



*Summary of Accounting  
and Auditing Enforcement  
Releases for the Year Ended  
December 31, 2012*

A N N U A L   R E P O R T   2 0 1 2

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### *Introduction and Our Objective*

We are pleased to present you with our summary of the U.S. Securities and Exchange Commission, Division of Enforcement’s Accounting and Auditing Enforcement Releases (“AAERs”) for the year ended December 31, 2012.

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

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

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

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

Floyd Advisory LLC  
JANUARY 2013



# 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 or settlement of administrative proceedings as Accounting and Auditing Enforcement Releases (“AAERs”). Importantly, the disclosed AAERs are intended to highlight certain actions and are not meant to be a complete and exhaustive compilation of all of the actions that may fit into the definition above.

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

As part of our review, we gathered information and key facts, identified common attributes, noted trends, and observed material events. Applying our professional judgment, which is based solely on 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 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 that 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.

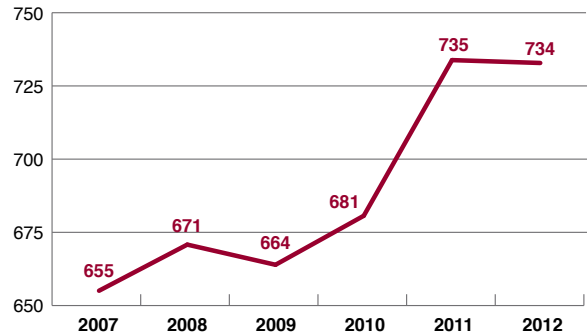
## REVIEW PROCESS

- 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

# SEC Enforcement Actions: 2012 Highlights

Before summarizing information related to the 2012 population of AAERs, summarizing the SEC's overall enforcement actions provides insights into the trends and types of actions receiving the most attention. As reflected on the chart below, the volume of actions filed for the year ended September 30, 2012 approximated the record level experienced in 2011.

**Total SEC Enforcement Actions**  
For The Years Ended September 30,



To dig further into these numbers, the following table provides data on the categories of actions filed annually for the years ended September 30, 2003 through September 30, 2012.

**SEC Categorization of Enforcement Actions**  
For the Years Ended September 30,

Enforcement Actions by Fiscal Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Broker-Dealer	137	140	94	75	89	67	109	70	112	134
Delinquent Filings	n/a	n/a	n/a	91	52	113	92	106	121	127
FCPA	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	* 20	15
Financial Fraud/Issuer Disclosure	199	179	185	138	219	154	143	126	** 89	79
Insider Trading	50	42	50	46	47	61	37	53	57	58
Investment Adviser/ Investment Co.	72	90	97	87	79	87	76	113	146	147
Market Manipulation	32	39	46	27	36	53	39	34	35	46
Securities Offering	109	99	60	61	68	115	141	144	124	89
Other	80	50	98	49	65	21	27	35	31	39
<b>Total Enforcement Actions</b>	<b>679</b>	<b>639</b>	<b>630</b>	<b>574</b>	<b>655</b>	<b>671</b>	<b>664</b>	<b>681</b>	<b>735</b>	<b>734</b>

\*Prior to FY 2011, FCPA was not a distinct category and FCPA actions were classified as Issuer Reporting and Disclosure.

\*\*Prior to FY 2011, this category was reported as Issuer Reporting and Disclosure and included FCPA actions, which are now tracked separately from financial fraud/issuer disclosure actions.

Source: U.S. Security and Exchange Commission <http://www.sec.gov/news/newsroom/images/enfstats.pdf>

## SPEECH BY SEC CHAIRMAN: REMARKS AT 2012 NEW ENGLAND SECURITIES CONFERENCE

“And when a series of groundbreaking cases reveals the systematic skimming of state and local tax dollars in hundreds of municipal bond offerings nationwide and results in the recovery of three-quarters of a billion dollars—we send a strong message that even long-standing cozy arrangements in dark corners of the financial world will be uncovered and pursued.”

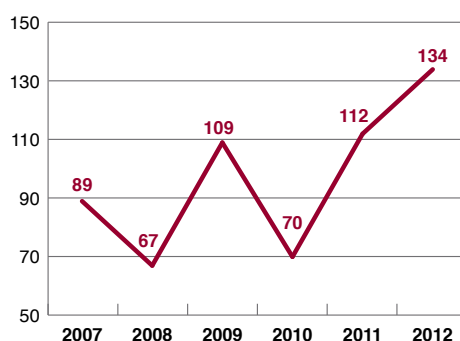
Chairman Mary L. Schapiro  
U.S. Securities and  
Exchange Commission  
Boston  
Oct. 11, 2012

Definitions for these categories however were not readily available from the SEC (including through the Freedom of Information Act) but based on examples of actions in each category and our experience, we prepared the following summary of the types of enforcement actions in each category.

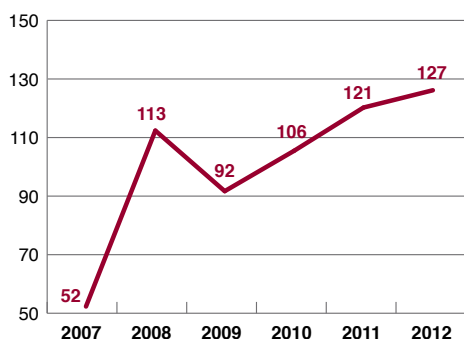
Category	Types of Enforcement Actions
<b>Broker-Dealer</b>	Stock price manipulation, violations arising out of compliance deficiencies, naked short selling schemes, improper trading activities by Broker-Dealers
<b>Delinquent Filings</b>	Failures to make required and or timely filings with the SEC including Forms 10K, 10Q, 8K and other mandated submissions
<b>FCPA</b>	Bribes and kickbacks to foreign officials to assist in obtaining or retaining business as well as cases involving internal control violations
<b>Financial Fraud/Issuer Disclosure</b>	Fraudulent financial reporting matters, cases involving misleading statements to investors and faulty and or inadequate disclosure matters
<b>Insider Trading</b>	Buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security
<b>Investment Adviser/Investment Company</b>	Misleading disclosures, improper fee arrangements, misappropriation of client assets, and other violations of the Investment Advisers Act
<b>Market Manipulation</b>	Creating false appearance of a liquid and active market, fraud involving dormant microcap shell companies and other disruptive trading activities
<b>Securities Offering</b>	Misleading and fraudulent representations to induce investors to enter into securities transactions

Most notable when reviewing the increase in the enforcement actions are trends in the volume of Broker-Dealer, Delinquent Filings, and Investment Adviser/Investment Company actions. Each category reported records results for the years ended September 30. The charts shown here display the six year trends in Broker-Dealer, Delinquent Filings, and Investment Adviser/Investment Company actions.

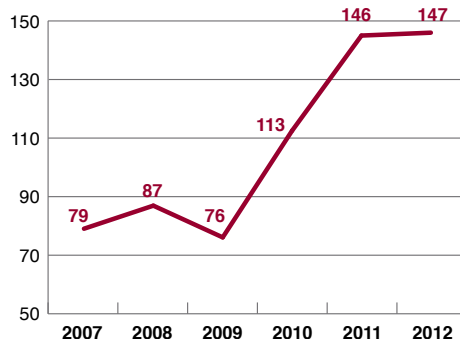
**Broker-Dealer**  
For The Years Ended September 30,



**Delinquent Filings**  
For The Years Ended September 30,



**Investment Adviser/  
Investment Company**  
For The Years Ended September 30,



Most notable when reviewing the increase in the enforcement actions are trends in the volume of Broker-Dealer, Delinquent Filings, and Investment Adviser/Investment Company actions.

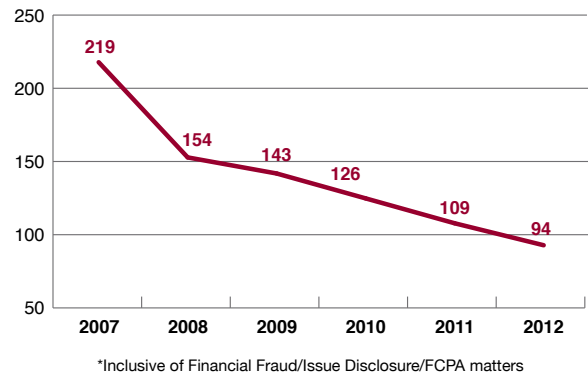




Of significance, the financial fraud related matters represented approximately 33% of all SEC enforcement actions in 2007 compared to only approximately 13% in 2012.

Conversely, the financial fraud related matters (categorically shown above as Financial Fraud/Issue Disclosure matters combined with FCPA cases) decreased by approximately 57% from 2007 to 2012. Of significance, the financial fraud related matters represented approximately 33% of all SEC enforcement actions in 2007 compared to only approximately 13% in 2012. The chart below illustrates this dramatic decline in financial fraud related matters.

**Financial Fraud Related Enforcement Actions**  
For The Years Ended September 30,

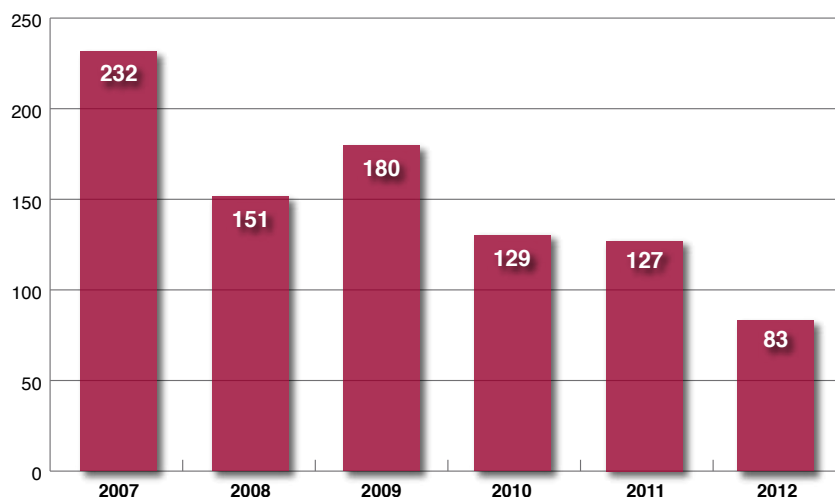


Interestingly this trend of fewer financial fraud matters is consistent with published information related to securities class action lawsuits. According to the “D&O Diary”, a periodic journal containing information of interest about the world of directors’ and officers’ liability, the volume of new securities class actions dropped to 156 in 2012 from 188 in 2011, and was well below the 1996 to 2011 average of 193 filings.

## AAERs for Year Ended December 31, 2012: Major Observations and Insights

For the year ended December 31, 2012, the SEC issued 83 AAERs, the lowest volume in several years, representing a 35% drop from the volume reported in 2011 and a 64% drop from the volume reported in 2007.

**AAERs**  
For The Years Ended December 31,

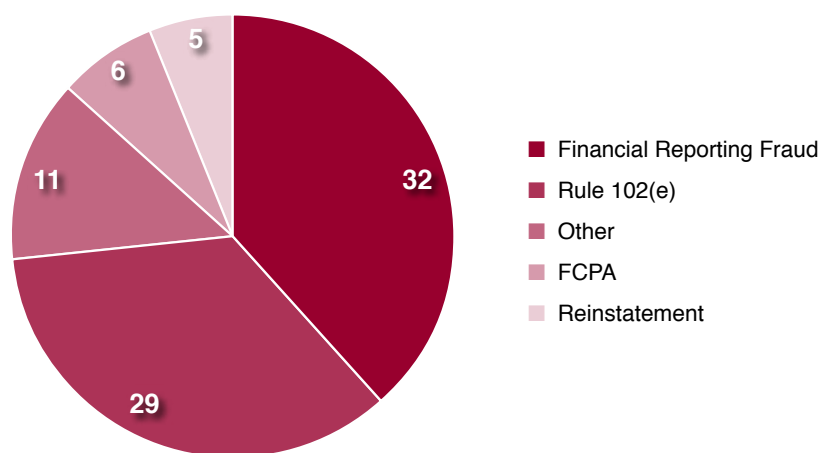


To evaluate the contrast between the volume of total enforcement actions to the decline in AAERs, one should consider the types of matters being handled by the SEC. Importantly, AAERs are intended to highlight certain enforcement actions and are not meant to be a complete and exhaustive compilation of all the actions that may fit into the definition the SEC provides for this classification. Furthermore, in our experience, matters reported as AAERs quite often arise out of financial reporting frauds and other related enforcement actions, a category that has experienced a similar drop in activity.

## *Financial Reporting Fraud Actions Earn the Top Position*

To evaluate the types of AAERs issued in 2012, we sorted the releases into major categories: Financial Reporting Frauds, Rule 102(e) Actions, Foreign Corrupt Practices Act violations (“FCPA”), Reinstatements, and Other.

**2012 AAERs by Category**



Based on our experience, financial reporting fraud releases often precede Rule 102(e) sanctions against the individuals held accountable for the reporting problem. And quite often one action against a registrant for an alleged reporting problem can result in several actions against individuals in subsequent periods. Therefore when reviewing the volume of financial reporting fraud actions in 2012, it’s fair to assume that there may be a rise in Rule 102(e) actions in the near term.

Rule 102(e) actions involve the censure and denial, temporarily or permanently, of the privilege of appearing or practicing before the SEC. For accountants, the standards under which one may be penalized with a Rule 102(e) action include reckless or 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 that indicate a lack of competence.

**SPEECH BY  
SEC CHAIRMAN:  
REMARKS AT 2012 NEW  
ENGLAND SECURITIES  
CONFERENCE**

**“If you invest, we will  
protect you. If you steal,  
we will punish you.”**

Chairman Mary L. Schapiro  
U.S. Securities and  
Exchange Commission  
Boston  
Oct. 11, 2012

# The 2012 AAERs: Summary of Financial Reporting Issues

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

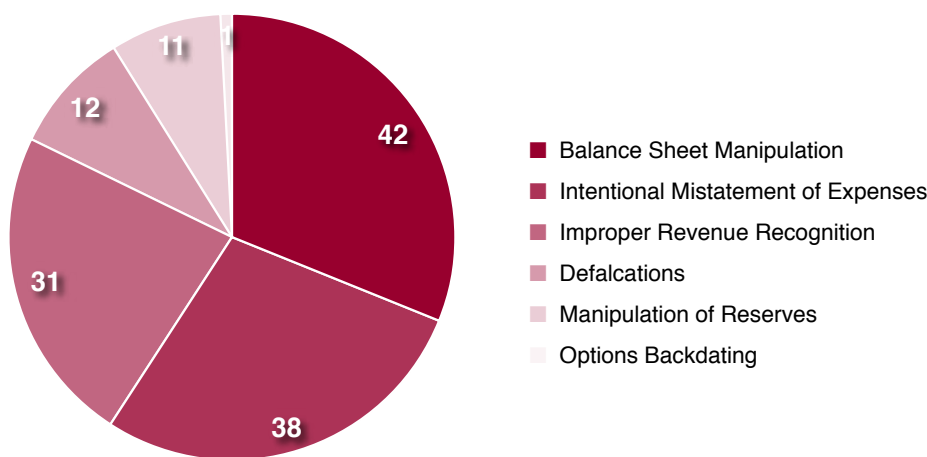
Classification	Definition
<b>Improper Revenue Recognition</b>	Overstated, premature or fabricated revenue transactions reported in public filings
<b>Manipulation of Reserves</b>	Improperly created, maintained and released restructuring reserves, general reserves or other falsified accruals
<b>Intentional Misstatement of Expenses</b>	Deceptive misclassifications or understatements of expenses
<b>Balance Sheet Manipulation</b>	Misstatement and misrepresentation of asset balances, or the recording of transactions inconsistent with their substance
<b>Options Backdating</b>	Intentional misdating of stock option awards

## TAKING A NO-NONSENSE APPROACH TO ENFORCING THE FEDERAL SECURITIES LAWS

“Many offenders, particularly Ponzi scheme offenders, have long track records of similar fraud schemes. That tells me that the first time that many defendants were prosecuted, the remedies and penalties did not effectively deter them from engaging in egregious fraud again.”

Commissioner Luis Aguilar  
U.S. Securities and  
Exchange Commission  
Securities Enforcement  
Forum 2012  
Mayflower Hotel  
Washington, D.C.  
October 18, 2012

Financial Reporting Issues Identified in 2012 AAERs



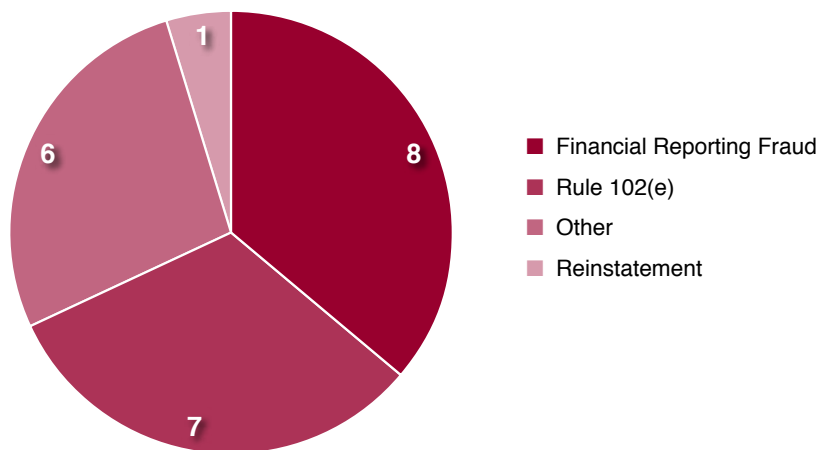
As shown above, balance sheet manipulation represented the most common financial reporting issue in the 2012 AAER population. Importantly, as described in our Process and Methodology section, we record each accounting problem identified in the releases as a separate item and therefore many actions involving improper revenue recognition, manipulation of reserves and the intentional misstatement of expenses also have a balance sheet impact.



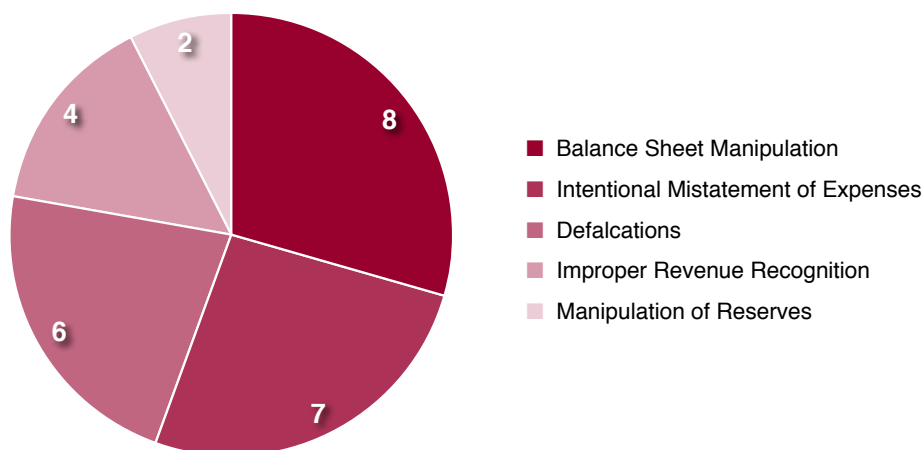
# Overview of Q4 2012 AAERs

As part of our annual report on AAER activity, we provide an abbreviated version of our quarterly reporting for the final quarter of the year. The SEC reported 22 AAERs in Q4 2012 (including four AAERs dated as if in Q3 but officially released in Q4) reflecting consistently with results of annual information presented earlier: Financial Reporting Fraud is leading category and balance sheet manipulation is the leading financial reporting issue.

**Q4 AAERs by Category**



**Financial Reporting Issues Identified in Q4 AAERs**




## *Q4 2012 “Recommended Reading” AAER*

While reviewing all of the SEC’s AAERs may prove insightful, certain releases present information that is worth further review and analysis by those involved with financial reporting matters. We deem these particular releases as earning the distinction of “Recommended Reading” for our clients.

### REMARKS DURING NEWS CONFERENCE CALL ABOUT ENFORCEMENT ACTIONS AGAINST J.P. MORGAN AND CREDIT SUISSE

“If a major investment bank misleads investors and places its own interests first, it is not just the investors who suffer, but the credibility of our financial system as well.”

Robert Khuzami  
Director of the  
SEC’s Division of Enforcement  
U.S. Securities and  
Exchange Commission  
Washington, D.C.  
November 16, 2012



Among the Q4 2012 AAERs, the opinion of the SEC issued following the appeal of a decision of an administrative law judge by a former audit manager in a major accounting firm over Rule 102(e) sanctions is remarkable for its discussion of the SEC's views regarding the heightened professional skepticism required when auditing related party transactions, the importance of challenging management representations when faced with inconsistent facts, holding the audit manager responsible while the partner was not sanctioned, and other important lessons gleaned from how best to handle an appeal to the SEC.

***In the Matter of the Application of Wendy McNeeley, CPA,  
Accounting and Auditing Enforcement Release No. 3427,  
Administrative Proceeding File No. 3-13797***

The Rule 102(e) action against the audit manager stemmed from the failed audit of an investment advisor, AA Capital Partners, Inc. ("Investment Manager"), an entity that had several affiliated private equity funds. The president and founder of the Investment Manager transferred approximately \$1.9 million from client trust accounts to allegedly pay a tax assessment by the Internal Revenue Service ("IRS"). The transfers were classified as accounts receivable from affiliates.

Unfortunately, the audit team was duped into accepting the representation of a tax need, didn't object to the use of the funds despite operating agreement language to the contrary, and never challenged the collectability of the receivable. Ultimately the funds failed, the moneys were not recovered and the wrongdoer was criminally convicted for improperly diverting client funds.

The opinion of the SEC responding to the appeal provides a thorough description of facts, a robust discussion of professional obligations, a description of the red flags that were missed and ultimately the SEC's reasoning as to why the manager should be sanctioned. But most significant was the tone and discussion surrounding the lack of professional skepticism displayed for the transactions, especially noting their related party nature. In fact the SEC invoked the "heightened scrutiny" standard found in Rule 102(e) when assessing the auditor's conduct.

Under Rule 102(e) "heightened scrutiny" is warranted "when matters are important or material, or when warning signals or other factors should alert an accountant" to a heightened risk. In this situation, the SEC identified as critical factors the related party nature of the transactions as well as the materiality of the transfers. Together these factors should have elevated the auditor's professional skepticism such that additional audit steps would be taken, and management representations would not be relied upon without third party support and evidential matter. The SEC cites the possibility of securing copies of IRS checks or correspondence to validate management's representations.

The SEC seems to be sending a message through its opinion that is consistent with the PCAOB's Staff Audit Practice Alert, *Maintaining and Applying Professional Skepticism in Audits*, issued on December 4, 2012. In the Alert, the PCAOB states, "The Office of the Chief Auditor is issuing this practice alert to remind auditors of the requirement to appropriately apply professional skepticism throughout their audits" which includes an attitude of a questioning mind and a critical assessment of audit evidence.

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Another not so subtle message from the SEC in from reading the opinion relates to the responsibilities of audit managers. Notably, the audit partner was not held responsible for the failure to detect the fraudulent transactions. He was not found to have acted highly unreasonably and thereby warranting rule 102(e) sanctions despite his failure to comply with auditing standards and the audit's failure.

Notably, the opinion of the SEC differentiates the partner's role as overseeing the audit manager, reviewing the audit workpapers and signing the audit report. In contrast, the manager was responsible for day-to-day audit planning, executing audit strategy, supervising audit staff and reviewing audit workpapers for significant risk areas, plus importantly alerting the partner to significant issues and questions regarding the audit. The opinion recognizes that the partner was told about the transactions, but described the record as unclear as to whether the manager advised him of the red flags that she was aware of regarding the transactions. In sum, managers have vital roles to fulfill for the proper functioning of the audit process, as do staff.

Another important lesson gleamed from the opinion of the SEC is the importance of accepting responsibility. The opinion states,

McNeeley's conduct also indicates a risk that she will commit future violations. As the D.C. Circuit has recognized, "the existence of a violation raises an inference that it will be repeated", and McNeeley has made clear that she intends to remain an auditor if permitted. **Our concern that McNeeley will commit future violations is exacerbated by McNeeley's subsequent failure to recognize the wrongfulness of her conduct.** McNeeley has consistently asserted that she conducted the audit appropriately. While a respondent has the right to present a vigorous defense, McNeeley's testimony and subsequent arguments on appeal reflect a continuing failure to grasp the role of an auditor. McNeeley argues, for example, that she had no duty to verify the legitimacy of the reasons for the Transfers (e.g., verifying that Orecchio owed the taxes that he claimed). This assertion ignores the importance of obtaining third-party evidence, especially when auditing related-party transactions and, more generally, displays a failure to appreciate the overarching obligation to exercise due care and professional skepticism. McNeeley also testified, and now argues on appeal, that the evidential matter she obtained from AA Capital was sufficient to understand the Transfers. That evidential matter, however, consisted almost exclusively of management representations that were often vague and contradictory. Perhaps most troubling, McNeeley not only fails to recognize her failures, but she also argues that "[t]his case arose only because a criminal audit client, who now resides in a federal prison, successfully led an effort to defraud her and the rest of the audit team." Orecchio's fraud, however, did not cause her auditing failures. Her highly unreasonable conduct caused her auditing failures. Orecchio's fraud served only to expose those failures. **Such an inability to recognize the wrongfulness of her conduct gives us concern that McNeeley will repeat her misconduct in the future.**

One can only wonder if a more conciliatory approach taken by the audit manager would have resulted in a different outcome.

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#### **ACKNOWLEDGEMENT**

We wish to acknowledge the valuable contribution to this analysis by Liz Klyuchnikova, Sarah Floyd and Saro Banoian.

#### **ABOUT Floyd Advisory**

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

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