LLC is an independent business advisory and forensic accounting firm with offices in Boston and New York City, providing services relating to: financial reporting problems, fraud investigations, SEC reporting issues, white collar defense matters, post-acquisition disputes, business damages, financial and valuation analyses.

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