Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended March 31, 2014

Q1 REPORT 2014

CONTENTS

Introduction and Our Objective

We are pleased to present you with our summary of the U.S. Securities and Exchange Commission, Division of Enforcement's Accounting and Auditing Enforcement Releases for the quarter ended March 31, 2014.

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

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

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

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

Floyd Advisory
APRIL 2014

Our Process and Methodology

The SEC identifies and discloses accounting- and auditing-related enforcement actions from within its population of civil lawsuits brought in federal court, and its notices and orders concerning the institution and/or settlement of administrative proceedings as Accounting and Auditing Enforcement Releases ("AAERs"). The disclosed AAERs are intended to highlight certain actions and are not meant to be a complete and exhaustive compilation of all of the actions that may fit into the definition above.

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

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

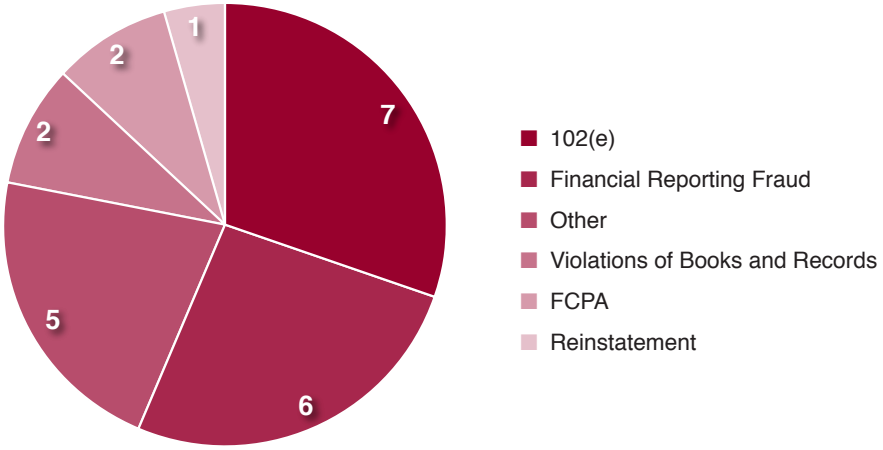
REVIEW PROCESS

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

The Q1 2014 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed 23 AAERs during Q1 2014 which we have sorted into the following categories as shown in the pie chart:

Q1 2014 AAERs by Category



SEC disclosed AAERs for the Quarter Ended March 31, 2014:

23

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

Rule 102(e) Actions

As reflected in the chart, Rule 102(e) actions accounted for 30% of the releases issued in Q1 2014. Notably, four out of seven actions were brought against auditors or audit firms.

Rule 102(e) actions involve the temporary or permanent censure and denial of the privilege of appearing or practicing before the SEC. For accountants, the standards under which one may be penalized with a Rule 102(e) action include reckless, as well as negligent conduct, defined as a single instance of highly unreasonable conduct that violates professional standards or repeated instances of unreasonable conduct resulting in a violation of professional standards and indicating a lack of competence.

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

The SEC charged a public accounting firm with violations of independence rules related to the firm's audits of three public companies. Specifically, the SEC alleged that the firm provided prohibited non-audit services to each of the companies at various times between 2007 and 2011. Auditor independence rules are intended to safeguard that auditors stay independent, both in fact and in appearance, from their audit clients that are registered with the SEC. The following are among the independence violations alleged by the SEC:

- The public accounting firm hired an employee who had recently retired from a senior position at an audit client's affiliate and then loaned him back to that affiliate to do the same work he had done as an employee of that affiliate, causing the public accounting firm to violate Rule 2-01 of Regulation S-X of the Exchange Act;
- The public accounting firm provided various prohibited non-audit services to an affiliate of an audit client, including restructuring, corporate finance, and expert services;
- The public accounting firm provided prohibited non-audit services, including bookkeeping and payroll services, to affiliates of an audit client;
- Finally, certain of the public accounting firm employees owned stock in two of the above referenced companies.

A judgment was entered convicting a Certified Public Accountant ("CPA") of one count of mail fraud and one count of conspiracy to commit securities fraud. According to the release, the individual is a former president of a company engaged in the development and commercialization of proprietary iodine-based agents and antimicrobials. As a result of this conviction, the CPA was sentenced to 18 months' probation and ordered to forfeit proceeds of his crimes. The previously filed SEC complaint alleged that the individual engaged in a fraudulent kickback and market manipulation scheme involving the common stock of the company, in violation of the federal securities law. Rule 102(e)(2) provides in a pertinent passage: "Any... person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission." This CPA was in fact convicted by a United States District Court of a felony in violation of 18 U.S. Code, Sections 1341 and 371, and therefore the SEC ordered in accordance with Rule 102(e)(2) that the CPA be suspended from appearing or practicing before the Commission.

The SEC has alleged that, in connection with audits and quarterly reviews of four microcap issuers, an auditing and accounting firm in California and a CPA who was the firm's sole owner failed to comply with auditing standards issued by the Public Company Accounting Oversight Board ("PCAOB"). Allegedly, the firm and the individual repeatedly engaged in unreasonable conduct that resulted in breaches of appropriate professional standards and demonstrated a lack of competence to practice before the SEC.

PROTECTING INVESTORS REQUIRES A STRONG PCAOB

"While I commend the PCAOB's on-going efforts, I also call upon the accounting profession to renew its longstanding commitment to audit quality for the benefit of investors and the public interest. As the Supreme Court has noted, the independent auditor is 'a public watchdog', whose role is 'a public responsibility transcending any employment relationship with the client.' Fulfilment of this responsibility is critical to the proper functioning of the capital markets and our economy."

Commissioner Luis A. Aguilar
U.S. Securities and Exchange Commission
SEC Open Meeting,
Washington, D.C.
Feb. 5, 2014

According to the complaint, the improper professional conduct extended over an 18-month period and was inconsistent with seven PCAOB standards. As stated by the SEC, the firm and the CPA "failed to: (1) comply with requirements for engagement quality reviews; (2) perform appropriate procedures to ascertain the occurrence of subsequent events; (3) properly document procedures relating to the evaluation of the adequacy of disclosure in the financial statements; (4) prepare engagement completion documents; (5) obtain sufficient evidence to support the firm's audit opinion; (6) properly supervise audits; and (7) obtain written representations from management." Additionally, per the SEC, the auditing and accounting firm and the CPA willfully violated Rule 2-02(b)(1) of Regulation S-X because each audit report at issue falsely claimed that the audit had been conducted in compliance with PCAOB standards.

Financial Reporting Frauds

There were six AAERs that we categorized as financial reporting frauds during the quarter, of which four resulted from just two events that are featured in our Recommended Reading section. The types of alleged fraudulent behavior described in a few of the more significant releases are as follows:

There were six AAERs that we categorized as financial reporting frauds during the quarter. In addition, there were two AAERs related to books and records violations, 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.

The court has approved settlements resolving claims by the SEC against two former sales executives of a California medical equipment company. The SEC's complaint alleged that the former vice president of commercial operations and a former vice president of sales took steps to complete fraudulent sales transactions in 2008 and 2009 to inflate the company's reported revenues. According to the complaint, individuals engaged in a scheme to provide false information to the company's finance department, resulting in publicly-disclosed financial statements that reported overstated revenue and sales numbers. Without admitting or denying the allegations, the former sales executives agreed to pay civil money penalties. The judgment also prohibits one of the individuals from acting as an officer or director of a public company under the Exchange Act for five years.

The SEC has announced that the final judgment was issued by default against the former chairman and Chief Executive Officer ("CEO") of a China-based media and advertising company, whose stock was previously publicly traded in the United States. The final judgment forever enjoins the individual from future violations of various provisions of the federal securities laws and forever bars him from serving as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act, and also holds him liable for a combination of disgorgement, prejudgment interest, and a civil monetary penalty. Previously, the SEC filed a complaint against the company and a former chairman and CEO alleging that from at least October 2009, the defendants engaged in a scheme to deceive and defraud investors by grossly overstating the company's cash balances.

The complaint alleged that after the company significantly misrepresented its financial condition and business operations, its stock price tripled, making the company attractive to the investing public and allowing it to raise more than $53 million from stock sales to investors. The complaint further alleged that the former CEO knowingly signed public filings with the SEC in which the company substantially misrepresented its cash balances and business operations, and that he attempted to bribe a member of the independent investigative team that was in the process of verifying the validity of bank records and other documents the company provided its external auditor.

Violations of Books and Records Rules

This quarter, there were two AAERs related to books and records violations, 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:

The SEC filed a civil injunctive action charging a former senior vice president of operations and a controller of a fourth-tier United States subsidiary of a multinational utilities and environmental services company with falsifying books, records, and accounts and bypassing internal controls in order to exaggerate the company's earnings before taxes ("EBT") over a period of at least three years. The complaint alleged that beginning no later than January 2008 and continuing through February 2011, individuals made and caused others to make false accounting entries in the company's general ledger, including entries for concocted revenue accruals and entries that improperly reclassified expenses as inventory and improperly reclassified expenses (such as rental equipment, including industrial tools and diving gear) as prepaid assets. The complaint further alleged that both individuals signed monthly certifications falsely authenticating the accuracy of the company's financial information and effectiveness of its internal controls. In addition, the complaint alleged that the former controller forged invoices and other documents to support the phony accounting entries and to conceal the scheme. Per the SEC, as a result of the misconduct, the company overstated its EBT by a total of approximately $64 million and the former senior vice president of operations and the controller received considerable ill-gotten bonus payments that were triggered by the inflated financial performance of the company. The complaint further alleged that the false financial information provided by the company was reported up through several intermediate subsidiaries and, ultimately, was consolidated into the parent company's publicly disclosed financial statements, which were filed with and furnished to the SEC.

PROTECTING INVESTORS REQUIRES A STRONG PCAOB

"The pervasiveness of the audit failures identified by the PCAOB raises a real risk that investors will ultimately lose confidence in the benefits of the audit process."

Commissioner Luis A. Aguilar
U.S. Securities and Exchange Commission
SEC Open Meeting,
Washington, D.C.
Feb. 5, 2014

The SECs alleged disclosure and internal controls failures relating to valuation, related party transactions, and executive compensation by four non-traded real estate investment trusts, their respective advisers, their former CEO and Chairman of the Boards of Directors, and their Chief Financial Officer ("CFO"). According to the SEC, the trusts made significant misrepresentations and omissions relating to the valuation of their units in their Form S-3 dividend reinvestment plan registration statements and in certain Form 10-K filings. Additionally, the trust allegedly failed to set up and uphold sufficient disclosure controls and procedures to meaningfully evaluate whether changes in market conditions or other factors required modifications to their valuation disclosures. Per the SEC, the trusts also failed to disclose numerous related party transactions involving short-term transfers between the trusts to meet cash needs and commercial loans personally guaranteed by the Chairman of the Boards of Directors between 2008 and 2011. In addition, the SEC alleged the trusts further failed to disclose significant compensation paid by the advisers and the Chairman to their executive officers. The claim states that the undisclosed related party transactions and secret supplemental compensation contradicted affirmative disclosures to unit-holders, including representations that the independent directors would favorably approve transactions between the trusts and their affiliates, and demonstrated insufficient internal controls.

"The FCPA can apply to prohibited conduct anywhere in the world and extends to publicly traded companies and their officers, directors, employees, stockholders, and agents. Agents can include third party agents, consultants, distributors, joint-venture partners, and others."

"Spotlight on Foreign Corrupt Practices Act." *U.S. Securities and Exchange Commission.* 9 Apr. 2014. Web. 17 Apr. 2014.

FCPA Violations

There were two SEC actions related to the Foreign Corrupt Practices Act ("FCPA") described in the Q1 2014 releases.

The court entered the final judgment against a former CFO of Europe's largest engineering company, based in Germany, and a final judgment against former heads of major projects at the company's division in Argentina. This resolved the SEC's civil action against the individuals for their roles in alleged violations of the anti-bribery, books and records, and internal controls provisions of the FCPA. The SEC alleged that between 2001 and 2007, the defendants paid bribes to senior government officials in Argentina to hold on to a $1 billion contract to produce national identity cards for Argentine citizens. The former CFO of the manufacturer with close ties to government officials is reported to have assisted their efforts. In addition, the SEC's complaint alleged that a member of the company's managing board and the most senior officer charged in connection with the scheme, met with payment go-betweens in the U.S. and agreed to pay bribes to Argentine officials while recruiting subordinates to hide payments and sidestep the company's internal accounting controls.

Another FCPA matter concerns alumina sales to an aluminum manufacturer owned primarily by the Kingdom of Bahrain. It is worth noting that if the alleged violations spanned the full period reported in the release, this is one of the longest-running FCPA violations reported in the past three years.

According to SEC, between 1989 and 2009, subsidiaries of the aluminum manufacturer retained a consultant to act as their middleman in connection with sales of alumina and knew, or deliberately overlooked, the fact that the relationship with the consultant was designed to generate funds that enabled corrupt payments to Bahraini officials. The claim states that commission payments to the consultant and the alumina sales to the consultant made pursuant to the distribution agreements were improperly detailed in the manufacturer's books and records as legitimate commissions or sales to a distributor and did not accurately reflect the transactions. The false entries were initially recorded by the manufacturer's subsidiaries which were then consolidated into the manufacturer's books and records. The allegations include that, during the relevant period, the manufacturer also lacked sufficient internal controls to prevent and detect the improper payments.

Other

The SEC filed a joint motion with an accounting and auditing firm to dismiss a subpoena enforcement action they filed against the firm back in 2011. The subpoena was initially imposed in connection to possible fraud committed by one of the audit firm's Chinese clients. Even though the firm had contended that it was forbidden by Chinese law to produce the requested documents for the SEC, the SEC was able to reach out to the China Securities Regulatory Commission ("CSRC"). The CSRC was cooperative and assisted in collecting a considerable number of documents from the firm for the SEC. The SEC found this result satisfactory and, in response, has taken the appropriate actions to dismiss the original subpoena. It is encouraging to see coordination between these two commissions.

Reinstatement

During Q1 2014, the SEC reinstated one individual to appear and practice before the SEC as an accountant. According to SEC, the individual was a practiced senior auditor at an accounting and auditing firm and was suspended for an alleged fraud in connection with a fiscal year audit of a manufacturer of tissue and paper products that filed for bankruptcy in 2001. According to the complaint, the manufacturer materially overstated its assets, shareholders' equity, revenue, and net income in periodic reports filed with the SEC during years 2000 and 2001 by taking advantage of previously recorded expenses as inventory and overvaluing finished goods inventory. The alleged improper conduct of the senior auditor included the alteration of audit workpapers in preparation for a peer review by another audit firm following the audit, and instruction of members of the audit engagement team to gather all of the manufacturer's related documents for shredding, other than the "official" work paper file.

THE SEC IN 2014

"As you would expect, we look closely at the auditors in every financial reporting case, but we are also closely focusing on senior executives for possible misconduct warranting charges. The message is that critical accounting issues are the responsibility of all those involved in the preparation and review of financial disclosures."

Chair Mary Jo White
U.S. Securities and Exchange Commission
41st Annual Securities Regulation Institute
Coronado, Calif.
Jan. 27, 2014

The Q1 2014 AAERs: Summary of Financial Reporting Issues

To report on the frequency of financial reporting issues involved in Q1 2014 AAERs, we identified the accounting problem(s) in each AAER based on the classification definitions below:

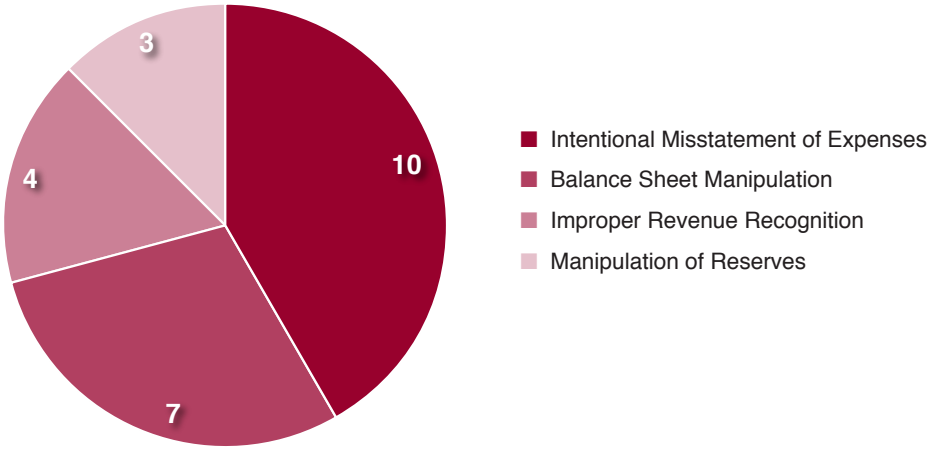
Classification	Definition
Improper Revenue Recognition	Overstated, premature, and fabricated revenue transactions reported in public filings
Manipulation of Reserves	Improperly created, maintained, and released restructuring reserves, general reserves, and other falsified accruals
Intentional Misstatement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

AAERs reported by Financial Reporting Issue for Quarter Ended March 31, 2014:

24

The following chart provides the results of our financial reporting issue analysis for the Q1 2014 AAERs.

Financial Reporting Issues Identified in Q1 AAERs



Notable Q1 2014 AAERs for "Recommended Reading"

While reviewing all of the SEC's AAERs would prove insightful, certain releases present information that is especially worthy of further review and analysis by those involved with financial reporting matters. We deem these particular releases as earning the distinction of "recommended reading" for our clients.

Below is an AAER related to actions brought by the SEC against a company, along with its former CEO and CFO, highlighting the significant role estimates and judgments play in accounting and financial reporting. In most cases, when making an estimate or judgment, there is a range of reasonable conclusions or outcomes. This makes it important to have robust and effective policies and procedures in place, ensuring proper internal control over the process. As we will see in this AAER, the nature of estimates and judgments makes them prone to manipulation and intentional misstatement, and, similarly, makes them difficult to audit.

As we will see in this AAER, the nature of estimates and judgments makes them prone to manipulation and intentional misstatement, and, similarly, makes them difficult to audit.

Securities and Exchange Commission v. Diamond Foods, Inc., Civil Action No. 3:14-cv-00122 (N.D. Cal.); Securities and Exchange Commission v. Steven Neil Civil Action No. 3:14-cv-00122 (N.D. Cal.)

Diamond Foods, Inc. ("Diamond") is an American snack food company whose walnut business represents a significant part of its revenue. The company purchases walnuts from growers, processes them, and sells them to retailers. According to the SEC complaints, Diamond had long-term supply contracts with walnut growers that generally required Diamond to buy the growers' entire crop for the year. The contracts also required Diamond to determine the price it paid "in good faith" based on relevant market prices. While the walnuts were delivered to Diamond during the fall harvest, Diamond paid the growers with a series of payments, with the first occurring at the time of delivery and the last payment almost a year later, just prior to the following fall's harvest. It was at the time of this last payment that the pricing for that year's walnuts was finalized, with the payment acting as a sort of "true-up." While the ability of a buyer to set the price of the commodity it is purchasing seems unusual, Diamond needed to pay a competitive walnut price in order to maintain its longstanding relationships with growers and to avoid losing its walnut supply to competitors in future years.

According to the allegations, the price of walnuts increased sharply in 2010 and Diamond's walnut growers were complaining about the estimated final price that Diamond had communicated. Any increase in the price would negatively affect Diamond's margins for the current fiscal year, as a significant portion of the walnuts had already been sold by Diamond. According to the complaints, in the spring and summer of 2010, Diamond management, including the CEO, Michael Mendes, and CFO, Steven Neil, began discussing a special payment to growers, termed a "continuity payment," which ultimately occurred in August 2010 and counted for approximately 14% of the price for the walnuts received from the fall 2009 harvest.

A letter accompanying the payment stated that it "represents both the final payment on the 2009 crop and a continuity payment reflecting the value of the multi-year supply arrangement with Diamond walnut growers."

The nature of Diamond's contracts with suppliers required it to estimate its walnut costs during the year for purposes of preparing its quarterly financial statements. Among other things, establishing such estimates would require communications with growers about prices being paid by other buyers along independent market research current walnut prices. These assessments should continue throughout the year, and any changes to walnut pricing should be reflected in the financial statements filed for that quarter as the revision of an estimate in the current period. According to the complaint, instead of revising its walnut cost estimates in the period in which the "continuity payment" was made, Diamond did not record the payment as a cost to acquire walnuts, thereby understating its cost of goods sold and overstating its net income for the year. Had Diamond more effectively estimated the increasing market prices of walnuts during the year, such a payment may not have been necessary, as the costs would have already been reflected in both the previously quarterly financial statements and in the installment payments already paid to suppliers.

"Corporate executives could lose their bonuses and other incentive compensation if their company is required to revise its financial statements as a result of misconduct, even when the executives did nothing improper."

Bondi, Bradley J., and Rockwood, Emily J. "United States: CEOs And CFOs Beware: Court Endorses SEC's Aggressive Use Of Section 304 Of Sarbanes Oxley To Clawback Compensation Of Executives Who Did Not Engage In Misconduct." *Cadwalader, Wickersham & Taft LLP.* 7 Jan. 2013. Web. 20 Mar. 2014.

Interestingly, Diamond's auditors inquired about the "continuity payment" made to Diamond's growers along with its last installment payment. According to the complaint, Diamond's finance department told the auditors that it was an advance payment on the next year's crop. The auditors required that the company state such in its management representation letter signed by the Mendes and Neil, which it did. PCAOB auditing standards state the following with regard to reliance on management representations:

> *"During an audit, management makes many representations to the auditor, both oral and written, in response to specific inquiries or through the financial statements. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit."*

While it is not publicly known what other documents the auditors requested or received, the absence of convincing documentation substantiating the business arrangement between Diamond and its growers – which is what presumably led to the request for a specific management representation – could in and of itself serve as a red flag.

The following year, according to the allegations, the CFO devised a similar, but larger payment. In 2011, Neil and others at Diamond began determining the final payment and final price for the 2010 crop. The complaint asserts that in addition to the executive team's agreed-upon final payment recorded for the crop, what was represented as an advance payment similar to the year prior had been made and dubbed the "momentum payment."

By once again ostensibly failing to recognize this payment as the cost of acquiring walnuts, Diamond's earnings for fiscal year 2011 were judged to be overstated by $23.6 million. Owing to these seemingly successful periods during which Diamond appeared to be outpacing analyst predictions, the company was able to raise $181 million through a secondary stock offering, also acquiring a major potato chip brand using its allegedly inflated shares as consideration.

Around November 2011, media outlets began to question the accounting behind the "continuity payment" and "momentum payment" made to growers. Many major newspapers picked up the story and speculated that Diamond was pushing their walnut costs into future quarters. Following that, Diamond restated its financials and its stock (DMND) tumbled from a high of $90 to just $17.

Source: Yahoo! Finance

The SEC has settled its actions against the company and its CEO. The company paid a fine of $5 million and, without admitting or denying the allegations, consented to an entry of a permanent injunction against future violations of the relevant securities laws. Mendes paid a fine of $125,000 and, without admitting or denying the findings against him, consented to the entry of a cease and desist order against committing future violations of the relevant securities laws. The SEC also noted that Mendes had already repaid or forfeited over $4 million in bonuses and other benefits related to the relative time period.

The SEC's complaint against Neil is currently filed in US District Court, and charges the CFO with fraud and other violations of various securities laws, and seeks reimbursement of his bonus payments and proceeds from stock sales during the relevant period under Section 304 of the Sarbanes-Oxley Act of 2002.

The SEC filed two AAERs in Q1 2014 that revolve around an administrative proceeding brought by the SEC alleging financial reporting fraud.

United States of America before the Securities and Exchange Commission
Administrative Proceeding File No. 3-15815
In the matter of L&L Energy, Inc. and Dickson Lee, CPA, Respondents

The SEC filed two AAERs in Q1 2014 that revolve around an administrative proceeding brought by the SEC alleging financial reporting fraud at L&L Energy, Inc. ("L&L"), a Seattle-based coal company with operations in China and Taiwan that became public through a reverse merger in 2001. The SEC alleges that the company, its former CEO, and the chair of its audit committee repeatedly and fraudulently misrepresented to the public that certain individuals were serving in critical executive management roles at the company when, in fact, these persons were not filling those roles. The SEC further alleges that the chair of the audit committee had sufficient knowledge of this proported misconduct and did not disclose any of it to the board of directors. This merits a discussion on the vital role the audit committee plays in financial reporting done at public companies.

Not enough can be said for how critical proper, independent oversight is for maintaining compliance and overall financial wellbeing in a company.

Dickson Lee, a CPA, resigned from his position as L&L's Chairman of the Board and CEO in 2007 after being disciplined by the National Association of Securities Dealers and receiving a one-year suspension for allegedly conducting private placement offerings of L&L securities with memoranda containing false statements. Subsequent to his resignation, he installed his brother as CEO but allegedly continued to assume the duties of CEO himself, running the day-to-day operations of the company. According to the release, in 2008, L&L was attempting to get its stock listed on NASDAQ and therefore sought to hire a CFO. Lee proposed the name of a former employee and L&L director (hereinafter, "the purported Acting CFO") as a candidate for L&L's Acting CFO position. By mid-2008, Lee allegedly announced that the purported Acting CFO would become L&L's Acting CFO in order to meet an investor placement agent's "requirement" and move L&L's funding forward. However, the SEC alleges that the purported Acting CFO never accepted the Acting CFO position.

On August 12, 2008, L&L filed its Form 10-K with the Commission for its fiscal year ended April 30, 2008. According to the SEC's allegations, the filing falsely represented that Lee's brother had performed the functions of the company's CEO when, in reality, Lee continued to perform those functions. Further, the SEC alleges that in the Form 10-K, L&L reported for the first time that the purported Acting CFO had been named as the company's Acting CFO, despite the fact that she had rejected the position. According to the SEC, Lee reviewed and certified the Form 10-K prior to its filing.

The allegations state that in approximately May 2009, the purported Acting CFO became aware that L&L had falsely represented her as the company's Acting CFO in the company's public filings and sent Lee an email reminding him that she had rejected the position and asking Lee for an immediate explanation. Lee allegedly replied to her confirming that she had not actually been conducting the work assigned to that title.

The SEC alleges that the purported Acting CFO next emailed Shirley Kiang, who was then the Chair of L&L's Audit Committee, informing Kiang that she had a "serious and urgent" matter related to L&L's public disclosures that had been made without her knowledge, and asked Kiang to investigate. According to the complaint, prior to this email, Kiang had no interaction with the purported Acting CFO with regard to any L&L business.

It was alleged that Kiang subsequently contacted Lee and asked whether the purported Acting CFO had actually served as the company's Acting CFO. Lee allegedly informed Kiang that the purported Acting CFO had served as the company's Acting CFO and was making false allegations in an attempt to obtain money from the company, for which Kiang asked Lee to provide evidence.

The SEC alleges that Lee provided a fabricated letter in which the purported Acting CFO accepted the position, but ultimately admitted to Ms. Kiang that the purported Acting CFO wasn't actually serving as Acting CFO. Furthermore, Lee then allegedly directed Kiang not to disclose this information to anyone, including the company's board or the public, so that L&L's stock price wouldn't drop. Kiang, in her role as Audit Committee Chair and Director, allegedly complied and signed L&L's 2009 Form 10-K statement in which the purported Acting CFO was listed as the Acting CFO, and in which there was no disclosure of any fraud, material or immaterial.

During the nearly one-year period in which the purported Acting CFO was allegedly falsely represented as the company's Acting CFO, L&L raised approximately $750,000 from investors. Additionally, on or around September 2009, L&L completed an application to become listed on the NASDAQ. As part of the application process, NASDAQ requested a variety of information, including confirmation that the company had made all of the required Sarbanes-Oxley certifications. L&L, in a communication from Lee, confirmed that the company had made all of the required Sarbanes-Oxley certifications. L&L is alleged to have misled NASDAQ in this communication because it did not inform NASDAQ that its required CFO Sarbanes-Oxley certifications for its 2008 Form 10-K or its three 2009 Form 10-Qs were false. L&L gained listing on NASDAQ in February 2010.

Improper oversight is one of the most obvious opportunities for existence of fraud within the company, which also includes neglectful behavior by the board of directors or audit committee.

Not enough can be said for how critical proper, independent oversight is for maintaining compliance and overall financial wellbeing in a company. Improper oversight is one of the most obvious opportunities for existence of fraud within the company, which also includes neglectful behavior by the board of directors or audit committee. The existence of an oversight function does not, in and of itself, guarantee the detection of fraudulent acts; the oversight function must also respond effectively. It is essential for the board to be knowledgeable about the company's financial reporting compliance program and to oversee its implementation.

The SEC has long been working on creating and improving rules for audit committees in order to improve financial reporting oversight function of the companies. The SEC's final rule on audit committees pursuant to the Sarbanes-Oxley Act of 2002 is as follows:

> *"The audit committee must place some reliance on management for information about the company's financial reporting process. Since the audit committee is dependent to a degree on the information provided to it by management and internal and outside auditors, it is imperative for the committee to cultivate open and effective channels of information. Management may not have the appropriate incentives to self-report all questionable practices… The establishment of formal procedures for receiving and handling complaints should serve to facilitate disclosures, encourage proper individual conduct and alert the audit committee to potential problems before they have serious consequences."*

More recently, in February of this year, Paul Beswick, Chief Accountant of the SEC, made a presentation entitled *"Audit Committees: Back to Basics."* Among other things, Mr. Beswick's presentation emphasized the following points:

- ***Audit committees are in a unique position to represent investors and play an important role in promoting high-quality, transparent financial reporting to investors; and***

- ***Frequent dialogue with management and a direct line of communication with the auditor are an important part of the oversight role.***

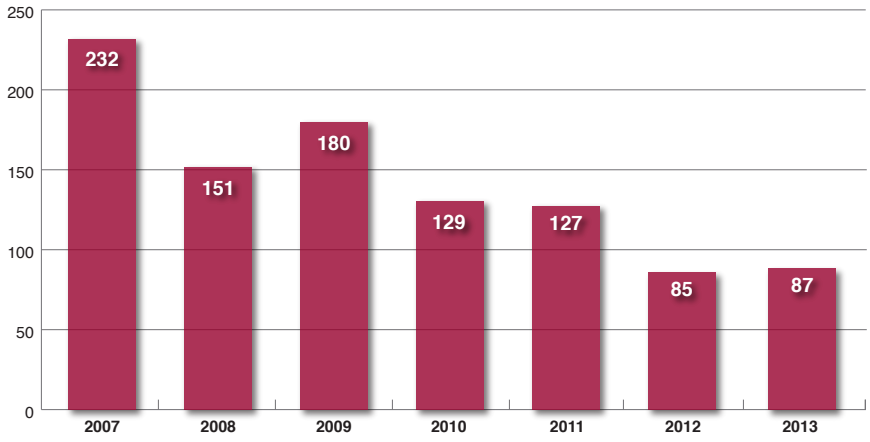
According to the allegations in this case, the Audit Committee of L&L failed to exercise the independent oversight that investors rely on it for. In particular, the allegations that an audit committee member knew about the falsity of the company's prior statements regarding the purported Acting CFO and yet took no immediate action to correct them, and allowed such false disclosures to continue in subsequent filings, would be actions that are contradictory to the very reason audit committees exist in the first instance.

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

Prior Period Comparisons: Year over Year and Quarterly Statistics

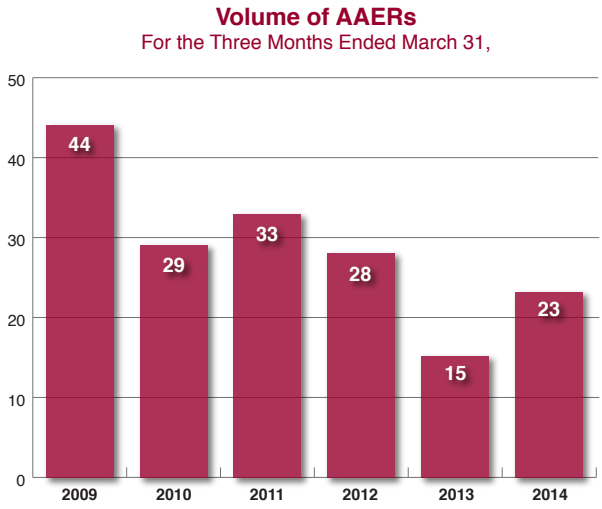
As described in the section titled "Our Process and Methodology," AAERs are intended to highlight certain actions and are not meant to be a complete and exhaustive compilation of all of the actions that may fit into the definition the SEC provides for the classification. That said, comparisons of the number of AAERs between periods may be a useful gauge of the SEC's activities.

Volume of AAERs
For The Years Ended December 31,

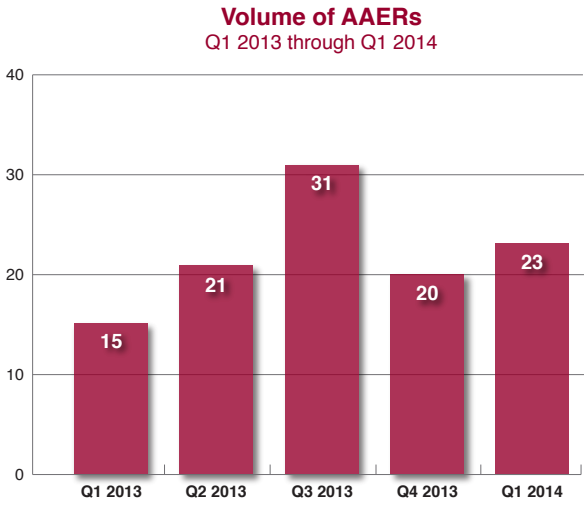


For the year ended December 31, 2013, the SEC issued 87 AAERs, the second lowest number of AAERs reported over the last seven years and almost equal to the volume reported in 2012. For comparison, the average rate for the periods 2007 through 2013 was approximately 142 releases, with the greatest number of releases issued in 2007.

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



When analyzing the AAER population issued over the last five quarters, we notice eight more AAERs issued in the trailing twelve months ending March 31, 2014 than the trailing twelve months ending December 31, 2013. This increase is a direct result of more issuances in first quarter of 2014 as compared to the first quarter of 2013, which may hint at a trend for the future.



The increase of AAERs in the first quarter of 2014 as compared to the first quarter of 2013 may hint at a trend for the future.

SEC NEWS: SPECIAL ANNOUNCEMENTS AND UPDATES

During the quarter ended Mar. 31, 2014 the SEC announced several newsworthy items including the major developments described below.

SEC Announces 2014 Examination Priorities

FOR IMMEDIATE RELEASE
2014-5
Washington D.C., Jan. 9, 2014 —

The Securities and Exchange Commission announced its examination priorities for 2014, which cover a wide range of issues at financial institutions, including investment advisers and investment companies, broker-dealers, clearing agencies, exchanges and other self-regulatory organizations, hedge funds, private equity funds, and transfer agents.

"We are publishing these priorities to highlight areas that we perceive to have heightened risk," said Andrew J. Bowden, Director of the SEC's Office of Compliance Inspections and Examinations. "This document, along with our Risk Alerts and other public statements, help us to increase transparency, strengthen compliance, and inform the public and the financial services industry about key risks that we are monitoring and examining."

The examination priorities address market-wide issues and those specific to particular business models and organizations. The market-wide priorities include fraud detection and prevention, corporate governance and enterprise risk management, technology controls, issues posed by the convergence of broker-dealer and investment adviser businesses and by new rules and regulations, and retirement investments and rollovers.

Based on program area, the priorities include:

- For investment advisers and investment companies—advisers who have never been previously examined, including new private fund advisers, wrap fee programs, quantitative trading models, and payments by advisers and funds to entities that distribute mutual funds
- For broker-dealers—sales practices and fraud, issues related to the fixed-income market, and trading issues, including compliance with the new market access rule
- For market oversight—risk-based examinations of securities exchanges and FINRA, perceived control weakness at exchanges, and pre-launch reviews of new exchange applicants
- For transfer agents—timely turnaround of items and transfers, accurate recordkeeping and safeguarding of assets
- For clearing agencies designated as systemically important—conduct annual examinations as required by the Dodd-Frank Act, and pre-launch reviews of new clearing agency applicants

The priorities listed for 2014 are not exhaustive and may be adjusted throughout the year in light of ongoing risk assessment activities. They were selected by senior exam staff and managers and other SEC divisions and offices in consultation with the chair and other commissioners, based on a variety of information and risk analytics, including:

- Tips, complaints and referrals, including from whistleblowers and investors
- Information reported by registrants in required filings with the SEC
- Information gathered through examinations conducted by the SEC and other regulators
- Communications with other U.S. and international regulators and agencies
- Industry and media publications
- Data maintained in third party databases
- Interactions outside of examinations with registrants, industry groups, and service providers ■

SEC Launches Enforcement Cooperation Initiative for Municipal Issuers and Underwriters

FOR IMMEDIATE RELEASE
2014-46
Washington D.C., March 10, 2014 —

The Securities and Exchange Commission announced a new cooperation initiative out of its Enforcement Division to encourage issuers and underwriters of municipal securities to self-report certain violations of the federal securities laws rather than wait for their violations to be detected.

"The Enforcement Division is committed to using innovative methods to uncover securities law violations and improve transparency in the municipal markets," said Andrew J. Ceresney, director of the SEC Enforcement Division. "We encourage eligible parties to take advantage of the favorable terms we are offering under this initiative. Those who do not self-report and instead decide to take their chances can expect to face increased sanctions for violations."

Under the Municipalities Continuing Disclosure Cooperation (MCDC) Initiative, the Enforcement Division will recommend standardized, favorable settlement terms to municipal issuers and underwriters who self-report that they have made inaccurate statements in bond offerings about their prior compliance with continuing disclosure obligations specified in Rule 15c2-12 under the Securities Exchange Act of 1934.

Rule 15c2-12 generally prohibits underwriters from purchasing or selling municipal securities unless the issuer has committed to providing continuing disclosure regarding the security and issuer, including information about its financial condition and operating data. The rule also generally requires that municipal bond offering documents contain a description of any instances in the previous five years in which the issuer failed to comply, in all material respects, with any previous commitment to provide such continuing disclosure.

"Continuing disclosures are a critical source of information for investors in municipal securities, and offering documents should accurately disclose issuers' prior compliance with their disclosure obligations," said LeeAnn Ghazil Gaunt, chief of the SEC Enforcement Division's Municipal Securities and Public Pensions Unit. "This initiative is designed to promote improved compliance by encouraging responsible behavior by market participants who have failed to meet their obligations in the past."

The SEC can file enforcement actions against municipal issuers for making misrepresentations in bond offerings about their prior compliance with continuing disclosure obligations. Underwriters for such bond offerings also can be liable for failing to exercise adequate due diligence regarding the truthfulness of representations in the issuer's official statement. For instance, the SEC recently charged a school district in Indiana and its underwriter with falsely stating to investors that it had been properly providing annual financial information and notices required as part of its prior bond offerings.

Eligibility for the MCDC Initiative is explained in a detailed announcement by the Enforcement Division. Issuers and underwriters must self-report by completing a questionnaire and submitting it via e-mail or by fax or mail no later than Sept. 10, 2014.

The MCDC Initiative is being led by Peter K.M. Chan, an assistant director in the Municipal Securities and Public Pensions Unit and the Chicago Regional Office. ■

SEC Announces Initiative Directed at Never-Before Examined Registered Investment Advisers

FOR IMMEDIATE RELEASE
2014-35
Washington D.C., Oct. 30, 2013 —

The Securities and Exchange Commission announced that its Office of Compliance Inspections and Examinations (OCIE) is launching an initiative directed at investment advisers that have never been examined, focusing on those that have been registered with the SEC for three or more years. OCIE previously announced that examining these advisers is a priority in 2014.

As part of the initiative, OCIE will conduct examinations of a significant percentage of advisers that have not been examined since they registered with the SEC. These examinations will concentrate on the advisers' compliance programs, filings and disclosure, marketing, portfolio management, and safekeeping of client assets.

"Our examinations will focus on areas most important to protecting investors," said Jane Jarcho, national associate director of OCIE's Investment Adviser/Investment Company examination program. "We will also promote compliance by engaging with these advisers through outreach efforts."

Starting later this year, OCIE will invite SEC-registered investment advisers who have yet to be examined to attend regional meetings where they can learn more about the examination process. Advisers also can find information regarding their obligations under the Investment Advisers Act of 1940 and other useful guidance on the SEC's website. ■

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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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