Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended March 31, 2016

Q1 REPORT 2016

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Introduction and Our Objective

We are pleased to present you with our summary of the U.S. Securities and Exchange Commission, Division of Enforcement's Accounting and Auditing Enforcement Releases ("AAERs") for the quarter ended March 31, 2016.

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
APRIL 2016

The Q1 2016 AAERs: Highlights

- Rule 102(e) violations accounted for the largest group of the SEC's accounting and auditing enforcement releases this quarter and auditors were charged in approximately one-third of them.

- Notably, six Foreign Corrupt Practices Act ("FCPA") cases were reported, more than any quarter since Q4 2010, and totaled approximately $40 million in civil penalties, disgorgement, and prejudgment interest.

- Of great significance to registrants and their staff and professional advisors, the SEC provided a valuable discussion regarding how registrants and auditors should distinguish between and document their judgments when deciding whether a control problem is a significant deficiency or a material weakness. This discussion is highlighted in our Recommended Reading section.

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.

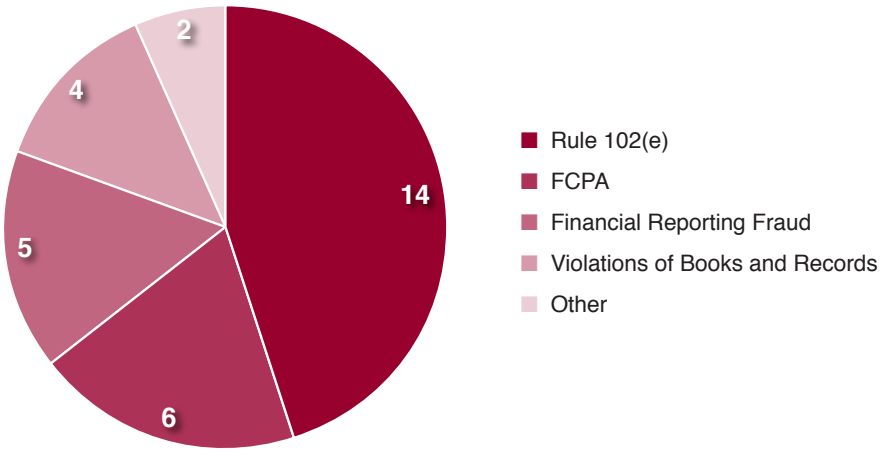
To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, www.sec.gov.

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 and Errors, 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.

The Q1 2016 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed 31 AAERs during Q1 2016, with Rule 102(e) actions representing approximately 45% of the total releases.

Q1 2016 AAERs by Category



"...the agency must continue to enhance its enforcement function to keep pace with the growing size and complexity of the nation's markets and to swiftly and aggressively address misconduct."

Chair Mary Jo White
U.S. Securities and Exchange Commission
Washington, DC
March 22, 2016

Testimony on the Fiscal Year 2017 Budget Request of the U.S. Securities and Exchange Commission

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

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.

The SEC accepted offers of settlement for six of the fourteen Respondents with Rule 102(e) violations and for all six, the Respondents neither admitted nor denied the SEC's findings. The SEC entered 102(e) orders against six additional Respondents, four of whom were instructed to file an answer to the allegations, and two of whom were given the opportunity to file petitions to lift their suspensions. One 102(e) respondent consented to the entry of a final judgment without admitting or denying the SEC's findings, while one 102(e) decision became final because the Respondent did not file a petition by the SEC's deadline.

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

- ***The SEC settled with the former CFO and Senior Vice President of a large retail operation for insider trading violations.*** The former CFO, who was also a CPA, allegedly possessed material nonpublic information about his employer and traded in advance of two public offerings. In January 2012, the former CFO allegedly became aware of positive holiday sales results. In breach of his duty to shareholders, according to the release, he traded securities in advance of the public release of this information. In March 2012, the former CFO is alleged to have become aware of plans to acquire another company. In breach of his duties, according to the release, he traded shares of the target company before the public announcement of the transaction. According to the SEC, by engaging in this conduct, the former CFO violated Sections 10(b) and 14(e) of the Exchange Act and Rules 10b-5 and 14e-3 thereunder. Of note, the former CFO settled the matter agreeing to Rule 102(e) sanctions and penalties, but neither admitted nor denied the SEC findings and allegations.

- ***A Florida-based CPA allegedly engaged in improper professional conduct and failed to exercise due professional care in the audits of the 2010 and 2011 financial statements of a nutritional supplement company based in Denver, CO.*** According to the SEC, the CPA audited the company's financial statements while allegedly knowing that his auditing firm was not an independent entity. Additionally, the CPA allegedly ignored the fact that the company's largest customer in 2011 was a related party, and did not make certain disclosures mandatory under GAAP. Per the claim, the CPA also failed to recognize improperly recorded sales incentives, advertising, and promotions and had also improperly disclosed its sponsorship commitments and international sales. In May 2001, the Denver-based company hired a new chief marketing officer ("CMO"), apparently a former executive and co-founder of its largest customer. According to the release, the new CMO's brother remained the CEO of the Denver-based company's largest customer, holding more than 10% indirect ownership. GAAP required that the Denver-based company disclose any transactions with this company as related party transactions. Rather than ensuring the Denver-based company made these disclosures, the CPA allegedly relied on the Denver-based company's memo supporting its reasoning for not including these transactions as related party transactions. According to the SEC, this memo was prepared by an executive without an accounting background, and was ultimately signed by the CFO who "lacked technical accounting expertise" and other executives, but never by an accountant.

- ***The SEC settled civil fraud charges against an agricultural seed and chemical company and certain employees for improperly accounting for millions of dollars of rebates offered to distributors and retailers to incent them to purchase products during 2009, 2010 and 2011.*** According to the allegations, the entity improperly accounted for the payments to customers as selling, general, and administrative expenses ("SG&A") rather than rebates and a reduction of revenue thereby improperly overstating gross profit. The accounting standard governing rebate programs is set forth in Emerging Issues Task Force ("EITF") Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)," codified as ASC 605- 50. Specifically, Issue 6 of EITF 01-9 (ASC 605-50-25-7) requires a vendor to recognize a rebate obligation as a reduction of revenue based on a systematic or rational allocation of the cost of honoring the rebate offer to each underlying transaction that results in progress by the

"Therefore, as you evaluate your contracts with customers, it would be appropriate to take a fresh look not only at your historical accounting policies and how they may need to change but also at the design of the related controls (both existing and new) to ensure they are designed to operate in a manner that is sufficiently sensitive or precise to prevent or detect a material misstatement in the financial statements."

James V. Schnurr
Chief Accountant
Office of the Chief Accountant
Philadelphia, PA
March 22, 2016

Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress

customer towards earning the rebate. Exceptions to this general rule exist when the customer provides services in return for the rebate, a situation that allegedly did not exist under this entity's rebate program. The respondents settled the matter without admitting or denying the charges.

FCPA Violations

There were six FCPA-related releases in Q1 2016, resulting in a total of $39.73 million in civil penalties, disgorgement and prejudgment interest. Summaries of select FCPA enforcement actions are described below:

- ***According to the SEC, a pharmaceutical company, headquartered in California, that primarily markets and sells products in China, violated the anti-bribery, books and records and internal accounting controls provisions of the FCPA.*** From at least 2007 to 2012, employees of a subsidiary of the entity allegedly gave money, gifts and other things of value to foreign officials, including healthcare professionals who were employed by state-owned hospitals in China, in order to obtain sales of pharmaceutical products. Per the release, various means were employed, and these schemes were known to and condoned by various managers within the entity's China-based corporate structure. The related transactions were falsely recorded in the entity's books and records as legitimate business expenses, such as sponsorships, travel and entertainment, conferences, honoraria, and promotional expenses. The SEC also charged the entity with failing to devise and maintain a sufficient system of internal accounting controls and failing to maintain an effective anti-corruption compliance program.

- ***The former CEO of a South American airline was charged with violations of the FCPA. Per the release, in 2006 and 2007, the former CEO authorized $1.15 million in improper payments*** to a third party consultant in Argentina in connection with the airline's attempts to settle disputes on wages and other work conditions between a subsidiary of the airline and its employees. At the time, the CEO allegedly understood that it was possible the consultant would pass on some portion of the $1.15 million to union officials in Argentina. In the SEC's claim, the payments were made pursuant to an unsigned consulting agreement that purported to provide services that the CEO understood would not be provided. Per the release, the CEO authorized subordinates to make the payments that were improperly recorded in the company's books and records, which circumvented internal accounting controls.

- ***A telecommunications company headquartered in California allegedly violated the anti-bribery, books and records, and internal controls provisions of the FCPA.*** According to the SEC, from 2002 through 2012, the telecommunications company provided things of value to foreign officials—including high-ranking employees of state-owned enterprises ("SOEs") and government ministers—to try to influence these decision makers to favor and/or promote a proprietary technology in an evolving international telecommunications market, thereby providing the company with a business advantage. Per the release, the entity's international operations accounted for more than 90% of the company's revenue. Even so, the entity's internal controls were apparently insufficient to prevent or detect improper payments to foreign officials. The SEC claimed that in several areas of its business operations, including hiring, hospitality planning, and business development, the entity lacked an adequate oversight process to determine whether things of value that it provided to foreign officials were made with the intent to induce those officials to provide a business benefit.

"Companies must effectively design and implement internal controls across all business operations to prevent FCPA violations, including its hiring practices. … For more than a decade, [a company] went to extraordinary lengths to gain a business advantage with foreign officials deciding between [this company's] technology and its competitors."

Michele Wein Layne
Director of the SEC's
Los Angeles Regional Office
Washington D.C.
March 1, 2016

Financial Reporting Frauds

There were five AAERs that we categorized as financial reporting frauds during the quarter, including the following:

- ***The SEC charged a Tennessee oil and gas company with financial accounting and reporting fraud related to the purchase accounting and valuation of certain acquired oil and gas assets.*** Per the release, the entity purchased these assets, which are located in Alaska, for $2.25 million in cash, along with the assumption of certain liabilities it valued at approximately $2 million in a bankruptcy competitive bid proceeding in December 2009. It is claimed the company subsequently reported those assets at an overstated value of $480 million and recognized a one-time "bargain purchase" gain of $277 million for its fiscal third quarter ended January 2010 and fiscal year ended April 2010. Per the release, the entity failed to account for the acquisition in accordance with Accounting Standards Codification ("ASC") 805, Business Combinations, which required the entity to record the value of its acquired Alaska assets at "fair value." However, contrary to authoritative accounting guidance, the entity's then CFO apparently used as fair value a reserve report that was prepared by a petroleum engineer firm using the rules for supplemental oil and gas disclosures. As set forth in GAAP, the numbers used in these supplemental disclosures do not reflect fair value, and the SEC claimed that the reserve report used by the CFO expressly disclaimed that the numbers therein represented the engineer firm's opinion of fair value. Apparently, the reserve report also contained understated expense amounts. Per the release, the CFO also double counted $110 million of certain fixed assets that were already included in the reserve report. In addition to charging the company, the SEC also filed charges against the auditors for violations of GAAS.

- ***The SEC settled against the former CFO of a California-based company that manufactures and sells biological-based pest management and plant health products.*** This matter involves allegedly misstated revenues at the company due to the former Chief Operating Officer and Head of Sales allegedly directing sales employees to offer various sales concessions to distributors in order to meet sales targets and analysts' revenue expectations, while simultaneously concealing those concessions from finance and accounting personnel. As a result, from March 2013 through June 2014, it is alleged the company improperly and prematurely recognized more than $4 million in revenue, including $2 million in revenue that will never be earned because the distributors returned the product. The CFO, a certified public accountant licensed in California, neither admitted nor denied the charges as part of the settlement. Though the SEC did not allege the CFO participated in the misconduct, as required by Section 304(a) of SOX, the CFO apparently agreed to return bonuses received during the alleged time period of the misstated financial statements.

"[A company] devised rebate programs that elevated form over substance, which led to the booking of substantial amounts of revenue without the recognition of associated costs. Public companies need to have robust systems in place to ensure that all of their transactions are recognized in the correct reporting period."

Scott W. Friestad
Associate Director in the
SEC's Division of Enforcement
Washington D.C.
February 9, 2016

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 examples of this quarter's releases are as follows:

- ***According to the SEC, a loan servicing company made erroneous valuations of its financing liability on certain mortgage servicing rights it had sold to a related company from 2012 to 2014.*** Per the release, the company reported

that it accounted for the mortgage servicing rights at fair value, but it relied on a valuation received from the related company, which was inaccurate. The Executive Chairman apparently recognized that there was a variance between the valuation and fair value, but according to the SEC, did not notify anyone within the company or its external auditors. When internal accounting controls allegedly failed to identify these errors, the company allegedly filed materially misstated financial results for four consecutive quarters. Additionally, the company allegedly failed to act appropriately in avoiding conflicts of interest in related party transactions. In 2012, according to the release, the company disclosed that the Executive Chairman should be recused from negotiations regarding certain transactions with related parties with which he was associated. However, the company apparently failed to implement proper controls to ensure that conflicts of interest did not arise, and it is alleged the Executive Chairman repeatedly approved transactions between the company and the related parties.

- ***The former CFO of a registered broker-dealer that is a subsidiary of a financial services company headquartered in Ohio settled charges with the SEC of financial reporting misconduct without admitting or denying the findings and allegations against him.*** Per the release, beginning at some point prior to January 2011, and through January 2012, the former CFO caused unsubstantiated or "plug" entries to be made to one or more accounts in the entity's general ledger. The amount of the allegation's unsubstantiated entries varied over time. The alleged plug entries arose over apparent discrepancies between investment account subledgers and the amounts in the general ledger. Rather than properly reconciling the accounts, the CFO allegedly recorded entries to equal the subledger amounts which were misstated. As a result, the financial statements for fiscal year 2010 included allegedly unsubstantiated assets of $13,679,000 and omitted liabilities of $4,305,000. Accordingly, the entity apparently restated net income as $3,136,000 versus the previously reported $14,428,000 (a 78% reduction) and restated shareholder's equity from $328,088,000 to $316,796,000 as of December 31, 2010.

"...progress in how the audit gets communicated to the public remains elusive. The only communication to investors, market participants, and regulators about all of the hard work that goes into an audit is a one-page standardized audit report that has changed little over the last 80 years. Other countries are experimenting with modernizing the standardized audit report. They are finding that additional transparency in the audit is extremely valuable for investors."

Commissioner Kara M. Stein
U.S. Securities and Exchange Commission
Washington, DC
March 14, 2016

Statement on the Commission's Consideration of the Public Company Accounting Oversight Board's Proposed 2016 Budget and Accounting Support Fee

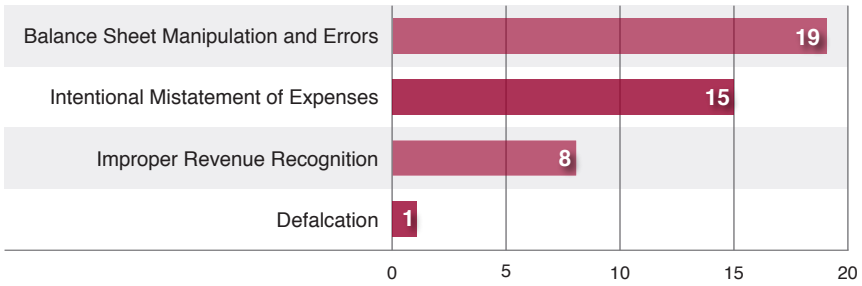
The Q1 2016 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in Q1 2016 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
Intentional Misstatement of Expenses	Deceptive misclassifications and understatements of expenses
Balance Sheet Manipulation and Errors	Misstatement or misrepresentation of asset balances and the recording of transactions inconsistent with their substance
Defalcation	Thefts of funds and assets

The chart below illustrates the frequency of financial reporting issues by category among all AAERs during Q1 2016. Balance Sheet Manipulation and Errors remains our top category for the fifth straight quarter. Notably, many enforcement actions with incidents of wrongdoing related to recognizing revenue, reserve accounting, and recording expenses identified during our analysis of each release also impact company balance sheets. The most prevalent matter inherent in incidents of balance sheet manipulation and errors this quarter related to the overstating of assets on company books and records.

Financial Reporting Issues Identified in Q1 2016 AAERs



Notable Q1 2016 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.

For this quarter, we selected two AAERs to highlight. The first describes some of the usual pressures and judgments encountered when categorizing an internal control problem as a significant deficiency or a material weakness, along with a discussion of the proper level of documentation for the decision. The second AAER summarized below is an example of a failed internal investigation that was entirely "internal" and didn't involve external independent counsel or accountants.

Accounting and Auditing Enforcement Release Nos. 3753, 3754, 3755, 3756, 3757 / March 10, 2016, Administrative Proceeding File Nos. 3-17163, 3-17164, 3-17165, 3-17166, 3-17167, In the Matter of Joseph R. Allred, CPA, Wayne Gray, CPA, David S. Krueger, CPA, Magnum Hunter Resources Corporation, Ronald D. Ormand, Respondents.

The Securities and Exchange Commission ("Commission") filed five AAERs this quarter related to the internal control failures by Magnum Hunter Resources Corporation ("MHR" or "the Company"). MHR is a Delaware corporation headquartered in Irving, Texas that operates as an independent oil and gas company engaged in the exploration and production of oil and gas in the United States. The releases involved MHR management, its auditors, as well as the legal entity and included cease and desist orders as well as Rule 102 (e) sanctions.

"Improper revenue and expense recognition practices that obscure a company's true financial results have long been a focus of the Commission. We are committed to vigorously pursuing and punishing corporate executives and other individuals whose actions contribute to the filing of inaccurate financial statements and other securities law violations."

Andrew J. Ceresney
Director of the SEC's
Division of Enforcement
Washington D.C.
February 9, 2016

Specifically, the allegations involved the failure to properly implement, maintain, and evaluate internal control over financial reporting ("ICFR") for the fiscal year-ended December 31, 2011 and to maintain ICFR sufficient to keep pace with MHR's growth from at least the fiscal year-ended December 31, 2011 through the quarter-ended September 30, 2013.

According to the release, MHR grew from $6 million in revenues in 2009 to $23 million in 2010, largely as the result of an $82 million acquisition in February 2010. In connection with the issuance of the external auditor's report on MHR's 2010 year-end audit results, the auditors advised MHR's Audit Committee that MHR's accounting department was experiencing "manpower issues" and lacked sufficient personnel to complete all required tasks on a timely basis. Subsequently, between December 2010 and April 2011, MHR acquired another $70 million in oil and gas properties and leasehold mineral interests. MHR also completed two other acquisitions in April and May 2011 for an aggregate purchase price of approximately $565 million. In 2011, MHR recognized over $100 million in revenues—largely as a result of these acquisitions.

MHR's rapid growth ostensibly created a significant burden on MHR's accounting department and created an internal control problem allegedly due to the lack of adequately trained accounting personnel.

There are two very significant discussions in the releases. The first pertains to the decision process to distinguish between a material weakness and a significant deficiency in internal controls. The second is related and emphasizes the importance of preparing contemporaneous documentation evidencing the thought process and criteria considered when making such a decision, a theme that holds for all financial reporting judgments, estimates, and assumptions.

For background, Exchange Act Rule 13a-15(f) defines ICFR as:

> [A] process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles[.] 17 C.F.R. 240.13a-15(f).

Item 308 of Regulation S-K requires management to provide an annual report that contains its assessment of the effectiveness of ICFR and any material weakness in ICFR. Under Item 308, "[m]anagement is not permitted to conclude that the registrant's [ICFR] is effective if there are one or more material weaknesses in the registrant's [ICFR]." *See* 17 C.F.R. 229.308. Item 308 of Regulation S-K further instructs that the registrant "must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's [ICFR]."

Rule 1-02(a)(4) of Regulation S-X defines categories of ICFR deficiencies based on the severity, as follows:

> A "material weakness" is a "deficiency, or a combination of deficiencies, in [ICFR] such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." *See* 17 C.F.R. 210.1-02(a)(4). A misstatement is reasonably possible if the chance of a misstatement is more than remote but less than likely. *See 2007 Guidance* at 34-35, n. 47.

"An important aspect of the revenue recognition standard is that the application requires judgments by the preparer that will be later evaluated by auditors, investors, and regulators. I encourage companies to develop the judgments with appropriate knowledge of the new standard and a careful assessment of all relevant facts and circumstances surrounding their transactions. … Of course, documentation of the judgments will be critical to the application of the standard and should be reflective of the complexity and materiality of the arrangement."

James V. Schnurr
Chief Accountant
Office of the Chief Accountant
Philadelphia, PA
March 22, 2016

Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress

> A "significant deficiency" is a "deficiency, or a combination of deficiencies, in [ICFR] that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." *Id.*

Importantly, the severity of a deficiency in ICFR does not depend on whether a misstatement has actually occurred.

As of December 31, 2011, per the SEC, the auditor's report identified control deficiencies within MHR's accounting function, including: (a) instances in which reconciliations were not prepared, reviewed, or approved on a timely basis; (b) failures to document the completion of required monthly management reviews; and (c) significant delays in preparing financial statements and reports due to "inadequate and inappropriately aligned staffing, a concern initially raised in the previous year. The report stated:

> [T]he potential for error in such a compressed work environment presents substantial risk. With complex financial and reporting structures there are few individuals within the team with the capacity to perform many tasks and there is little time for senior reporting personnel to review, analyze, and evaluate because they are performing transaction level reporting tasks.

According to the release, the report concluded, without explanation, that MHR's staffing deficiency represented only a significant deficiency—rather than a material weakness. Per the SEC, the report did not explain how a deficiency that created a "substantial risk" of a financial statement error did not rise to the level of a material weakness, defined as a deficiency in ICFR that creates a reasonable possibility of a material misstatement not being prevented or detected on a timely basis.

Also according to the release, management accepted the assessment that MHR's insufficient accounting staffing represented a significant deficiency. The claim also stated that management also relied on the absence of an actual identified material error in MHR's financial statements as evidence that a material weakness did not exist as of December 31, 2011. It also alleged that management did not prepare any documentary evidence to supplement the documentation created by the auditors.

The SEC claimed that because MHR management concluded that the control deficiency only rose to the level of a significant deficiency, rather than a material weakness, MHR did not publicly disclose the deficiency but instead stated that its ICFR was effective.

In February 2012, according to the release, a year after first raising concerns over MHR's accounting "manpower issues," the auditors reported to MHR's Audit Committee a "[d]elay in closing the books due to [the] Company manpower shortage relative to [the] volume of financial activity." This allegedly resulted in "[n]umerous top-side adjustments" creating significant audit inefficiencies.

Per the SEC, the engagement partner further reported that:

> We believe there is not adequate internal control over financial reporting due to inadequate and inappropriately aligned staffing. This factor increases the possibility of a material error occurring and being undetected and reduces the Company's ability to file its 10-K on time.

"Effective internal controls are a critical safeguard against false and inaccurate information that may harm shareholders. ...all those involved in ICFR assessments—companies, management, external auditors and consultants—must take their responsibilities seriously and rigorously assess controls, including those over financial reporting."

Shamoil T. Shipchandler
Director for the SEC's
Fort Worth Regional Office
Washington D.C.
March 10, 2016

Despite assessing that there was "not adequate internal control over financial reporting due to inadequate and inappropriately aligned staffing," according to the SEC, the auditors concluded that this control deficiency rose only to the level of a significant deficiency—rather than a material weakness. The claim stated that the audit work papers failed to adequately document the basis for this conclusion. They also failed, according to the release, to explain how the fact that MHR did "not [have] adequate internal control over financial reporting" was not indicative of a material weakness, defined as weakness that creates a reasonable possibility (i.e., "more than remote but less than likely") of a material error not being detected or corrected on a timely basis.

When reporting audit results on the effectiveness of MHR's ICFR as of December 31, 2011 to MHR's Audit Committee, the auditors apparently identified MHR's "inadequate and inappropriately aligned staffing" as a significant deficiency rather than as a material weakness.

According to the SEC, the auditors determined that MHR's inadequate and inappropriately aligned accounting staff did not constitute a material weakness because, among other things: (i) the audit work did not identify material errors for the reporting period, and (ii) he understood that MHR had recently hired additional accounting staff and that the existing staff, while overworked, was competent.

However, this was a misapplication of the applicable standards, as the severity of a deficiency does not depend on whether an error actually occurred (per AS 5, ¶ 64). While actual errors may inform assessments of control deficiencies, the presence of an actual error is not a prerequisite to concluding that a material weakness exists. Rather, auditors and management are to consider whether there is a reasonable possibility that a material misstatement will not be timely detected or prevented. In addition, the effectiveness of a company's ICFR is assessed at a specific point in time—as of the end of the fiscal reporting period. Planned or anticipated remedial efforts are irrelevant to the analysis.

The control deficiency caused by MHR's purportedly inadequate accounting staffing was particularly important because it was an entity-level control. Because it was an important control that could affect other controls throughout the company, it needed to be fully understood and defined in order to determine the nature, extent, and severity of the deficiencies.

MHR management should have assessed whether a reasonable possibility existed that a material misstatement of the company's financial statements would not be prevented or detected on a timely basis.

Needless to say, the apparent inadequate controls problem resulted in an error. On November 14, 2012, MHR filed an amended Form 10-Q restating its June 30, 2012 financial statements to correct a material error related to stock-based compensation and certain other errors. MHR disclosed that management concluded that material weaknesses existed as of June 30, 2012 related to (i) a lack of sufficient, qualified personnel to design and manage an effective control environment; (ii) MHR's period-end financial reporting process; and (iii) controls over calculation and review of share-based compensation expense. MHR also disclosed management's plans to remediate and improve the company's ICFR and disclosure controls and procedures.

"…there have been some signs of progress in the issuer reporting area more generally in recent years. For example, restatement trends are flat over the last five years, and down significantly from last decade. Specifically, across all public companies, over the past fourteen years, restatements fell from a peak of 1,842 in 2006 to a low of 761 in 2009. Since then, restatements have remained relatively flat, in the range of approximately 800 to 850 annually."

Andrew Ceresney
Director of the SEC's
Division of Enforcement
San Diego, CA
January 25, 2016

Directors Forum 2016
Keynote Address

Accounting and Auditing Enforcement Release No. 3758 / March 15, 2016, Administrative Proceeding File No. 3- 17171, In the Matter of ModusLink Global Solutions, Inc., Joseph C. Lawler, Steven G. Crane, and Catherine L. Venable, Respondents.

During Q1 2016, ModusLink Global Solutions, Inc. ("ModusLink"), a Massachusetts-based company that provides supply chain and logistics services to other companies, consented to the entry of Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order ("Order").

According to the SEC, the origin of ModusLink's problem relates to how it invoices for products and services that it provides to its clients. Notably, ModusLink routinely purchases products and services from third-party vendors on behalf of its clients and ModusLink also routinely obtains rebates from vendors. In numerous instances, and without a sufficient basis to conclude that it was entitled to do so, ModusLink allegedly kept the rebates that should have benefited certain ModusLink clients, which were contractually entitled to them under cost-plus and pass-through contracts. In certain instances, according to the release, ModusLink even marked-up the prices charged by the vendors and billed the higher price to certain ModusLink clients, also in contravention of their contracts. Per the release, ModusLink had no legal entitlement to these rebates and mark-ups and inappropriately included these sums in the revenue and net income reported in its financial statements filed with the SEC.

In June 2012, ModusLink announced its intent to restate certain financial statements, which it did in January 2013, restating more than five years of inaccurate financial statements that had appeared in the company's periodic filings with the Commission. Per the SEC, the restated financial statements reversed the revenue and net income ModusLink had inappropriately reported from these rebates and mark-ups. As a result of these practices, ModusLink apparently misstated its net income by up to 1038%, 23%, and 22% in certain years.

Per the SEC, ModusLink's management was made aware on multiple occasions that certain rebates needed to be passed through to clients.

In November 2008, an anonymous whistleblower put ModusLink's management and Audit Committee on notice of the problem posed by ModusLink's rebate practices, but according to the SEC, ModusLink failed to effectively respond.

Specifically, the release describes that an allegation was received through ModusLink's "EthicsPoint" system regarding the collection of rebates. This system allowed for the reporting of anonymous tips concerning improper conduct at the company. The allegation stated that ModusLink's sourcing department—which was part of the operations function at ModusLink—was conducting a rebate program in which purchase orders provided to vendors and invoices received from vendors were not reduced by the rebate amount, and rebates were paid from vendors to ModusLink on separate paperwork. The allegation further asserted that these rebates were not being disclosed to clients, who were told they were receiving cost-plus pricing.

Per the SEC, the allegation was referred to ModusLink's Internal Audit team, which began to investigate the rebate program. At the outset, the Internal Audit director identified that the allegation raised concerns "from a legal and accounting perspective."

"We're seeing a significant uptick in whistleblower tips over prior years, and we believe that's attributable to increased public awareness of our program and the tens of millions of dollars we've paid to whistleblowers for information that helped us bring successful enforcement actions."

Sean X. McKessy
Chief of the SEC's
Office of the Whistleblower.
Washington D.C.
March 8, 2016

The investigation, however, apparently failed to sufficiently evaluate and investigate the allegation from either perspective.

The claim stated that no one at ModusLink appeared to have sought either a legal or accounting opinion about whether ModusLink could properly charge the non-rebate price to clients on cost and cost-plus contracts. The SEC also stated that the Internal Audit investigation did not involve a review by anyone of the terms of the cost and cost-plus contracts to determine whether rebate amounts needed to be passed back to those clients. Instead, per the release, the Internal Audit team simply asked the operations staff, including its finance personnel, about the rebate program, and they uniformly asserted that the collection of rebates was acceptable because the vendors providing the rebates served multiple ModusLink clients. When the internal auditors sought historical data concerning rebate practices, they were apparently told that the available data did not contain the level of detail requested and was unreliable, notwithstanding that the requested data was, in fact, being maintained by ModusLink's operations staff. Interestingly, when later being told that more detailed information was available, Internal Audit apparently did not obtain or evaluate the information.

Per the claim, Internal Audit, along with ModusLink's general counsel, thereafter closed the investigation, calling the allegation "unfounded" based on its insufficient inquiry. In March 2009, Internal Audit apparently reported to ModusLink's Audit Committee that the investigation was closed and that Internal Audit had concluded that the rebates received were ModusLink's "entitlement."

During the Internal Audit investigation, according to the SEC, staff at ModusLink identified a risk "that a client could come back and ask for the rebates received on their part orders when the client contract holds a cost or cost-plus option." That risk does not appear to have been communicated to ModusLink's Audit Committee when the complaint was closed.

It is alleged that the Audit Committee did not engage in any discussion or ask any questions about Internal Audit's review or its conclusions. Also, according to the claim, no legal opinion was sought or obtained and no inquiry was made regarding the basis for the cursory conclusion reported to the Audit Committee. In other words, per the SEC, the Audit Committee tacitly accepted Internal Audit's report that the rebate program was justified.

According to the SEC, following the closing of the investigation, ModusLink's supply chain managers were told to review the company's rebate practices to eliminate the risk that a client with a cost or cost-plus contract might seek rebates ModusLink received on that client's business. While the managers and staff reviewed the company's rebate practices, they allegedly did nothing to change their fundamental nature. Per the claim, ModusLink failed to implement any new processes, including any processes to check client contracts to determine whether they were cost or cost-plus. Instead, it appears the responsible managers merely documented the rebate practices then in existence.

"…regulators must safeguard the investment and capital raising process from unacceptable risks that can dilute, distort, or disable the fair playing field that is integral to robust free financial markets. In 1934, just two days after he signed the Securities Exchange Act, President Franklin D. Roosevelt told Congress, 'We have sought to put forward the rule of fair play in finance and industry.' That is the core responsibility we carry forward today."

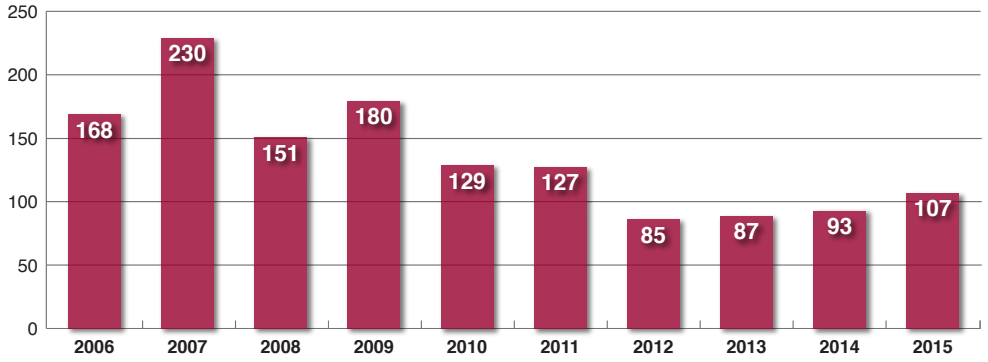
Chair Mary Jo White
U.S. Securities and Exchange Commission
Washington, DC
February 19, 2016

Chairman's Address at SEC Speaks—"Beyond Disclosure at the SEC in 2016"

Prior Period Comparisons: Annual and Quarterly Statistics

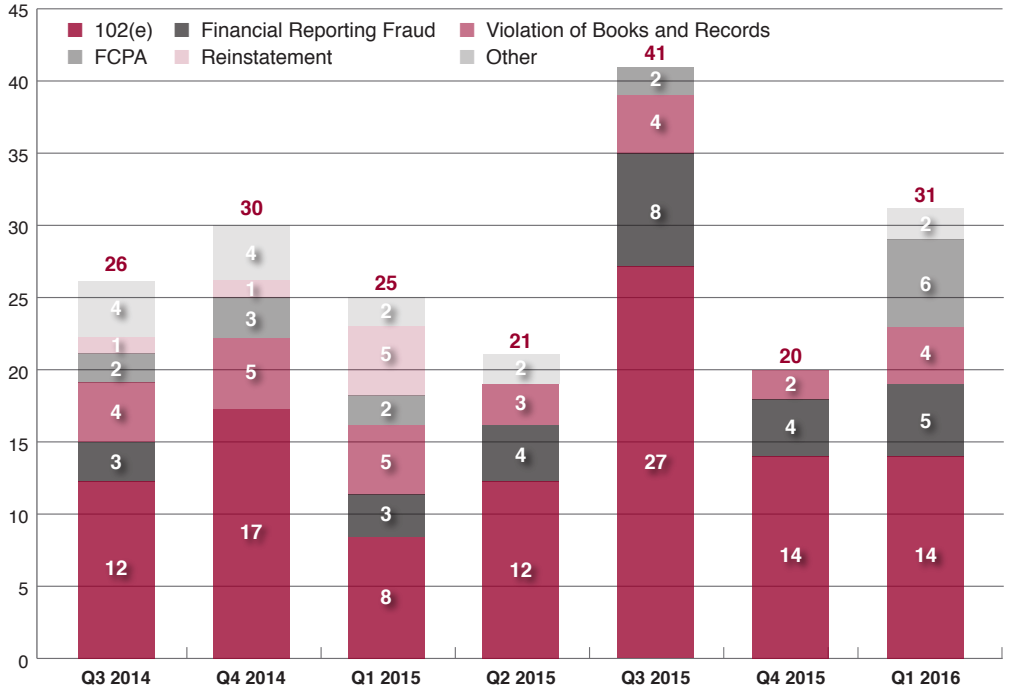
As described on page one in "Our Process and Methodology", AAERs are intended to highlight certain actions and are not meant to be a comprehensive compilation of the SEC's accounting- and auditing-related enforcement actions. Prior period statistics for year-over-year and quarterly comparisons of AAERs provided below.

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



This quarter's increase in AAERs appears driven by six FCPA cases compared to Q4 2015. The number of AAERs in Q1 2016 increased about 55% over Q4 of 2015, yet the number of 102(e) suspensions for each quarter remains the same. Our Financial Reporting Fraud category has one violation more than last quarter. Except for Q3 2015, AAERs during the last seven quarters number highest in Q1 2016. We have mapped quarterly totals for each AAER category in the following chart.

Quarter to Quarter AAER Comparison
Q3 2014 through Q1 2016



"…the SEC increasingly needs to go "beyond disclosure" as we carry out our tripartite mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. While our all-important disclosure powers are generally at the forefront of what we do, today's ever-more complex markets—and the multitude of risks they face—require more of us."

Chair Mary Jo White
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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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