Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended June 30, 2014

Q2 REPORT 2014

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, 2014.

As an independent consulting firm with financial and accounting expertise, we are committed to contributing thought leadership and relevant research regarding financial reporting matters that will assist our clients in today's fast-paced and demanding market. This report is just one example of how we intend to fulfill this commitment.

The Division of Enforcement at the U.S. Securities and Exchange Commission ("SEC") is a law enforcement agency established to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. As such, the actions they take and releases they issue provide very useful interpretations and applications of the securities laws.

For those involved in financial reporting, SEC releases concerning civil litigation and administrative actions that are identified as related to "accounting and auditing" are of particular importance. Our objective is to summarize and report on the major items disclosed in the AAERs, while also providing useful insights that the readers of our report will find valuable.

We welcome your comments and feedback, especially requests for any additional analysis you would find helpful.

Floyd Advisory
JULY 2014

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.

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 (e.g., Rule 102(e) Actions, Financial Reporting Frauds, Foreign Corrupt Practices Act violations ("FCPA"), Reinstatements to Appear and Practice before the SEC, Violations of Books and Records, and Other) and classifications of the financial reporting issues involved (e.g., Improper Revenue Recognition, Manipulation of Reserves, Intentional Misstatement of Expenses, Balance Sheet Manipulation, 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.

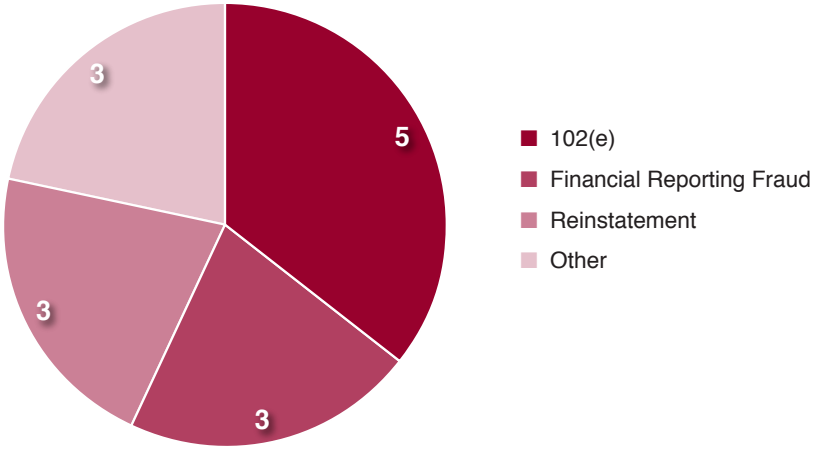
REVIEW PROCESS

- 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 2014 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed 14 AAERs during Q2 2014 which we have sorted into the following categories as shown in the pie chart.

Q2 2014 AAERs by Category



SEC disclosed AAERs for the Quarter Ended June 30, 2014:

14

While the categorical breakdown is analytically useful, a closer look into each category provides a clearer understanding of the SEC's actions.

Rule 102(e) Actions

As reflected in the chart, Rule 102(e) actions accounted for 36% percent of the releases issued in Q2 2014. Notably, two out of five actions were brought against auditors or audit firms, one of which is discussed in the "Recommended Reading" section of this report.

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 types of actions reported in this quarter's Rule 102(e) releases are as follows:

- ***The SEC filed a complaint against a CPA who is a former chief financial officer ("CFO") of a jewelry company, alleging that the individual was part of a fraudulent scheme that led to the filing of materially misleading and false financial statements for fiscal years ended December 31, 2009, 2010 and deceiving the company's external auditors.*** The company buys and sells jewelry and bullion products such as fine watches, precious metals, diamonds, and rare coins as well as collectibles and other valuables, and its products and services are offered to individual consumers, dealers, and institutions in the United States.

  The former CFO allegedly inflated the value of the company's inventory by creating falsified accounting entries and making it appear as though the company owned inventory that it in fact did not. The goods in question still belonged to customers with whom the company had consignment arrangements; the company was merely holding on to certain items on the owners' behalf until the sale was made.

  Additional allegations state that the former CFO signed false management certifications and the company failed to maintain proper accounting controls. As a result of these allegations, the SEC barred the former CFO from appearing or practicing before the SEC as an accountant and ordered him to pay a civil monetary penalty of $75,000.

- ***The SEC charged a former chief risk officer and a partner of a regional audit firm for improper professional conduct and infractions of independence rules.*** While working on an audit engagement of a casino and hospitality provider, the audit advisory partner allegedly pursued and received casino markers from one of the audit client's casinos. The individual allegedly visited the casino at least five times while serving as an advisory partner on the client's 2009 audit. According to the SEC, he opened his first line of credit with the casino in June 2004 and increased it to $110,000 by December 2009, subsequently defaulting on the total amount.

  The advisory partner had allegedly concealed from his firm the fact that he drew a line of credit with the casino. Furthermore, per the release, he lied to a colleague when asked, in a general way, if he had any casino markers from the firm's clients. The SEC stated that when the former partner retired from his firm, the company remained unaware that he possessed casino markers from a client.

  The SEC ruled that the former partner must cease and desist from committing or causing to commit future violations of the Exchange Act. The individual was also denied the privilege of appearing or practicing before the SEC as an accountant, with the option to submit an application of reinstatement in two years.

THREE KEY PRESSURE POINTS IN THE CURRENT ENFORCEMENT ENVIRONMENT

". . . we focus our investigations initially on the individuals closest to the wrongdoing and work outward and upward from there to determine who else should be charged, including whether to charge the corporation. A company, after all, can only act through its employees and if an enforcement program is to have a strong deterrent effect, it is critical that responsible individuals be charged, as high up as the evidence takes us. And we look for ways to innovate in order to further strengthen our ability to charge individuals."

Chair Mary Jo White
NYC Bar Association's Third Annual
White Collar Crime Institute
New York, NY
May 19, 2014

- ***The SEC filed a complaint alleging a CPA, licensed in California, obtained material nonpublic information about his employer's financials in 2009 and 2010 and shared that information with his friend outside of the company, who then relayed the information to an analyst at a wealth management firm in exchange for payment.*** According to the release, the CPA held several finance-related positions from 2005 until May 2012 at a company that developed and sold graphics processors used in various computing devices. After obtaining the information, the analyst at a wealth management firm allegedly traded the company's securities and reaped about $295,000 in gains and avoided losses. The confidential information included calculations of revenues, gross profit margins, and other important financial data that was then passed along to other individuals, according to the SEC. By disclosing the material nonpublic information to his friend, the CPA allegedly breached a fiduciary duty of trust and confidence to his employer.

  The CPA consented and settled with the SEC without admitting or denying the allegations. The individual was ordered to pay a $30,000 civil monetary penalty and was barred for five years from acting as an officer or director of any issuer.

"Accountability means that actions have consequences. When corporate governance embodies the principle of accountability, shareholders know that performance will be measured. They know that good performance will be rewarded, and poor performance will not. And, most importantly, they know that misconduct will not be tolerated."

Luis A. Aguilar
Commissioner
Emory University School of Law,
Corporate Governance
Lecture Series,
Atlanta, Georgia
April 21, 2014

Financial Reporting Frauds

There were three AAERs that we categorized as financial reporting frauds during the quarter. Two of these arose from same event, which we describe below; the third release also merits further discussion and is described in our "Recommended Reading" section.

- ***During the first quarter of 2009, a company's former Executive Vice President, the Chief Credit Officer ("CCO") and head of the Special Assets Department allegedly engaged in misstating the company's financial statements (failing to conform with GAAP) and falling short in maintaining an adequate system of internal controls.*** The officers in question allegedly recorded a $6.8 million commercial loan as an accruing loan, despite direction from supervisors to record the loan as non-accrual status (interest income would not be recorded on a non-accrual loan). Per the SEC pleadings, the individuals also ordered subordinates to remove from the company's Asset Quality Forecast (AQF) report about $150 million of commercial loans that were properly recorded as non-accrual. The former officers allegedly engaged in this scheme without documentation or justification that supported the removal of these loans from the AQF. These actions led directly to the company improperly classifying $168 million of their loans as being in accrual status. According to the SEC, the individuals understated non-performing loan data to senior executives, including the company's CFO.

The former Executive Vice President of the company's Risk Management Credit Division also caused a $24.7 million commercial loan to be reclassified to "Loans Held For Sale", without a corresponding charge to earnings for the quarter ended March 31, 2009. As a result of this oversight, the company's net income was overstated by $2.9 million, in addition to the $11 million overstatement attributed to the misclassified non-accrual loans. Including other material misstatements, the company's income was overstated by $16 million and its earnings per common share was overstated by $.02 per share.

In response to these allegations, the SEC has ordered a public hearing to take evidence on the questions outlined in the AAER. The former Executive Vice President is also ordered to file an answer to the SEC's questions.

The former Executive Vice President and head of the company's Special Asset Department, as well as the company's former Senior Executive Vice President and CCO, have been ordered to cease and desist from committing or causing to commit any future violations. They are also barred from acting as an officer or director of any registered issuer of securities for five years. Additionally, both are ordered to pay a penalty of $70,000.

Other

Three of the AAERs that we placed in the "Other" category focus on several foreign public accounting firms based in the People's Republic of China and their alleged willful refusal to provide the SEC with audit work papers, a violation of the Sarbanes-Oxley Act. This matter gave rise to a number of AAERs, one of which had been highlighted in our report for the previous quarter:

- ***According to the SEC, the matter involved audits performed for ten audit clients headquartered in China and whose securities were traded on the US stock exchange.*** The SEC is conducting, or had conducted in the past, fraud investigations of all of the aforementioned audit clients, and had requested audit work papers as part of its investigation. The allegations state that the audit firms refused to provide the work papers claiming that their interpretation of Chinese law, including regulations promulgated by the China Securities Regulatory Commission, prevented them from providing such documents to U.S. regulators.

  Initially, a law judge ruled that four of the five respondents are barred from practicing or appearing before the commission for a six-month period. The SEC censured the remaining respondent. Importantly, according to the SEC, remedial measures were warranted on the ground that "future violations [were] virtually certain because Respondents consider themselves unable to produce audit work papers directly to the Commission even under any future Sarbanes-Oxley 106 request." The latter AAERs, issued in Q2 2014, are orders "granting leave to adduce additional evidence and granting the petitions for review", "denying the division's motion to strike the notice of withdrawal of appearance and setting a briefing schedule", and an "extension order."

"Legislative history and context, meanwhile, further support the Commission's exercise of authority here. In Dodd-Frank, not only did Congress explicitly expand the triggering conditions for a foreign firm's production under Section 106 . . . it also added subsection (e) to Section 106, defining a willful refusal to produce documents as a violation of the securities laws."

Security and Exchange Commission
Administrative Proceeding
File Nos. 3-14872, 3-15116, Pg. 35.
February 22, 2013

Reinstatement

During Q2 2014, the SEC reinstated three individuals to appear and practice before the SEC as an accountant, two of which are worth highlighting:

- ***The SEC approved a former CFO's application for reinstatement to appear and practice before the commission as an accountant responsible for the preparation or review of financial statements.*** The suspension occurred in 2009, when the SEC charged the former CFO of a healthcare company with conducting fraudulent accounting practices that led to improper recognition of revenue. As a result, the company filed materially false and misleading financial statements in their annual reports for 2002 through 2004 and the first three quarters of fiscal year 2005. The SEC complaint alleged that the company failed to properly execute contracts and/or failed to deliver products in the same fiscal period in which the revenue was recorded. It also alleged that the company failed to create and implement a system of internal accounting controls to prevent the fraud.

  The former CFO settled the charges without admitting or denying the SEC's allegations and was permanently enjoined from committing future violations of the antifraud provisions of the federal securities laws. In addition to barring the former CFO from serving as an officer or director of a public company for five years and suspending him from appearing or practicing before the SEC as an accountant (with the right to reapply after three years), he was ordered to pay $180,000 in disgorgement, $50,000 in prejudgment, and a $50,000 penalty.

  The SEC ruled that he complied with the terms of their January 6, 2010 order suspending him from practicing as an accountant, and found no new information pertaining to his character, integrity, professional conduct, or qualifications that would rule against his reinstatement.

- ***According to the SEC, an auditor allegedly was engaged in improper professional conduct while performing audit and reviews of one of the client's financial statements.*** Between December 31, 2004 and the second quarter of 2007, the SEC alleged that the individual violated PCAOB standards when conducting the engagements and materially misrepresented the client's financial position, operating results, and cash flows. In 2009, the SEC filed a complaint alleging that the client's financial statements during the period in question were misstated due to improperly deferred expenses related to year-end bonuses; improperly recorded fictitious and/or premature revenue; and failure to disclose material transactions with related parties.

During Q2 2014, the SEC reinstated three individuals to appear and practice before the SEC as an accountant, two of which are worth highlighting.

According to the SEC, the CPA was the manager of the engagement during the 2004 and 2005 audits and 2005 and 2006 quarterly reviews. The CPA allegedly supervised the 2006 audit and served as engagement partner supervising his company's reviews for the first and second quarters of year ending December 31, 2007. In 2010, the CPA was denied the privilege of appearing or practicing as an accountant before the SEC. He is currently on probation under the California Board of Accountancy, where he holds his license. His probation is scheduled to end in March 2016, and he has attested that he will notify the SEC if he violates the terms of his probation. The SEC has opted to approve his application for reinstatement on the grounds that he has complied with the terms of his license revocation and that no information has come to light that would adversely affect his application.

The Q2 2014 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in Q2 2014 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

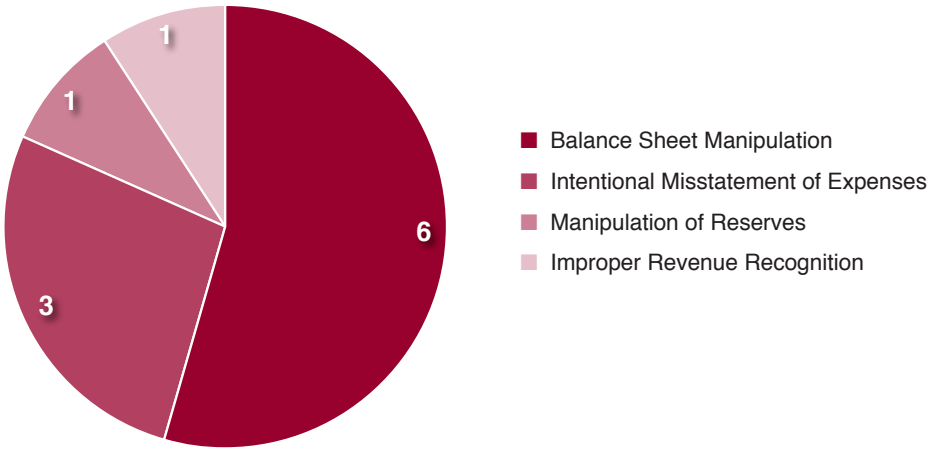
REMARKS AT THE FINANCIAL ACCOUNTING FOUNDATION TRUSTEES DINNER

"At its core, financial reporting, using accounting standards adopted by the FASB, is a critical component of communication between a company and its investors. Financial reporting can and should provide investors with a clear picture of a company's financial condition—information that investors need to make an informed investment or voting decision. And, as I will discuss later, these standards must be enforceable, and in fact, enforced."

Chair Mary Jo White
U.S. Securities and Exchange Commission
Washington D.C.
May 20, 2014

The following chart provides the results of our financial reporting issue analysis for the Q2 2014 AAERs.

Financial Reporting Issues Identified in Q2 AAERs



AAERs reported by Financial Reporting Issue for Quarter Ended June 30, 2014:

11

Notable Q2 2014 AAERs 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.

Below is an AAER related to actions brought by the SEC against a former controller that highlights the significant role estimates and judgments play in accounting and financial reporting. In most cases, when making an estimate or judgment, there is a range of reasonable conclusions or outcomes. Next, we highlight the sensitive issues that may arise when an audit firm relies on others for audit procedures yet assumes full responsibility for the audit opinion.

Accounting and Auditing Enforcement Release No. 3548 / April 8, 2014 Administrative Proceeding File No. 3-15825, In the Matter of Laird Daniels, CPA, Respondent.

Laird Daniels ("Daniels"), a CPA and former Retail Controller of CVS Caremark Corporation ("CVS"), settled with the SEC for materially and without public disclosure changing the company's accounting for its October 20, 2008 acquisition of 525 Longs drugstores ("Longs"). The SEC alleged Daniels changed CVS's assumptions used in purchase price accounting to improve the company's financial results.

According to the SEC, CVS acquired Longs and hired an outside accounting firm to perform valuation services for Longs' purchase price allocation accounting (PPA). Working with CVS management, the firm allegedly applied a "continued use" premise, assuming that CVS would retain and continue employing Longs' property, plant and equipment. Based on this assumption, the firm valued the Longs stores at more than $1.2 billion, including $229 million of personal property.

These assets were reported in CVS's audited financial statements for fiscal year ended December 31, 2008, filed on Form 10-K on February 27, 2009. In addition, CVS's financial statements for the first two quarters of 2009 reported these assets. However, according to the SEC, under Mr. Daniel's instructions, the purchase price allocation changed during the third quarter of 2009 in a manner that improved CVS's financial results, while at the same time not disclosing the specifics of the changes. Key reported facts included:

- February 27, 2009: CVS filed its annual report for year ended December 31, 2008 with the SEC and its management represented to CVS's outside accounting firm that the value of the personal property at the acquired Longs stores was $229 million.

- May 2009: Mr. Daniels outlined CVS's remodeling strategy with regard to the Longs stores. He indicated that 420 stores would face some remodeling, with at least 360 set to undergo a "full remodel", (i.e. all existing fixtures and equipment scrapped). The SEC noted that "at no point between January 27 and May 13 [2009] did CVS tell the valuation firm about any plans to dispose of almost all of the Longs stores' personal property."

- October 1, 2009: According to the SEC, the value of Longs stores' personal property was revised to $39.6 million, based on earlier statements by Mr. Daniels that CVS had always intended to scrap Longs stores' personal property. The release stated, "CVS's failure to provide the firm with the correct information for six months after the firm was retained was due to a 'miscommunication.'"

- On November 5, 2009, CVS filed their Q3 report containing unaudited financial statements that included adjustments to the PPA. One of the adjustments included a reduction in the value of Longs tangible assets by $212 million and goodwill was increased by the same amount. The reduction of tangible assets resulted primarily from a $189 million decrease in the value of the Longs stores' personal property. CVS wrote off all personal property in approximately 430 Longs stores, including more than 360 stores that initially were going to be operated in the long term.

- In addition, CVS allegedly reversed the $49 million depreciation that was previously taken on Longs' assets from October 2008 to June 2009, thereby increasing CVS' EPS by approximately 2.4¢.

In most cases, when making an estimate or judgment, there is a range of reasonable conclusions or outcomes.

According to the SEC, it wasn't until months after the acquisition date that CVS even developed remodeling plans for the Longs stores. As such, the changes advocated and made by Mr. Daniels were based on facts that were not in existence as of the acquisition and valuation dates and any new facts or changes arising thereafter should have received separate accounting treatment and recorded as of the date they arose.

The SEC argued that had Mr. Daniels adhered to proper accounting principles, CVS would have had current-period expenses as much as $189 million higher than was actually reported for the third quarter of 2009. This misstatement overstated operating profits by as much as 13.7% and earnings per share by as much as 17%.

A review of the purchase price allocation rules will provide further insights on Mr. Daniels' judgments, especially considering the ability of registrants to adjust the purchase price allocations for up to one year after the acquisition is recorded.

At the time of Mr. Daniel's alleged violations, FASB's Statement of Financial Accounting Standards No. 141R, ("SFAS 141R") Business Combinations, provided relative authoritative guidance. As of the third quarter of 2009, the relevant authoritative guidance was contained in ASC (Accounting Standards Codification) 805.

The ability to make adjustments to accounting judgments under SFAS 141R is unique among GAAP, and confusion as to what constitutes the "existence" of information as of the acquisition date, such as actual written material, people's discussions, vague plans, or even simple ideas that need finalization such as store renovations, can easily arise.

SFAS 141R and ASC 805 both specify that "the acquirer shall consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized." Of significance, SFAS 141R calls for a measurement period after the acquisition date in which the acquiring company adjusts the acquisition accounting to consider information that existed as of the acquisition date. The measurement period ends either a) one year from the acquisition date or b) when the acquirer receives the information necessary to complete the business combination accounting, whichever date is sooner. The ability to make adjustments to accounting judgments under SFAS 141R is unique among GAAP, and confusion as to what constitutes the "existence" of information as of the acquisition date, such as actual written material, people's discussions, vague plans, or even simple ideas that need finalization such as store renovations, can easily arise.

The SEC outlines three reasons why CVS's decision to decrease the valuation of Longs stores' personal property from $229 to $39.6 million conflicts with the proper application of SFAS 141R: (1) the adjustments did not reflect CVS's intended future use of the assets as of the acquisition date; (2) the adjustments did not reflect information that was known or knowable to CVS as of the acquisition date; and (3) the adjustments did not reflect CVS's use of the assets to generate future revenue after the acquisition date.

The SEC ordered Mr. Daniels to cease and desist from committing or causing to commit any future violations. Mr. Daniels also accepted a 102(e) bar from appearing or practicing before the SEC as an accountant, though he is eligible to apply for reinstatement after one year. Daniels also agreed to pay a fine of $75,000. Importantly, Mr. Daniels is still employed by CVS as Senior Vice President for International Operations and Business Development. This may be a sign that his culpability for any improper accounting treatment is not viewed by CVS as an intentional act to deceive investors, but rather an improper application of judgment and assumptions in a financial reporting area that can nonetheless be subject to differing interpretations.

Accounting and Auditing Enforcement Release No. 3555 / May 20, 2014 Administrative Proceeding File No. 3-15877, In the Matter of Bryce Walker, CA and Spence Walker, CA, CPA, Respondents.

Two Canadian accountants, Bryce Walker and Spence Walker ("auditors"), agreed to Rule 102(e) sanctions for their audit of China-based Subaye, Inc. ("Subaye"). According to the SEC's allegations, the two auditors failed to comply with PCAOB Auditing Standards for their 2010 audit, including specific allegations that they failed to properly supervise the overall engagement, gathered insufficient audit evidence, and did not act with the due professional care required of auditors.

The SEC had previously charged Subaye and its former CFO with engaging in a fraudulent scheme involving misrepresentations about the company's business and operations, deceiving the company's auditors, and misleading investors about the company's true status and revenues.

As part of their audit, the Canada-based auditors relied on contract accountants based in China for significant audit procedures, certain of which appear to have contributed to their failure to detect fraudulent activities.

When an audit firm involves another firm in its audit for purposes of arriving at its audit opinion, special considerations are required. One such consideration is whether the contracted auditor (in this case, the Chinese contract accountants) should be referred to in the audit opinion, thereby alerting financial statement users that the responsibility for the audit was shared between two firms.

According to the SEC complaint, Subaye represented that it provided online services, including video advertising and entertainment media services, for small-to-medium sized businesses in China. It also claimed to offer a cloud computing business. According to the SEC, Subaye further misrepresented itself as a company with high revenue growth, vibrant business operations, and a very bright future. According to the SEC, Subaye reported approximately $39 million in revenues and over 1,500 employees in its public filings for the fiscal year ending September 30, 2010. By the end of calendar year 2010, it reported more than 14,600 customers. The allegations state that the company's customers paid monthly for the services and that sales agents interacted with the customers and collected the monthly fees in cash. According to the complaint, the reality is that Subaye had few, if any, verifiable revenues or paying customers for its online membership business, and no infrastructure to support its claimed cloud computing business.

In order to hide its alleged accounting fraud, Subaye's management represented that millions of dollars in cash were being held by third-party sales agents to be "reinvested" and used for marketing and promotional expenses. The purported aim of these reinvestments was to support the company's future growth and investments in new markets.

When an audit firm involves another firm in its audit for purposes of arriving at its audit opinion, special considerations are required. One such consideration is whether the contracted auditor . . . should be referred to in the audit opinion, thereby alerting financial statement users that the responsibility for the audit was shared between two firms.

In the 4th quarter of 2010, the auditors began questioning the $18.8 million "Cash Held in Trust" account. However, management could only provide supporting documentation for the balance in the form of general ledger and journal entries and contracts signed by third party agents showing their relationship with Subaye. When the auditors asked for documents to support the existence of this cash supposedly held by sales agents for development, Subaye's management was unable to produce bank account statements, receipts, or any other evidence that could be deemed sufficient under PCAOB standards.

Subaye had another unusual asset account on its balance sheet called "Deposits for Purchases of Inventoriable Assets." According to the SEC, management represented to the auditors that the deposits were related to Subaye's future launch of an online 3D mall. However, the only supporting documents provided to the auditors for this account were similar general ledger information and journal entries that showed amounts being recorded as deposits for various types of purchases with an offset to accounts receivable due from third-party sales agents.

When two audit firms collaborate or one firm relies on the other for material procedures, special reporting rules apply to avoid confusion and misunderstandings over roles and responsibilities.

After being questioned by the auditors about the lack of proper support, Subaye agreed to expense the outstanding balance as "marketing promotions" and presented the amounts as if they were still proper expenses, thereby correcting one financial reporting error by recording another. Nevertheless, the auditors provided an unqualified opinion on these financial statements.

Subaye's fraud came to light in December 2010 when the company dismissed its auditors and hired a large Hong Kong-based audit firm as its new independent auditor. As the SEC describes in its pleadings, this decision launched a series of events that exposed Subaye's fraudulent activities.

Adding to the alleged facts of the case, the Canadian auditors neither visited Subaye's offices nor performed essential audit procedures themselves. Instead they retained a local China-based audit firm as a contractor to assist in conducting the audit fieldwork.

For example, obtaining audit confirmations to attain third party evidence of management's financial statement assertions are a required audit procedure. For Subaye, the auditors and the contract accountants disagreed as to who was in charge of controlling the confirmation process. There is even uncertainty as to whether the confirmations were actually sent. According to the SEC complaint, four of the confirmations returned to the auditors included a handwritten note at the top indicating that the confirmations may have been faxed from Subaye's bookkeeper. The SEC also notes that all ten of the confirmations for accounts receivable that were sent out in November 2010 had been returned to the auditors within approximately ten days, a turnaround time that even the auditors admitted was unusually fast. The confirmation process must be controlled entirely by the auditors for their results to maintain integrity and reliance.

When two audit firms collaborate or one firm relies on the other for material procedures, special reporting rules apply to avoid confusion and misunderstandings over roles and responsibilities. The auditing standards promulgated by the PCAOB, in particular AU 543 *Part of Audit Performed by Other Independent Auditors*, addresses an audit firm's consideration when another firm takes part. The following guidance is from paragraphs .02 and .03 of AU 543:

> *"The auditor considering whether he may serve as principal auditor may have performed all but a relatively minor portion of the work, or significant parts of the audit may have been performed by other auditors. In the latter case, he must decide whether his own participation is sufficient to enable him to serve as the principal auditor and to report as such on the financial statements".*
>
> *"If the auditor decides that it is appropriate for him to serve as the principal auditor, he must then decide whether to make reference in his report to the audit performed by another auditor. If the principal auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, no reference should be made to the other auditor's work or report. On the other hand, if the principal auditor decides not to assume that responsibility, his report should make reference to the audit of the other auditor and should indicate clearly the division of responsibility between himself and the other auditor in expressing his opinion on the financial statements. Regardless of the principal auditor's decision, the other auditor remains responsible for the performance of his own work and for his own report."*

As described above, the Canadian auditors chose not to refer to the contracted auditor's work, which is allowable under PCAOB standards but places complete responsibility for the other audit firm's work on their shoulders. According to the SEC, there was a failure by the auditors to completely understand the procedures performed by the contracted firm and there was an apparent lack of proper supervision by the auditors.

In addition to reviewing the sufficiency and quality of the other audit firm's work, auditors would also be responsible for ensuring that the other firm is independent and has a favorable professional reputation. Of significance is the fact that the SEC release never indicates the identity of the contracted audit firm and whether it was registered with PCAOB, an omission that raises certain questions about the firm's reputation.

Of significance is the fact that the SEC release never indicates the identity of the contracted audit firm and whether it was registered with PCAOB, an omission that raises certain questions about the firm's reputation.

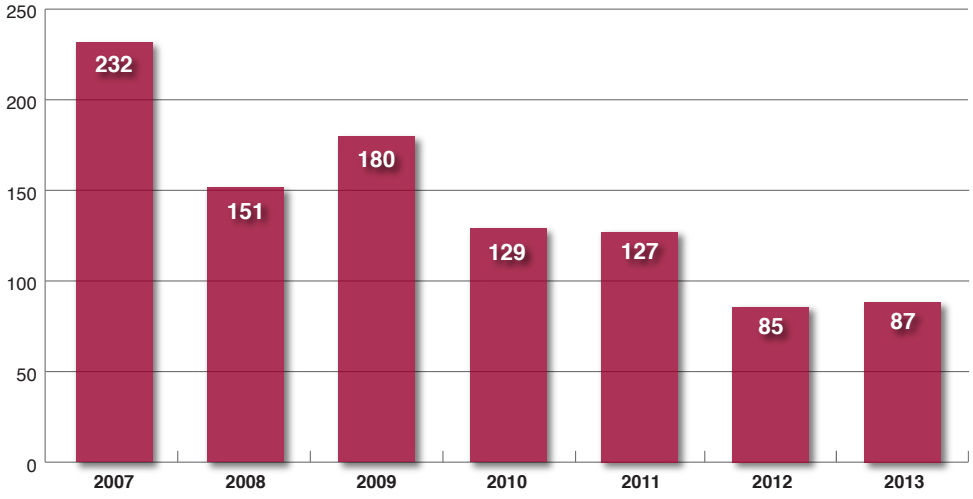
Prior Period Comparisons: Year over Year and Quarterly Statistics

As described in the section titled "Our Process and Methodology," 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 AAERs between periods may be a useful gauge of the SEC's activities.

For the year ended December 31, 2013, the SEC issued 87 AAERs, remarkably the second lowest number of AAERs reported over the last seven years. For comparison, the average rate for the periods 2007 through 2013 was approximately 142 releases, with the greatest number of releases issued in 2007. The downward trend since then, albeit fluctuating, may be at its lowest mark. With recent SEC talk about a "task force" and "several new investigations", we may see the number of enforcement actions by U.S. securities regulators increase in the coming years.[1]

For the year ended December 31, 2013, the SEC issued 87 AAERs, remarkably the second lowest number of AAERs reported over the last seven years.

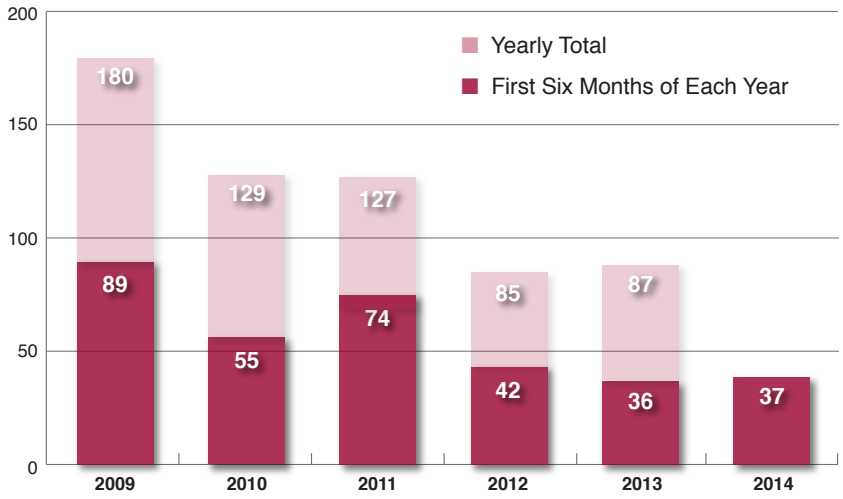
Looking Back at Total AAERs in Preceding Years
For the Periods January 1 - December 31,



[1] http://blogs.wsj.com/cfo/2014/06/17/sec-official-financial-reporting-audit-fraud-are-next-frontier/

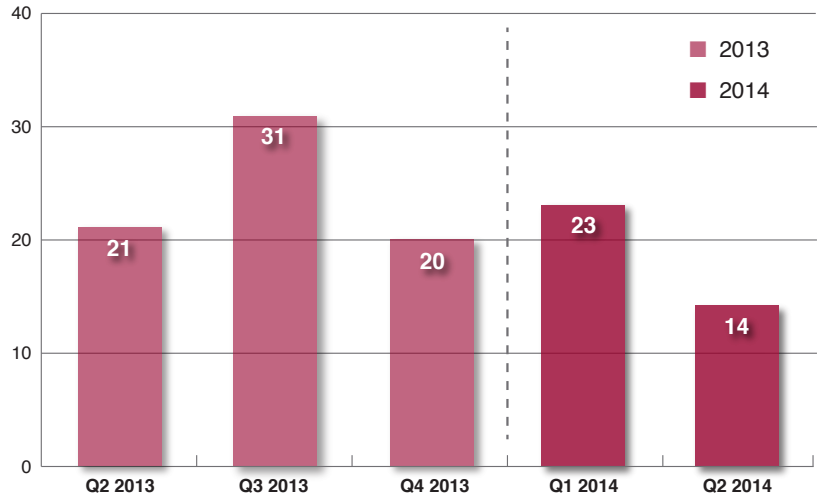
When analyzing the AAER population issued during the first six months for the years 2009 through 2014, the 2014 results reflect a slight increase over 2013, but a material drop from earlier years, as reflected below.

Analysis of AAER Volume for the First Six Months of Each Year
For the Period Ended June 30,



Over the last four quarters there have been 88 issuances, almost the same number of issuances as the SEC posted in the 2013 fiscal year.

Quarter to Quarter AAER Number Comparison over One Year Period
Q2 2013 through Q2 2014



THREE KEY PRESSURE POINTS IN THE CURRENT ENFORCEMENT ENVIRONMENT

"One the SEC's most powerful non-monetary remedies to protect the public from future harm is our authority to bar wrongdoers who work in the industry or appear before the SEC. And I have encouraged our Enforcement Division to increase the use of these bars in appropriate cases and to ensure that we obtain bars for periods of time that respond to the seriousness of the misconduct."

Chair Mary Jo White
NYC Bar Association's Third Annual White Collar Crime Institute
New York, NY
May 19, 2014

SEC NEWS: SPECIAL ANNOUNCEMENTS AND UPDATES

During the quarter ended June 30, 2014 the SEC announced several newsworthy items including the major developments described below.

SEC Announces Additional $150,000 Payment to Recipient of First Whistleblower Award

FOR IMMEDIATE RELEASE
2014-68
Washington D.C., April 4, 2014 —

The SEC announced that the whistleblower who received the first award under the agency's new whistleblower program will receive an additional $150,000 payout after the SEC collected additional funds in the case.

The whistleblower, who the SEC did not identify in order to protect confidentiality, has now been awarded a total of nearly $200,000 since the award was announced on Aug. 21, 2012. The award recipient helped the SEC stop a multi-million dollar fraud by providing documents and other significant information that allowed its investigation to move at an accelerated pace and prevent the fraud from ensnaring additional victims.

The award represents 30 percent of the amount collected in the SEC enforcement action against the perpetrators of the scheme, the maximum percentage payout allowed under the law. The additional payout comes after the SEC collected an additional $500,000 from one of the defendants in the case.

"This latest payment shows that the SEC's aggressive collection efforts pay dividends not only for harmed investors but also for whistleblowers," said Sean McKessy, chief of the SEC's Whistleblower Office. "As we collect additional funds from securities law violators, we can increase the payouts to whistleblowers."

The SEC expects to collect additional money from defendants in this case as some are making payments under a periodic payment schedule ordered by the court.

The 2010 Dodd-Frank Act authorized the whistleblower program to reward individuals who offer high-quality original information that leads to an SEC enforcement action in which more than $1 million in sanctions is ordered. Awards can range from 10 percent to 30 percent of the money collected. The Dodd-Frank Act included enhanced anti-retaliation employment protections for whistleblowers and provisions to protect their identity. The law specifies that the SEC cannot disclose any information, including information the whistleblower provided to the SEC, which could reasonably be expected to directly or indirectly reveal a whistleblower's identity. ■

SEC Charges Utah-Based Retirement Plan Administrator With Defrauding Investors

FOR IMMEDIATE RELEASE
2014-86
Washington D.C., April 30, 2014 —

The SEC announced fraud charges and an asset freeze against a Utah-based retirement plan administrator who defrauded investors in self-directed individual retirement accounts (IRAs), causing them to lose millions of dollars of savings.

The SEC alleges that American Pension Services Inc. (APS) and its founder, president and CEO Curtis L. DeYoung squandered more than $22 million of investor funds on high-risk investments. DeYoung hid the losses by issuing inflated account statements, allowing him to continue collecting fees and further victimizing his customers.

"This misconduct jeopardized retirement security for thousands of APS customers," said Karen L. Martinez, director of the SEC's Salt Lake Regional Office.

According to the SEC's complaint unsealed yesterday in federal court in Salt Lake City, DeYoung's scheme dates back to at least 2005 and targeted customers with retirement accounts holding non-traditional assets typically not available through traditional 401(k) retirement plans or other IRA custodians. Although APS has no authority to direct customer trades, DeYoung allegedly used forged letters and signatures to invest on behalf of customers, including in promissory notes issued by a friend whose businesses never turned a profit. DeYoung continued to recommend that APS customers invest in the notes, and he sent customer funds to the friend until at least April 2013 without disclosing to investors that the friend had defaulted on the notes in 2010 and DeYoung had forgiven the debt.

The SEC further alleges that investments in other bankrupt ventures, including an office building in Wichita, Kan., caused APS customers to lose more money. APS concealed those losses and issued account statements that inflated the value of customer holdings, allowing APS to levy fees based on the full value of the holdings even when they were worthless.

According to the SEC's complaint, when DeYoung was questioned by the SEC about a $22 million gap between actual holdings and those showing on account statements, he invoked his Fifth Amendment privilege against self-incrimination and refused to answer.

The Honorable Robert J. Shelby granted the SEC's request for a temporary restraining order to freeze the assets of APS and DeYoung. The court appointed Diane Thompson of Ballard Spahr LLP as the receiver in this case to recover investor assets. ■

SEC Charges NYSE, NYSE ARCA, and NYSE MKT for Repeated Failures to Operate in Accordance With Exchange Rules

FOR IMMEDIATE RELEASE
2014-87
Washington D.C., May 1, 2014 —

The SEC announced an enforcement action against the New York Stock Exchange and two affiliated exchanges for their failure to comply with the responsibilities of self-regulatory organizations (SROs) to conduct their business operations in accordance with Commission-approved exchange rules and the federal securities laws. Also charged was the NYSE exchanges' affiliated routing broker Archipelago Securities.

The NYSE exchanges agreed to settle the SEC's charges by retaining an independent consultant and together with Archipelago Securities paying a $4.5 million penalty.

"The SEC regulates exchanges, in part, by reviewing rules proposed by the exchanges that govern exchange activities and allow market participants to decide how and where to place orders," said Andrew J. Ceresney, director of the SEC's Division of Enforcement. "We will hold exchanges accountable if they fail to have rules governing their operations or fail to follow them."

As SROs, the NYSE exchanges are required to conduct their operations in accordance and compliance with their own rules as well as the federal securities laws. They are required to file all proposed rules and rule changes with the Commission, which publishes them for public comment, before they take effect. This transparency enables all participants trading on the exchanges to understand how their orders are processed and executed.

According to the SEC's order instituting settled administrative proceedings, the NYSE exchanges repeatedly engaged in business practices that either violated exchange rules or required a rule when the exchanges had none in effect. For example, all of the NYSE exchanges used an error account maintained at Archipelago Securities to trade out of securities positions taken on as a result of their operations despite not having rules in effect that permitted them to maintain and use such an account. In another example, NYSE Arca failed to execute a certain type of limit order under specified market conditions despite having a rule in effect that stated that NYSE Arca would execute such orders.

"The order highlights instances where the exchanges conducted business without a rule in place due to weak or inadequate policies and procedures," said Antonia Chion, an associate director in the SEC's Division of Enforcement. "In other instances, the exchanges did not operate in compliance with their effective rules. Both failures reflect a troubling lack of compliance with the requirements and obligations imposed on securities exchanges."

The violations detailed in the SEC's order occurred during periods of time from 2008 to 2012. The SEC's order finds that the NYSE exchanges violated Section 19(b) and 19(g) of the Securities Exchange Act of 1934 through misconduct that included the following:

- *NYSE, NYSE Arca, and NYSE MKT (formerly NYSE Amex) used an error account maintained at Archipelago Securities to assume and trade out of securities positions without a rule in effect that permitted such trading and in a manner inconsistent with their rules for the routing broker, which limited Archipelago Securities' activity primarily to outbound and inbound routing of orders on behalf of those exchanges.*
- *NYSE provided co-location services to customers on disparate contractual terms without an exchange rule in effect that permitted and governed the provision of such services on a fair and equitable basis.*
- *NYSE operated a block trading facility (New York Block Exchange) that for a period of time did not function in accordance with the rules submitted by NYSE and approved by the SEC.*
- *NYSE distributed an automated feed of closing order imbalance information to its floor brokers at an earlier time than was specified in NYSE's rules.*
- *NYSE Arca failed to execute Mid-Point Passive Liquidity Orders (MPLOs) in locked markets (where the bid and ask prices are the same) contrary to its exchange rule in effect at the time.*

In addition, the SEC's order finds that NYSE Arca accepted MPLOs in sub-penny amounts for National Market System stocks trading at over $1.00 per share, in violation of Rule 612(a) of Regulation NMS.

The SEC's order further finds that Archipelago Securities failed to establish and maintain policies reasonably designed to prevent the misuse of material, nonpublic information in connection with error account trading. Archipelago Securities also violated and failed to give the SEC timely notice of its violation of the net capital rule—a critical federal securities law provision intended to ensure that brokers and dealers remain solvent and can meet their financial obligations.

Now wholly-owned subsidiaries of IntercontinentalExchange Inc., NYSE, NYSE Arca, NYSE MKT, and Archipelago Securities have consented to the SEC's order without admitting or denying the findings. They agreed to collectively pay the penalty of $4.5 million, and the NYSE exchanges agreed to complete significant undertakings including retaining an independent consultant to complete a comprehensive review of their policies and procedures for determining whether (1) a new business practice or a change to an existing business practice requires the filing with the SEC of a proposed rule or rule change, and (2) business practices requiring an exchange rule are conducted pursuant to and in accordance with an effective exchange rule. ■

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ABOUT Floyd Advisory
Floyd Advisory is a consulting firm providing financial and accounting expertise in areas of Business Strategy, Valuation, SEC Reporting, and Transaction Analysis.

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