Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended September 30, 2015

Q3 REPORT 2015

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 September 30, 2015.

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
OCTOBER 2015

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

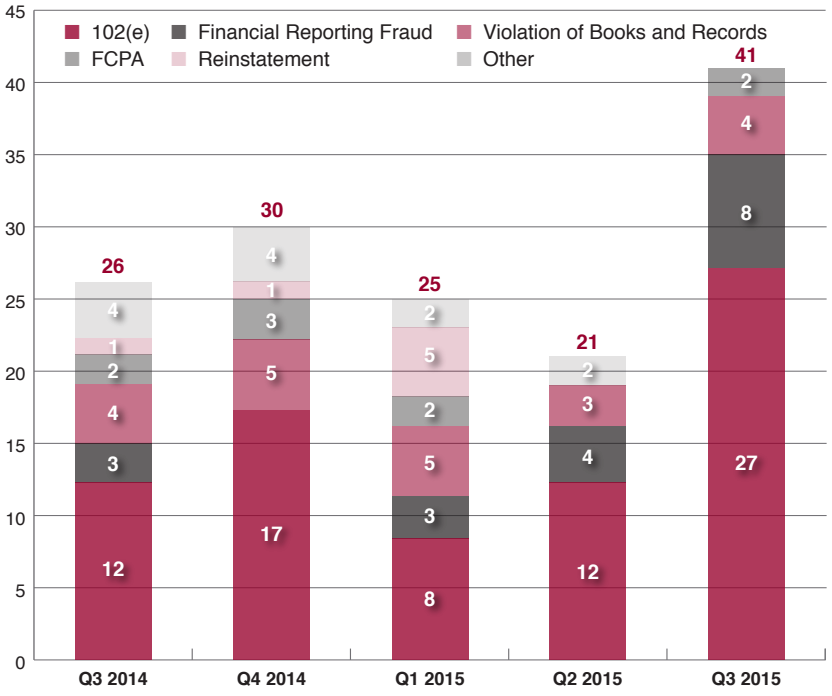
The Q3 2015 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed 41 AAERs during Q3 2015, which represents a remarkable spike in the number of AAERs for a given quarter, and is the highest number of AAERs reported since Q2 of 2011.

The SEC disclosed 41 AAERs for the quarter ended September 30, 2015.

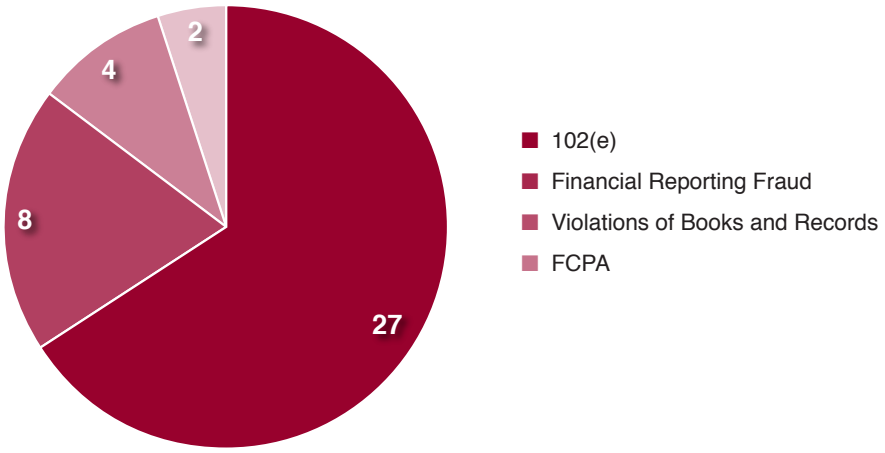
Compared to Q2 2015, the number of AAERs increased approximately 95%, and increased nearly 58% over Q3 of 2014. A more than doubling over the prior quarter in the number of 102(e) suspensions and a twofold increase in financial reporting fraud enforcement actions helped drive the total upwards in Q3 2015. For further analysis, we have sorted releases and totals for each category as depicted in the following charts.

Quarter to Quarter AAER Comparison Over Period of Last Five Quarters
Q3 2014 through Q3 2015



When looking at the enforcement categories, the number of 102(e) violations has increased dramatically, and there was also a substantial increase in AAERs involving Financial Reporting Frauds. FCPA cases made a return this quarter after being absent during Q2 of this year, but remain low compared to prior years. In addition, there were no reinstatement cases reported during Q3 2015.

Q3 2015 AAERs by Category



This quarter brought both the highest percentage and the highest volume of 102(e) releases that we have seen over the past five years.

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

As reflected in the chart, the 27 Rule 102(e) actions accounted for approximately 66% of the releases issued in Q3 2015 and are both the highest percentage and the highest volume of 102(e) releases that we have seen over the past five years. It is also worth noting that for this quarter, approximately half of the Rule 102(e) actions were brought against financial statement auditors and audit firms. In addition, thirty out of the forty-two individuals brought before the SEC around Rule 102(e) allegations were certified public accountants and five were chartered accountants. Of the CPAs cited, one was permanently disqualified from appearing and practicing before the SEC with no ability to seek reinstatement at any time.

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:

- ***Four AAERs were filed during Q3 2015 that arose from proceedings alleging fraud against two audit firms and the firms' seven auditors, based on their alleged involvement in a fraudulent microcap scheme involving attorneys and twenty purported mining companies ("the issuers") all believed to have included false information in their Form S-1 registration statements. All seven auditors were CPAs.***

  In the alleged scheme, the attorney, who was already suspended in 2010 from practicing before the SEC, controlled twenty companies, each registered with the SEC as firms exploring mining activities. According to the SEC, each registration statement misleadingly declared that distinct individuals governed and controlled each company. The SEC's claim asserts that the attorney had recruited these individuals to serve as directors and executives while allegedly he alone controlled these companies and made all material decisions. The SEC also claimed each registration statement contained material misrepresentations and omissions. The cases brought against the audit firms and the auditors by the SEC alleged unprofessional conduct and violations of the Securities Act regulations prohibiting fraud and misrepresentations in the offer or sale of securities.

  The SEC has ordered that the individuals be denied the privilege of appearing or practicing before the SEC as accountants and ordered to pay disgorgement, prejudgment interest, and civil penalties.

- ***On July 1, 2015, the SEC instituted cease-and-desist and 102(e) proceedings against several parties: a limited liability partnership which is an audit firm, its consulting affiliate, and an individual.*** These proceedings were pursuant to allegations of an independence-impairing business relationship between the consulting affiliate and the individual who was hired by the consulting affiliate. The individual served on the board of trustees and the audit committees of three funds that were audit clients of the LLP and were registered with the SEC. The business relationship in question allegedly entailed the consulting affiliate's purchase of intellectual property rights to a brainstorming business methodology from the individual and his partners, as well as a three-year consulting agreement to train the consulting affiliate's personnel in the use of the methodology and assisting the affiliate in serving both internal and external clients using that approach. According to the release, an independence review had not been performed in 2006, which was the time the individual entered into the business relationship with the affiliate,

"Effective audit committee oversight is essential to investor protection and the functioning of our capital markets. ... The way audit committees exercise their oversight of independent auditors has evolved and it is important to evaluate whether investors have the information they need to make informed decisions."

SEC Chair Mary Jo White

Press Release: SEC Solicits Public Comment on Audit Committee Disclosures
July 1, 2015

and yet the LLP claimed independence from the funds the individual worked for in its audit reports for the years ended 2007-2011 with no disclosure of the business relationship with the individual. According to the SEC, the three funds failed to adopt sufficient written policies and procedures designed to prevent auditor independence violations. This alleged independence-impairing business relationship between the affiliate and the individual resulted in improper professional conduct and violations of Regulation S-X for the LLP, reporting violations for the three funds and the individual, and violations of the Investment Company Act by the funds. As a result of the SEC's findings, the LLP was censured and must cease and desist from committing or causing violations of Rule 2-02 of Regulation S-X and all involved parties are subject to monetary penalties.

- ***The SEC alleged a Colorado-based public accounting firm failed to adequately complete surprise examinations of funds and securities after being engaged to do so by a former registered investment adviser, thereby allegedly violating the Custody Rule.*** According to the SEC, the company had never performed a surprise examination for a registered investment advisor prior to the 2010 surprise examination, nor did the engagement team, including the engagement partner in charge of all three examinations, have prior experience of this nature. Furthermore, the SEC stated that work for the 2010 examination was actually completed in 2011, and for both the 2010 and 2011 examinations the company filed paperwork certifying that the former registered adviser company was in compliance with the Custody Rule when it was not. Finally, it was alleged that the company never completed work for the 2012 examination and failed to file any report or document relating to the examination.

  As a result, according to the SEC, the public accounting firm's conduct during the 2010-2012 surprise examinations violated the professional standards for certified public accountants set forth in the AICPA's Attestation Standards Section 101 and Compliance Attest procedures Section 601. Among other missteps, the firm allegedly failed to obtain any engagement quality control review for the 2010 and 2011 surprise examinations, failed to consider documents from sources other than the former registered investment adviser under examination, and failed to perform alternative procedures in lieu of confirmations from affiliated entities. The firm was ordered to cease and desist from committing or causing any violations of the Advisers Act and along with its engagement partner is denied the privilege of appearing or practicing before the SEC as an accountant and may reapply after one and three years, respectively. Furthermore, the firm and the engagement partner are subject to monetary penalties.

- ***The SEC instated cease-and-desist proceedings and 102(e) sanctions against the former chief financial officer ("CFO") of a nutrition company that develops, manufactures, and markets sports nutrition products, in connection with allegations of a series of accounting and disclosure failures.*** These alleged failures resulted in filing company's materially false and misleading financial statements with the SEC between 2010 and 2012.

"Our enforcement program also emphasizes the importance of a strong compliance program. We do this by highlighting in our orders situations where a compliance program operated effectively in identifying misconduct; by bringing enforcement actions when those programs have failed ... ; and by requiring independent consultants in appropriate cases to ensure that compliance policies are crafted to guard against misconduct recurring."

SEC Chair Mary Jo White

Opening Remarks at the Compliance Outreach Program for Broker-Dealers
Washington, D.C.
July 15, 2015

According to the release, the former CFO, a licensed CPA, was unprepared for the SEC's reporting requirements when the company went public in 2010 and failed to develop sufficient infrastructures to report the company's rapid growth. In addition, the SEC stated that the individual failed to educate himself to meet the required expertise and ensure that sufficient internal controls were enacted and that proper books and records were maintained. As a result, the company allegedly failed to disclose perquisite compensation to its executive officers, various related party transactions and related bankruptcies, as well as committing numerous other financial statement, accounting, and disclosure failures.

According to the SEC, the company's improper recordings resulted in books and records that did not accurately and fairly reflect its transactions and dispositions of assets. Furthermore, the company allegedly failed to implement internal controls sufficient to provide reasonable assurances that transactions were recorded in conformity with generally accepted accounting principles ("GAAP"). The SEC finds that the individual violated the Securities Act and the Exchange Act and is barred from appearing or practicing before the SEC as an accountant for a period of three years. Due to the individual's sworn representations in his Statement of Financial Condition and other evidence that asserted the individual's inability to pay, the SEC is not imposing a penalty.

" ... we must, of course, take enforcement action against compliance professionals if we see significant misconduct or failures by them. Being a CCO obviously does not provide immunity from liability, but neither should our enforcement actions be seen by conscientious and diligent compliance professionals as a threat. We do not bring cases based on second guessing compliance officers' good faith judgments, but rather when their actions or inactions cross a clear line that deserve sanction."

SEC Chair Mary Jo White

Opening Remarks at the Compliance Outreach Program for Broker-Dealers
Washington, D.C.
July 15, 2015

- ***The SEC filed charges against a former president of a diversified global manufacturer which produces a broad range of equipment, primarily for construction, infrastructure, and surface to mining industries.*** In its complaint, the SEC alleged that the individual knowingly and substantially aided and abetted certain former officers of an equipment rental company with violations of the antifraud, reporting, and books and records provisions of the federal securities laws by improperly recognizing revenue from two fraudulent sale-leaseback transactions between the companies.

  Specifically, the equipment rental company was alleged to have sold used equipment to a third-party financing company and then leased it back for an 8-month period. The rental company also arranged through the former president of the manufacturing company to remarket the equipment at the end of the lease period and guarantee that the financing company would receive no less than 96% of the purchase price it had paid for used equipment. Finally, per the release, the manufacturing company and rental company entered into a fraudulent "backup" remarketing agreement, signed by the former president, under which the rental company assumed the manufacturer's remarketing obligations and guaranteed to cover any losses the manufacturer may have incurred over the amount of a $5 million advance payment made by the rental company.

  The SEC alleged that the financial statements the rental company incorporated into its filings were materially false and misleading, and that the individual aided and abetted the fraud by helping to conceal the rental company's assumption of the risks and obligations of the transactions from its auditors. The individual is suspended from appearing or practicing before the SEC as an accountant for five years.

Financial Reporting Frauds

There were eight AAERs that we categorized as financial reporting frauds during the quarter, examples of which are described below:

- ***Four AAERs arose out of the case involving proceedings against two former chief executive officers and the outside auditors of a staffing services company that provides professional placement and temporary staffing services.*** Specifically, according to the release, the matter concerns $2.3 million of cash and cash equivalents included in the financial statements, comprising approximately 50% of the company's assets in the form of a certificate of deposit ("CD") and an assignment agreement to sell the CD for full face value to an unrelated party. The company's management repeatedly provided the auditors with conflicting explanations regarding both the status of the CD and the nature of transfers totaling $2.3M made to the company by entities unaffiliated with the bank, according to the release. The SEC stated that the auditors raised questions and issued a five-page letter wherein the company was advised that the auditors had not been provided sufficient audit evidence to formally conclude on the matter, and demanded that the company's audit committee commission a full investigation of the matter by an independent firm. However, according to the SEC, soon thereafter the auditors agreed to withdraw the demand for an independent investigation and issued an audit report containing an unqualified opinion on the company's financial statements.

  According to the release, approximately two months after the audit was filed, the auditors learned of a criminal complaint filed against the president of the bank at which the CD was allegedly deposited. The complaint alleged a wide-ranging conspiracy involving the company's former chief executive officer and a former majority shareholder and chairman of the board. In addition, the allegations stated that the company's CD never existed, that the bank president signed a false confirmation to the company regarding the CD, that the bank spent the company's $2.3M to conceal a loan default related to the larger conspiracy, and that the entities that transferred the company's funds were in fact affiliated with the bank president's co-conspirators. The SEC stated that despite these findings, the auditor failed to determine whether this new information would affect the company's financial statements or the audit firm's 2009 and 2010 10-K audit reports thereon.

  As a result of this alleged misconduct, the SEC determined civil penalties payable for all of the parties involved in this proceeding. The auditors were also suspended from appearing and practicing before the SEC as accountants.

"When an investor puts money into a far off corporate enterprise, the auditor is an independent accounting professional who serves as the eyes and ears of the investor. In conducting an independent audit, the accountant facilitates trust between management and investors. Through understandable and comparable reports, accounting facilitates investment and corporate development."

SEC Commissioner Kara M. Stein

Accountants and Capital Markets in an Era of Digital Disruption: Remarks to the Institute of Chartered Accountants in England and Wales and BritishAmerican Business
Sept. 9, 2015

- ***The SEC ordered cease-and-desist proceedings against a Delaware corporation, its CFO, vice president and director of accounting, and vice president of finance, who were accused of intentionally manipulating the company's financial results for Q2 2012 to meet and/or exceed analyst estimates by recording additional revenue without any supporting documentation.*** The company is headquartered in North Palm Beach, Florida and owns and operates an Internet-based consumer banking and personal finance network. Its common stock is registered with the SEC and traded on the NYSE.

  Importantly, according to the SEC, after falling short on projected financial results, the company's CFO directed two company divisions, Insurance and Credit Cards, to book additional unsupported revenue of $300,000 and $500,000, respectively. The Insurance division readily complied, as stated in the release, and misleading justifications for the revenue were signed by certain company officials and provided to the company's auditor. According to the release, the Credit Cards division agreed to book only $176,000 of the $500,000, and the CFO ordered the difference to be recorded as revenue on the books of the company's mortgage business. The SEC stated that both recordings were contrary to GAAP. Furthermore, the CFO allegedly directed an accountant in the mortgage business to reduce the accrual for marketing expenses by $400,000, which had acted as a "cushion" account for over a year. Finally, the company allegedly failed to book approximately $99,000 in known expenses incurred in the second quarter.

  Due to the alleged manipulations, the company's Q2 2012 earnings were materially overstated. According to the release, because the CFO and the vice president of finance sold company stock, they profited from an artificially inflated stock price. In addition to violating the Securities Act and Exchange Act, the SEC alleged that company also failed to accurately and fairly reflect its transactions and dispositions of assets and provide assurances that its accounts were in accordance with GAAP. The SEC ordered the company to cease and desist from committing or causing any violations of the Securities Act and Exchange Act and to pay a civil money penalty of $15,000,000.

"As I have witnessed, corporate culture, tone at the top, and incentives can have long-lasting and significant impact on individual actions throughout the organization. Unfortunately, as we all know, unethical behavior can spread quickly and have serious negative implications on an organization."

SEC Commissioner Kara M. Stein

Accountants and Capital Markets in an Era of Digital Disruption: Remarks to the Institute of Chartered Accountants in England and Wales and BritishAmerican Business Sept. 9, 2015

Violations of Books and Records

This quarter we categorized four AAERs under Violations of Books and Records, a category that includes alleged improper accounting treatments and internal control problems deemed worthy of an enforcement action but not meriting financial reporting fraud allegations. Two of the releases are worthy of further discussion:

- ***One of the notable AAERs in this category involves a company that develops and operates several websites focusing on music, music videos, and gaming.*** The SEC's release highlighted various books and records and internal controls violations by the company, including improperly recorded revenues and expenses, and failure to appropriately account for consolidation of its parent company during the reporting period from August 2012 through December 2013.

First, according to the release, the company determined that its 2012 financial statements required restatement because it failed to record revenue and expenses generated by a subsidiary, which were processed through the accounts of its parent company. Rather than correcting these misallocated line items, the company is alleged to have improperly consolidated the parent company as a variable interest entity ("VIE".) The company then allegedly failed to include the parent company's accounts within each financial statement line item, resulting in a second restatement. Once the company acknowledged that the consolidation of the parent company as a VIE was incorrect, it issued a third and final restatement to deconsolidate the parent company's financial statements and recognize the subsidiary's revenue and expenses in its own financial statements. Throughout the relevant period, the company is alleged to have failed to maintain adequate books and records; for instance, it allegedly failed to segregate its accounts from those of its parent company and failed to ensure that the company properly allocated revenues and expenses to the correct entity. It is also alleged that the company failed to maintain any written policies or take other meaningful steps to ensure that the company accurately reported its financial results.

The SEC ordered that the company cease and desist from committing or causing any violations and future violations of the Exchange Act. Both the company and its chief executive officer must pay a civil money penalty.

- ***During Q3 2015, several AAERs were filed related to a matter involving a New Mexico corporation and its wholly owned subsidiary, a national banking organization, in connection with the bank allegedly failing to properly account for its loan portfolio during the periods of 2010, 2011, and the first two quarters of 2012.*** Importantly, one of the releases was filed against a former CFO and a former head of internal audit of the company who, according to the SEC, were primarily responsible for the internal control function of the bank. The release stated that the former CFO failed to implement adequate internal controls over, among other areas, impaired loan loss calculations, troubled debt restructurings, subsequent events, other real estate owned, and appraisals. In addition, the individual was linked to the bank's production of false books and records and the submission of inaccurate reports because of an alleged failure to correct the accounting errors. The head of internal audit, according to the SEC, was directly responsible for testing the bank's internal accounting controls and compliance with GAAP. When the individual became aware of issues with loan accounting, the individual allegedly failed to report his concerns to the bank's audit committee and to take action to remedy inaccurate reports and books and records as required by the bank's policies and procedures.

The SEC ordered the former CFO and the head of internal audit to cease and desist from committing or causing to commit any violations and future violations of the Securities Act and Exchange Act. The individuals are also scheduled for a public hearing following the entry of a final judgment against the defendants.

"Appropriate tone at the top is the foundation for the consistent application of the sound judgments required by the new standard. Management should consider whether the existing controls support the formation and enforcement of sound judgments or whether changes are necessary."

Wesley R. Bricker
SEC Deputy Chief Accountant

Remarks at the Bloomberg BNA Conference on Revenue Recognition
New York, NY
Sept. 17, 2015

FCPA Violations

There were two FCPA related releases in Q3 2015. Details of the enforcement actions are described below:

- ***One case involves violation of the anti-bribery, books and records, and internal controls provisions of the FCPA by a vice president in charge of sales in Latin America for a large global technology solutions company based in Waldorf, Germany.*** The individual was accused of being involved in paying bribes of at least $145,000 to a senior government official of the Republic of Panama in order to secure software license sales of approximately $3.7 million to various government agencies, and offering to pay bribes to two other government officials. According to the SEC, the individual bypassed the company's internal controls by falsely justifying the discount amount offered to its local partner, thereby helping the local partners to generate excess earnings on the final, end-user sale, which were then used to finance the bribes paid to government officials.

  The company has agreed to cooperate fully with the SEC in any proceedings arising from this matter, to produce any documents and materials as requested by the SEC, to appear and testify in investigations, interviews, depositions, and hearings related to the matter, and to respond promptly to all inquiries from the SEC. The individual was ordered to cease and desist from committing or causing to commit any violations and future violations of the Exchange Act and pay disgorgement of $85,965 allegedly representing the kickback the individual received in connection with the bribery scheme as well as additional prejudgment interest. The individual also entered into a plea agreement with the US Department of Justice agreeing to plead guilty to one count of conspiring to violate the FCPA.

- ***Another release concerns a violation of the FCPA by a Delaware-incorporated bank headquartered in New York City during 2010 and 2011, when employees of the bank allegedly attempted to corruptly influence foreign officials in order to retain and win business managing and servicing the assets of a Middle Eastern sovereign wealth fund.*** During the relevant time period, the bank conducted business in the EMEA (Europe, Middle East, and Africa) region and collected fees through its global asset servicing unit and global investment management business division, both of which serviced EMEA region clients. According to the release, the bank, along with two officials affiliated with the bank's Middle Eastern sovereign wealth fund, provided valuable internships to three relatives of the officials, thereby violating the anti-bribery and internal accounting controls provisions of the Foreign Corrupt Practices Act.

  Notably, the bank's pre-existing internship programs were extremely competitive and featured stringent hiring standards. According to the SEC, the officials regarded the internships as "personal favors" and contemporaneous emails state that other employees were "not in a position to reject the request from a commercial point of view." Though none of the recipients met the criteria for these internships, the bank designed customized work experiences for the interns and handled the visa paperwork and legal fees required to hire them.

"Investors expect companies to have internal controls in place to reasonably assure the reliability of the financial information reported by management."

Wesley R. Bricker
SEC Deputy Chief Accountant

Remarks at the Bloomberg BNA Conference on Revenue Recognition
New York, NY
Sept. 17, 2015

As valuable and, in two of the three cases, paid learning experiences, the internships are a violation of the Exchange Act and of the bank's policies, which state that "any money… gift… or anything of value" provided to a foreign official could constitute a bribe. The AAER also notes that the bank's internal accounting controls were not tailored to the corruption risks of hiring client referrals, and were therefore inadequate to effectuate the bank's policy against bribing foreign officials. The company was ordered by the SEC to cease and desist from committing or causing any violations and any future violations of the Exchange Act and to pay disgorgement of $8,300,000, prejudgment interest of $1,500,000, and a civil money penalty of $5,000,000.

The Q3 2015 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in Q3 2015 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

"Insiders may hold the key to helping our investigators unlock intricate fraudulent schemes. ... By providing significant financial incentives for people to come forward, the SEC's whistleblower program continues to be profoundly effective in helping us protect investors and hold wrongdoers accountable."

Andrew Ceresney
Director of the SEC's
Division of Enforcement

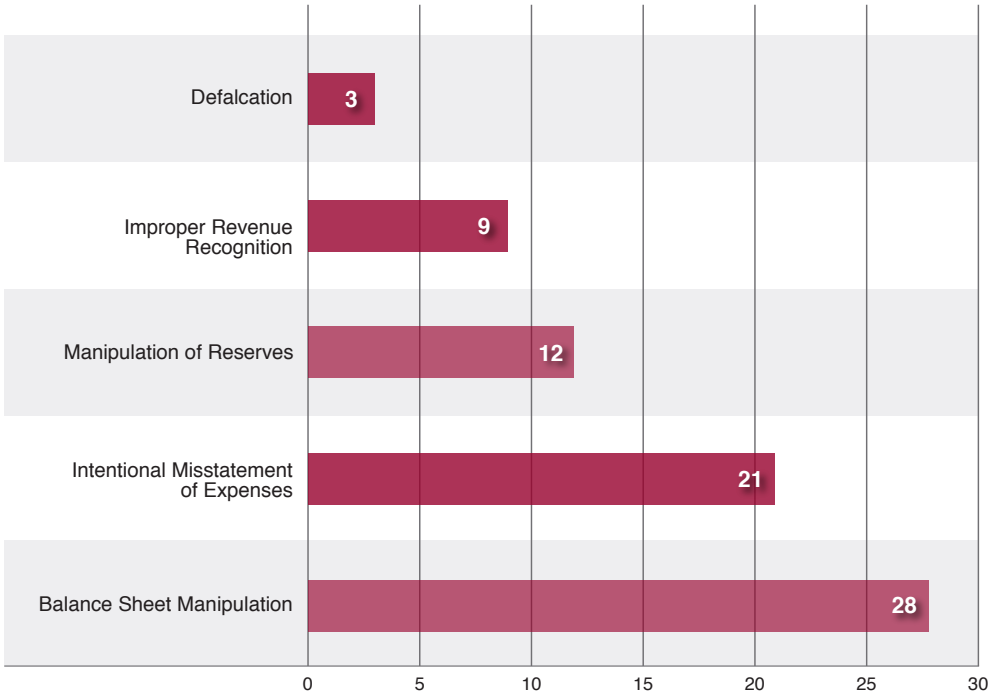
Press Release: SEC Pays More than $3 Million to Whistleblower
July 17, 2015

The following chart provides the results of our financial reporting issue analysis for the Q3 2015 AAERs.

Balance Sheet Manipulation is the leading category of accounting issues identified within AAERs in Q3 2015, the category that almost always leads the charts. Some of the issues within this group included concealing losses on loans and other assets.

In Q3 2015, some of the issues concerning Balance Sheet Manipulation included concealing losses on loans and other assets.

Financial Reporting Issues Identified in Q3 2015 AAERs



Notable Q3 2015 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 the importance of implementing and upholding effective internal controls over financial reporting and keeping an open dialogue with the external auditor, especially where significant accounting judgments are involved. In another AAER, our review highlights the need for diligence when a specialist's findings are used for purposes of preparing financial statements. Auditing standards related to engaging a specialist serve as a useful guide to both management and audit committees.

Accounting and Auditing Enforcement Release No. 3704 / September 22, 2015 Administrative Proceeding File No. 3-16826, In the Matter of Stein Mart, Inc., Respondent.

In September of 2015, the SEC reached a settlement with Stein Mart, Inc. ("Stein Mart") related to almost three years of materially misstated financial statements resulting from the alleged improper valuation of inventory. We chose this AAER as a recommended reading as it highlights two key areas of importance: (1) the significance of effective internal controls over financial reporting ("ICFR"), and (2) the importance of keeping an open dialogue with the external auditor, particularly with regard to significant accounting judgments.

Background

Stein Mart is a Jacksonville, Florida-based retailer that operates approximately 270 stores in 30 states. As a retailer, Stein Mart carries inventory as one of its most significant assets. According the SEC, from at least 2010 through November of 2012, Stein Mart employed three types of markdowns or discounts on its in-store merchandise, including: (1) temporary markdowns related to promotional and clearance sales, (2) permanent markdowns (such merchandise was exhibited in a separate area of each store), and (3) "Perm POS" markdowns, which in 2009 also were, according to the SEC's claim, converted into a form of permanent markdown, but were allegedly continued to be marketed and exhibited in each store in the same manner as merchandise that was subject to temporary markdowns.

"To state the obvious, an effective compliance program must necessarily start at the top. A company's senior leadership should be strong advocates for a robust and enduring culture of compliance; such a culture fosters an environment where everyone understands the firm's core values of honesty and integrity."

SEC Commissioner Luis A. Aguilar

Public Statement: The Role of Chief Compliance Officers Must be Supported
June 29, 2015

GAAP requires that inventory be valued at the lower of cost or market ("LCM"). The claim states that Stein Mart historically followed two policies with regard to adjusting the value of its inventory to comply with the LCM requirement in GAAP. For temporary markdowns, Stein Mart reduced the value of the inventory at the time of sale. For permanent markdowns, Stein Mart reduced the value of the inventory at the time the merchandise was marked down.

But it is alleged that in 2009, Stein Mart's merchandising department changed its markdown strategies to favor permanent markdowns, resulting in also operationally changing the once-temporary Perm POS markdowns so this discounted merchandise allegedly remained permanently marked down until stock was depleted. However, it is alleged Stein Mart's ICFR were not effective and did not provide a process to allow its accounting department to learn of this change to the third markdown type, or otherwise understand how the merchants categorized their markdown types. Due to this alleged gap in Stein Mart's ICFR, accounting personnel were not in a position to make a judgment regarding the appropriate accounting treatment for the modified Perm POS markdowns.

"Inventory is one of the most significant assets for retail companies, and as a result, it is critical that companies have effective internal accounting controls to ensure that inventory is valued properly."

Michael Maloney
Chief Accountant of the SEC's Enforcement Division

Press Release: SEC Charges Retailer for Improper Valuation and Inadequate Internal Accounting Controls
September 22, 2015

According to the SEC's claim, Stein Mart's CFO first learned about the use of Perm POS markdowns in the summer of 2011. Prior to that, the CFO apparently believed the company only used temporary and permanent markdowns. After making further inquiries, it is alleged the CFO also learned that Perm POS markdowns were treated as temporary markdowns for accounting purposes. According to the claim, the CFO subsequently engaged in internal and external consultations regarding the proper accounting treatment for the Perm POS markdowns, including discussions with the company's Audit Committee Chair. Ultimately, the CFO allegedly concluded that the existing practice of adjusting inventory for Perm POS markdowns at the time of the sale complied with GAAP.

During that period, the SEC claims Stein Mart's external auditor was not among the parties consulted by the CFO regarding the appropriate accounting for Perm POS markdowns. In the fall of 2012, the Audit Committee Chair apparently concluded that the company should account for Perm POS markdowns as permanent markdowns (that is, to adjust the value of the inventory at the time of the markdown). When this change in accounting policy was communicated to the external auditor, the auditor apparently informed the company that its prior accounting treatment for Perm POS markdowns was not in accordance with GAAP, and represented an accounting error in its previously issued financial statements.

Consequently, in May of 2013, Stein Mart restated its financial statements for 2010, 2011, and the first quarter of 2012, reducing the value of its inventory related to Perm POS markdowns, a net reduction in pre-tax income of approximately $4.8 million for those periods.

Effective ICFR—Not Just for the Accountants

Effective ICFR constitute controls to reach beyond the activities of a company's accounting and finance function. It is critical to note that operating decisions made by a company—particularly ones that institute a new practice or significantly change an existing practice—can have material accounting and financial reporting consequences. Because operations personnel are generally not trained in GAAP, effective ICFR must include controls that assure that the accounting and finance function is kept informed about the activities of the operations function.

In the case of Stein Mart, it is apparent that accounting and finance management did not learn about operational changes to Perm POS markdowns for more than a year after the new process was instituted. As such, they were not provided with the opportunity to evaluate and assess the appropriate accounting treatment under GAAP for this new policy. This apparent control failure allegedly led the company to issue inaccurate financial statements for more than two years.

In practice, we have observed other breakdowns in ICFR between a company's accounting personnel and other key departments. Examples include sales staff entering into "side agreements" or other forms of extra-contractual arrangements with customers (including, in some instances, verbal promises) which could alter the proper accounting treatment for a particular contractual arrangement. These agreements are often entered into without the knowledge or approval of those responsible for financial reporting, and can have a material effect on revenue recognition.

Effective ICFR often include periodic training for key non-accounting personnel on GAAP concepts and the company's critical accounting policies, and the consideration of those accounting policies when implementing key operational changes. Additionally, formal communication processes related to those operational changes are often part of an effective ICFR model.

Communications with Auditors

The communication of significant accounting policies to the auditors is vital to an effective audit and the financial reporting process. Although the financial statements and underlying accounting judgments are the responsibility of management, external auditors have valuable technical accounting expertise, including experience with the accounting practices of many similar companies, and can provide insight into the appropriateness of accounting judgments such as those seemingly made by the CFO regarding Perm POS markdowns. Ostensibly, had the CFO communicated to the external auditor the existence and new application of this third type of markdown when he became aware of the practice in the summer of 2011, the company may have been able to avoid several quarters of misstated financial statements.

Without admitting or denying the SEC's charges, Stein Mart agreed to a civil money penalty in the amount of $800,000 and to cease and desist from committing or causing any violations or any future violations of the reporting, books and records, and internal controls provisions of the federal securities laws.

Although the financial statements and underlying accounting judgments are the responsibility of management, external auditors have valuable technical accounting expertise, including experience with the accounting practices of many similar companies, and can provide insight into the appropriateness of accounting judgments.

Accounting and Auditing Enforcement Release No. 3673 / August 6, 2015 Administrative Proceeding File No. 3-16729, In the Matter of Miller Energy Resources, Inc., Paul W. Boyd, CPA, David M. Hall, and Carlton W. Vogt, III, CPA, Respondents.

The SEC alleged that in 2009, after acquiring oil and gas properties in Alaska for $2.25 million along with the assumption of certain liabilities, Tennessee-based Miller Energy Resources, Inc. ("Miller Energy") overstated the value of these assets, reporting them to be worth more than $400 million, thereby artificially inflating the company's net income and total assets. As a result, Miller Energy, its former CFO, Paul W. Boyd, CPA (hereafter "former CFO"), and its current chief operating officer, David M. Hall (hereafter "COO"), are alleged to have violated an SEC anti-fraud rule and U.S. securities laws. The company is also alleged to have violated books and records and internal controls requirements, with the former CFO and COO allegedly causing or aiding and abetting those violations. Furthermore, the SEC alleged that the fiscal 2010 audit of Miller Energy's financial statements was deficient. The audit partner in charge of the audit was also in the release for allegedly improperly issuing an unqualified opinion on Miller Energy's 2010 financial statements, falsely stating that Miller Energy's financial statements were presented fairly and in conformity with US GAAP, and that the audit was not conducted in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB").

Pursuant to GAAP, Miller Energy was required to record the acquired assets at fair value in its financial statements. Miller Energy valued those assets at approximately $480 million, having established this value based on a "reserve report" prepared by an independent petroleum engineering firm that estimated oil and gas reserves contained in the acquired assets. Reserve reports are common in the oil and gas industry, and are typically prepared in accordance with SEC regulations for purposes of providing supplemental disclosures concerning future oil and gas production. However, per GAAP, such reserve reports cannot be considered an estimate of fair value. In fact, the reserve report allegedly used by Miller Energy to establish the fair value of the acquired assets explicitly stated that "(t)he discounted values shown are for your information and should not be construed as our estimate of fair market value." Additionally, the SEC alleges that the reserve report was flawed, as Miller Energy provided the engineering firm with intentionally understated expenses.

Based on the allegedly inflated asset values, the acquisition resulted in a nearly 5,000% increase in Miller Energy's total assets, a bargain purchase gain (also referred to as negative goodwill) of approximately $277 million, and a reported net income of $272 million in the quarter in which the acquisition occurred. Bargain purchase gains, particularly of this magnitude, are rare, and often subject to intense scrutiny.

The issues discussed in the AAER highlight the need for diligence when a third-party specialist is engaged as part of the preparation of financial statements. The use of a specialist for purposes of preparing financial statements is a common and accepted practice. There are related auditing standards that, while specifically applying to the independent auditor, also serve as an instructive guide to management and audit committees when a third-party specialist is used. AU Section 336, *Using the Work of a*

" ... the Commission has approached CCO cases very carefully, making sure that it strikes the right balance between encouraging CCOs to do their jobs competently, diligently, and in good faith, and bringing actions to punish and deter those that engage in egregious misconduct. ... [T]he Commission and its staff think long and hard when considering enforcement actions against CCOs, and oftentimes exercise prosecutorial discretion not to bring such actions."

SEC Commissioner Luis A. Aguilar

Public Statement: The Role of Chief Compliance Officers Must be Supported
June 29, 2015

Specialist, provides the relevant guidance. The SEC alleges that Miller Energy's auditor failed to appropriately follow this guidance in conducting its audit. Key steps in the guidance include:

- ***Consider the qualifications of the specialist, including professional certifications, reputation, and relevant experience.***
  This is particularly important in instances where the third-party specialist is being used for the first time. Steps management or an auditor could take when undergoing such a consideration include:
  - Obtaining insight and references from the specialist's peers or clients about his or her capabilities and performance;
  - Confirming the specialist's professional certifications;
  - Assessing whether the specialist's skillsets and areas of expertise are relevant to the task assigned;[1] and
  - Understanding the specialists experience conducting prior engagements similar in nature.

- ***Obtain an understanding of the work performed by the specialist, including methods and assumptions used and any prior relationship to the Company.***
  Work product produced by specialists is often based on numerous assumptions, some of which require judgment and significantly impact the overall outcome. For example, in a fair value analysis using the income approach, the assumed discount rate can have a material effect on value. In addition, the specialist may have the option to choose among various methods of performing his or her analysis. In assessing the fair value, a valuation specialist has three generally accepted methods to choose from: (1) cost approach; (2) market approach; and (3) income approach. Both management and the auditor should understand the method used by the specialist and consider whether an alternative method would be more appropriate or provide a significantly different value.

  Finally, assumptions provided to the specialist by management should be evaluated and compared to assumptions used in preceding periods to any evaluate significant changes. If the specialist has done prior work with the company, comparing the methods used in the current analysis to those used in prior analyses is a similarly useful way to evaluate the employed methods.

- ***Make appropriate tests of data provided to the specialist, evaluate whether the specialist's findings support the related financial statement assertions, and conduct additional procedures if the findings appear unreasonable.***
  Generally, third-party specialists rely on the accuracy and completeness of data provided to them by management. Given such, it is critical that management thoroughly evaluate the quality of the data it provides, as the work of the specialist has little usefulness if it is based on flawed information. Similarly, as required by GAAS, auditors should make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk.

Work product produced by specialists is often based on numerous assumptions, some of which require judgment and significantly impact the overall outcome. For example, in a fair value analysis using the income approach, the assumed discount rate can have a material effect on value.

[1] *This was of critical importance in the Miller Energy matter, as the specialist was a petroleum engineer with expertise in estimating oil and gas reserves, not in establishing the fair value of assets.*

Additionally, management, and in some cases the auditor, will have a stronger understanding of the overall business than an outside specialist. As such, it is important to evaluate the reasonableness of the specialist's analysis. If the auditor believes the findings are unreasonable, they should apply additional procedures, which may include obtaining the opinion of another specialist. In the case of Miller Energy, using the report of the specialist, the company reported the fair value of the acquired assets at approximately $480 million as well as bargain purchase gain of approximately $277 million, implying Miller Energy significantly underpaid for these assets. While possible, it raises the obvious question of why no other buyer was willing to pay more for these assets than the $2.25 million paid by Miller Energy.

Specialists can play a critical role in the financial reporting process, providing knowledge and skills that management and auditors often do not possess. However, specialists should not be blindly relied upon. Instead, the work of a specialist should be analyzed and evaluated to ensure that the results of the specialist's analysis are reasonable and support the financial statement assertions.

It is important to evaluate the reasonableness of the specialist's analysis. If the auditor believes the findings are unreasonable, they should apply additional procedures, which may include obtaining the opinion of another specialist.

Sanctions and Settlement

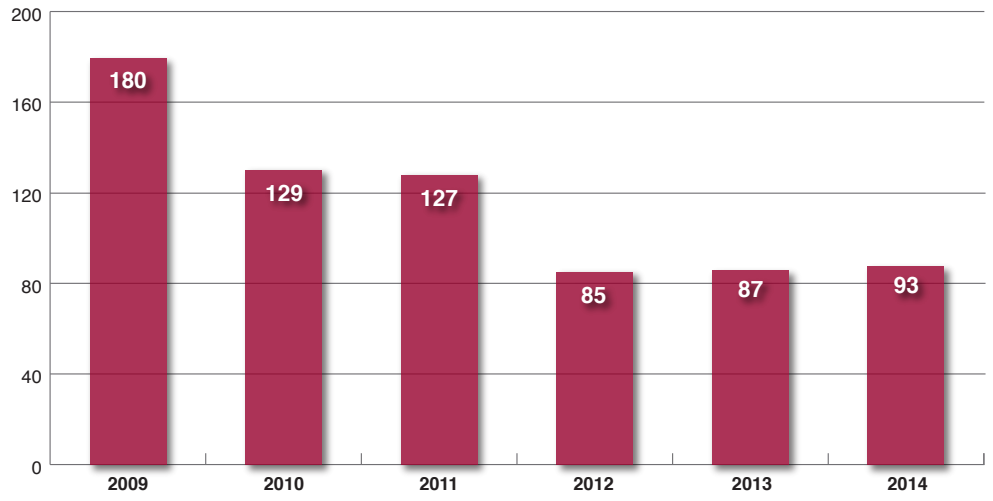
Based on their investigative findings, the SEC is seeking to bar the auditor and the former CFO from any public company accounting. It is also is seeking to obtain cease-and-desist orders, civil monetary penalties, and return of allegedly ill-gotten gains from Miller Energy, the former CFO, and the COO, and bar both executives from serving as public company officers or directors. The matter is waiting to be scheduled for public administrative proceedings.

Prior Period Comparisons: Year over Year 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.

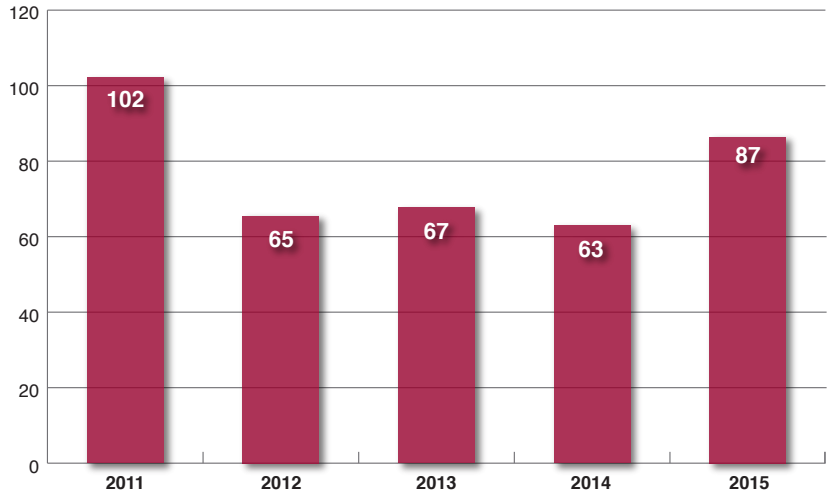
For the year ended December 31, 2014, the SEC issued 93 AAERs, representing a slight increase in the volume of AAERs reported over the previous two years. But the volume was still significantly lower than the volume of AAERs issued by the SEC just four-to-five years ago. The volume of AAERs in 2014 represents 48% fewer enforcement releases than 2009.

Looking Back at Total AAERs in Preceding Years
For The Periods January 1 – December 31,



When analyzing the AAERs issued during the first nine months of the years 2011 through 2015, the 2015 results reflect a significant increase over years 2012 through 2014, but did not reach the volume observed in 2011, as reflected in the graph. However, the Q3 2015 volume of AAERs is equal to almost the entire volume of the first half of 2015. If matched in Q4 2015, this rate would result in a material increase for the year and a return to levels observed in 2010 and 2011.

Q1-Q3 AAER Volume for the First Nine Months of Each Year
For The Periods January 1 – September 30,



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SEC NEWS: SPECIAL ANNOUNCEMENTS AND UPDATES

During the quarter ended September 30, 2015 the SEC announced several newsworthy items including the major developments described below.

SEC Pays More Than $3 Million to Whistleblower

Washington D.C., July 17, 2015 —

The SEC announced a whistleblower award of more than $3 million to a company insider whose information helped the SEC crack a complex fraud. The multi-million dollar payout is the third highest award to date under the SEC's whistle-blower program.

The whistleblower's specific and detailed information comprehensively laid out the fraudulent scheme which otherwise would have been very difficult for investigators to detect. The whistleblower's initial tip also led to related actions that increased the whistleblower's award.

"Insiders may hold the key to helping our investigators unlock intricate fraudulent schemes," said Andrew Ceresney, Director of the SEC's Division of Enforcement. "By providing significant financial incentives for people to come forward, the SEC's whistleblower program continues to be profoundly effective in helping us protect investors and hold wrong-doers accountable."

"The award made today is another testament to the agency's commitment to reward those who provide high-quality information that leads to successful enforcement actions and related actions," said Sean X. McKessy, Chief of the Office of the Whistleblower.

"Our office continues to receive thousands of whistleblower tips each year. When those tips bear fruit, those individuals, like today's whistle-blower, may receive significant financial awards."

Whistleblowers who provide the SEC with unique and useful information that contributes to a successful enforcement action are eligible for awards that can range from 10 percent to 30 percent of the money collected when financial sanctions exceed $1 million. By law, the SEC protects the confidentiality of whistleblowers and does not disclose information that might directly or indirectly reveal a whistleblower's identity.

Since its inception in 2011, the SEC's whistleblower program has paid more than $50 million to 18 whistleblowers, including a more than $30 million award in 2014 and a more than $14 million award in 2013. All payments are made out of an investor protection fund established by Congress that is financed entirely through monetary sanctions paid to the SEC by securities law violators. No money is taken or withheld from harmed investors to pay whistleblower awards. ■

SEC Proposes to Amend Rules Governing Administrative Proceedings

Washington D.C., Sept. 24, 2015 —

The SEC announced it has voted to propose amendments to rules governing its administrative proceedings.

"The proposed amendments seek to modernize our rules of practice for administrative proceedings, including provisions for additional time and prescribed discovery for the parties," said SEC Chair Mary Jo White.

The proposals include three primary changes to the Commission's Rules of Practice that:

- *Adjust the timing of administrative proceedings, including by extending the time before a hearing occurs in appropriate cases*
- *Permit parties to take depositions of witnesses as part of discovery*
- *Require parties in administrative proceedings to submit filings and serve each other electronically, and to redact certain sensitive personal information from those filings*

The proposals also make certain other clarifying and conforming changes. For example, the proposals include procedures related to the mechanics of the proposed expanded deposition practice, such as location, methods of recording, forms of objections, and duties of the deposition officer. The proposed amendments also would simplify the requirements for seeking Commission review of an initial decision and provide enhanced transparency

into the timing of the Commission's decisions in such appeals.

The SEC will seek public comment on the proposed rule amendments concerning procedures in administrative proceedings and electronic filing for 60 days following each proposal's publication in the Federal Register. ■

SEC Proposes Rules Requiring Companies to Adopt Clawback Policies on Executive Compensation

Proposed Rules Designed to Improve Quality of Financial Reporting and Enhance Accountability Benefiting Investors

Washington D.C., July 1, 2015 —

The SEC proposed rules directing national securities exchanges and associations to establish listing standards requiring companies to adopt policies that require executive officers to pay back incentive-based compensation that they were awarded erroneously. With this proposal, the Commission has completed proposals on all executive compensation rules required by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Under the proposed new Rule 10D-1, listed companies would be required to develop and enforce recovery policies that in the event of an accounting restatement, "claw back" from current and former executive officers incentive-based compensation they would not have received based on the restatement. Recovery would be required without regard to fault. The proposed rules would also require disclosure of listed companies' recovery policies, and their actions under those policies.

"These listing standards will require executive officers to return incentive-based compensation that was not earned," said SEC Chair Mary Jo White. "The proposed rules would result in increased accountability and greater focus on the quality of financial reporting, which will benefit investors and the markets."

Under the proposed rules, the listing standards would apply to incentive-based compensation that is tied to accounting-related metrics, stock price or total shareholder return. Recovery would apply to excess incentive-based compensation received by executive officers in the three fiscal years preceding the date a listed company is required to prepare an accounting restatement.

Each listed company would be required to file its recovery policy as an exhibit to its annual report under the Securities Exchange Act. In addition, a listed company would be required to disclose its actions to recover in its annual reports and any proxy statement that requires executive compensation disclosure if, during its last fiscal year, a restatement requiring recovery of excess incentive-based compensation was completed, or there was an outstanding balance of excess incentive-based compensation from a prior restatement.

The comment period for the proposed rules will be 60 days after publication in the Federal Register. ■

SEC Publishes Request for Comment on Regulation S-X

Washington D.C., Sept. 25, 2015 —

The SEC announced that it is seeking public comment on the effectiveness of financial disclosure requirements in Regulation S-X. The request for comment focuses on the requirements for the form and content of financial disclosures that companies must file with the Commission about acquired businesses, affiliated entities, and guarantors and issuers of guaranteed securities.

"This is an important step in our review of the disclosure requirements that apply to public companies," said SEC Chair Mary Jo White. "We are interested in feedback from investors, companies, and other market participants to help us evaluate potential changes to Regulation S-X that would benefit both investors and companies."

The request for comment is part of the Disclosure Effectiveness Initiative, which is a broad-based staff review of the disclosure requirements and the presentation and delivery of the disclosures.

The public comment period will remain open for 60 days following publication of comment request in the Federal Register. ■

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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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