Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended March 31, 2019

Q1 REPORT 2019

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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, 2019.

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 2019

Highlights:

- **The SEC released sixteen AAERs in Q1 2019, a figure identical to Q1 2018 and slightly down from Q4 2018. Notably, this quarter lacks releases related to Financial Reporting Fraud and is the second straight quarter in which we do not observe any Reinstatements. Despite this, we observe the return to prominence of the 102(e) category which was responsible for half of the quarter's releases, up from just over 25% in Q4 2018.**

- **Half of this quarter's Rule 102(e) AAERs relate to accounting firms and accountants who violated independence or related party transaction policies established by the Public Company Accounting Oversight Board ("PCAOB"). Separately, all four of the Violations of Books and Records releases were issued due to a lack of adequate internal controls which resulted in materially misstated financial statements.**

- **Finally, we report on the Behavioral Recognition Systems, Inc. (now known as Giant Gray, Inc.) case in our Recommended Reading section. The case involves incomplete disclosure of related party transactions and the auditor's failure to adhere to the appropriate audit procedures required for these transactions.**

Our Process and Methodology

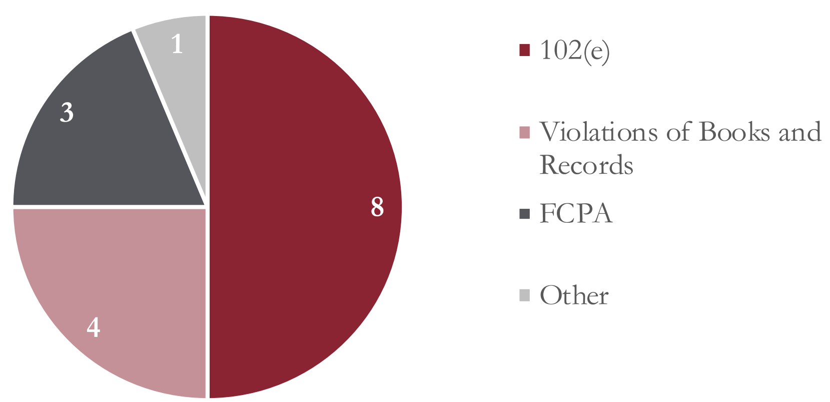
The SEC identifies and discloses accounting- and auditing-related enforcement actions from within its population of civil lawsuits brought in federal court, and its notices and orders concerning the institution and/or settlement of administrative proceedings as Accounting and Auditing Enforcement Releases. 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 (i.e., 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). 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. Based on this process and methodology, we prepared a database of the key facts in each release.

The Q1 2019 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed sixteen AAERs during Q1 2019, with SEC Rule 102(e) actions representing 50% of the total releases.



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.

During Q1 2019, five accounting firms and ten individuals received Rule 102(e) sanctions. Three of the five firms and seven of the ten individuals neither admitted nor denied the charges.

"[A] vast majority of the work of the SEC staff goes unheralded by our public agenda but is critical to the efficient functioning of our capital markets. The staff reviews tens of thousands of issuer filings and disclosures. They provide informal guidance and respond daily to questions from investors, issuers and other market participants. ... Our investigative, litigation and examination teams work tenaciously to enforce compliance with our securities laws."

Chairman Jay Clayton
Washington, D.C.
April 8, 2019

Management's Discussion and Analysis of the SEC: Remarks at the "SEC Speaks" Conference

Examples of the actions reported in this quarter's Rule 102(e) releases include the following:

- ***The SEC ordered administrative and cease-and-desist proceedings for a firm and two Certified Public Accountants ("CPAs") for engaging in improper professional conduct.*** According to the Commission's release, a CPA served as the engagement quality reviewer on fourteen audits of certain broker-dealers for which the CPA's daughter was the financial and operations principal. The release further alleges that another CPA, the engagement partner of these audits, was aware of this relationship and nonetheless directed the firm to issue audit reports for these clients, falsely stating that the audits were conducted in accordance with PCAOB standards. As a result, the firm and the CPAs failed to meet auditor independence requirements. The parties also lacked adequate quality control systems required to assure and monitor the integrity, objectivity, independence and impartiality of these audits, which resulted in negligent professional care.

- ***The SEC instituted public administrative and cease-and-desist proceedings for a firm and a CPA for numerous audit deficiencies.*** According to the SEC, the CPA, who is also the owner of the public accounting firm, conducted deficient audits and interim reviews of five public company clients. The release further alleges these deficiencies included failure to obtain sufficient appropriate audit evidence, maintain audit documentation, reconcile underlying accounting records to the issuers' financial statements or footnotes, and perform adequate reviews of interim financial information. As such, the audits were not conducted in accordance with PCAOB standards. The parties are suspended from appearing or practicing before the Commission as accountants. Additionally, the SEC fined the parties with disgorgement, prejudgment interest and a civil penalty.

- ***The SEC instituted public administrative proceedings for a Chief Financial Officer ("CFO") for violating provisions of the federal securities laws.*** The CFO, who is also a CPA, allegedly participated in a scheme that served to defraud investors who purchased oil and gas securities in transactions with four companies. The CPA signed several public reports filed by the company containing materially false and misleading representations, including information about the company's business model, its results and operations, and its internal controls. The release further alleges the CPA made similar false and misleading statements to the company's auditors and approved the reimbursement of the Chief Executive Officer's ("CEO") personal expenses. Furthermore, the CPA aided-and-abetted the company's failure to keep and maintain accurate books and records. The SEC suspended the CPA from appearing or practicing before the Commission as an accountant for five years and ordered the CPA to pay a civil penalty.

- ***The SEC ordered administrative and cease-and-desist proceedings related to a company's failure to comply with the Commission's auditor independence rules.*** The Commission alleges that the accounting firm conducted deficient audits for two funds that it also advised. Specifically, the company failed to meet the requirements of the Custody Rule as it prepared and subsequently audited the funds' financial statements for the years 2012 and 2013. The release further alleges that the company engaged in improper professional conduct as it lacked relevant knowledge, issued a modified opinion, and failed to exercise due professional care. Furthermore, the company failed to establish sufficient quality control standards. The SEC fined the company with disgorgement, prejudgment interest and a civil money penalty as a result of these violations.

"Apart from rulemaking, the interests of long-term Main Street investors also require capital markets that are vigorously policed for fraud and other misconduct. The ongoing efforts by our Division of Enforcement to deter misconduct and punish securities law violators are critical to safeguarding millions of investors and instilling confidence in the integrity of our markets."

Chairman Jay Clayton
Washington, D.C.
April 8, 2019

Management's Discussion and Analysis of the SEC:
Remarks at the "SEC Speaks" Conference

- ***The SEC ordered public administrative and cease-and-desist proceedings for an engagement quality reviewer for audit deficiencies.*** The Commission alleges the engagement quality reviews of an accounting firm's audits were deficient. The release further alleges one individual served as the engagement quality reviewer for eleven of the firm's deficient audits and reviews related to five clients. The audit deficiencies included failure to obtain sufficient appropriate audit evidence, failure to maintain audit documentation, failure to reconcile underlying accounting records to the issuers' financial statements or footnotes, and failure to perform adequate reviews of interim financial information. The release also alleges the individual did not possess the necessary qualifications to perform an engagement quality review. The SEC denied the individual from the privilege of appearing or practicing before the Commission as an accountant and fined the individual with disgorgement and prejudgment interest.

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. Examples of releases within this category include the following:

- ***The SEC instituted a cease and desist order against a global technology company based in Texas.*** The SEC alleges the company disclosed material weaknesses that repeated year after year, related to its financial close process, reporting processes and controls over its accounting systems. The release further alleges these weaknesses were a result of the company failing to employ sufficient qualified personnel or maintain adequate accounting systems, which resulted in a manual close process with insufficient documentation of the employed procedures. Hence, the SEC alleges the company failed to maintain adequate ICFR. The company also failed to devise and maintain a system of sufficient internal accounting controls. The SEC fined the company with a civil penalty for this violation.

- ***The SEC issued a cease and desist order to an Illinois-based dairy food producer for failing to create and implement effective ICFR.*** The SEC alleges the company disclosed material weaknesses for a period of nine years, concerning either financial reporting, accounting, or entity controls, and the company announced three financial statement restatements between 2007 and 2016. The SEC further alleges the company failed to create and maintain books, records and accounts that accurately reflected their transactions and dispositions of assets. The company also failed to devise and maintain a system of sufficient internal accounting controls. The SEC fined the company with a civil money penalty in response to this violation.

"Companies cannot hide behind disclosures as a way to meet their ICFR obligations. Disclosure of material weaknesses is not enough without meaningful remediation. We are committed to holding corporations accountable for failing to timely remediate material weaknesses."

Melissa Hodgman, Associate Director, Division of Enforcement
Washington, D.C.
January 29, 2019

"SEC Charges Four Public Companies with Longstanding ICFR Failures"

- ***The SEC instituted a cease and desist order to a company that manufactures, processes, and distributes iron and steel alloy products.*** The release alleges the company disclosed material weaknesses for a period of ten years and that these persistent and extensive material weaknesses indicate management neither assessed nor addressed the issue appropriately. The release further alleges management failed to complete their annual evaluation of internal controls in both 2015 and 2016. As a result, the company failed to maintain effective Internal Control over Financial Reporting. The company also failed to devise and maintain a system of sufficient internal accounting controls. The SEC fined the company with a civil money penalty for this violation.

FCPA Violations

There were three FCPA-related releases in Q1 2019 resulting in over $272 million in civil money penalties, disgorgement, and prejudgment interest. Examples of the releases within this category include the following:

- ***A provider of products and services for individuals with chronic kidney failure was issued a cease and desist order for violating the anti-bribery, books and records and internal accounting controls provisions of the FCPA.*** From at least 2009 through 2016, the company allegedly paid millions of dollars in bribes to procure business in Saudi Arabia, Angola, and eight countries in West Africa. The company's payments for its operations in these countries, as well as Turkey, Spain, China, Serbia, Bosnia and Mexico were not accurately reflected in the company's books and records. The SEC further alleged the company lacked sufficient internal accounting controls which enabled the misconduct to continue for many years across multiple continents, resulting in improper payments benefiting the company of over $135 million. The SEC ordered the company to pay $135 million in disgorgement and $12 million in prejudgment interest for this violation.

- ***A provider of telecommunications services was issued a cease and desist order for violating the anti-bribery, books and records and internal accounting controls provisions of the FCPA.*** The release states that from 2004 until at least 2012, the company offered and paid bribes to a government official in connection with its Uzbek operations. These improper payments allegedly enabled the company to enter the Uzbek market, operate as a telecommunications provider, and receive commercial benefits. The illicit payments added up to at least $420 million and generated more than $2.4 billion in revenues for the company. Furthermore, the company made the payments through a variety of means including equity transactions with the government official, sham contracts, and in the form of charitable contributions or sponsorships. The company improperly characterized the payments as legitimate expenses in its books and records and the company's financial statements filed with the Commission. The SEC ordered the company to pay a $100 million civil money penalty due to this violation.

"Adequate internal controls are the first line of defense in detecting and preventing material errors or fraud in financial reporting. When internal control deficiencies are left unaddressed, financial reporting quality can suffer."

Wesley Bricker, SEC Chief Accountant
Washington, D.C.
January 29, 2019

"SEC Charges Four Public Companies with Longstanding ICFR Failures"

Special Feature

The Who, What, Where and How for Reporting Related Party Transactions

The United States Securities and Exchange Commission ("SEC") recently filed an action against an audit firm for failing to identify and ensure that its audit client, Behavioral Recognition Systems, Inc. (currently known as Giant Gray, Inc.) ("BRS") made proper related party disclosures in its 2012 financial statements. Of concern, per the SEC, the auditors relied exclusively on BRS's management to disclose related party transactions to them; the same people they were engaged to audit. Making matters worse, according to the SEC, the auditors had knowledge of facts indicating that there were significant related party transactions that BRS management didn't share with the auditors, yet the auditors did nothing in response to this information.

"[O]ur disclosure requirements are intended to provide investors with the material information they need about companies and their securities offerings to make informed investment and voting decisions. Robust disclosure decreases information asymmetries and is the foundation of reliable price discovery. When investors have confidence that they are receiving full and transparent disclosure, markets operate more efficiently and the cost of capital is reduced."

William Hinman, Director, Division of Corporation Finance
London, England
March 15, 2019

"Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks"

Why are Related Party Disclosures so Important?

Related party disclosures are essential for financial statement users to understand and evaluate when reviewing a company's financial results. Imagine the risks to the integrity of financial statements when information being reported is influenced by undisclosed self-dealing that can arise from the common control of both sides of a transaction.

While many related party transactions reflect business transactions and events conducted in good faith and in the ordinary course of business, others may be structured to manipulate financial results or divert assets or funds. The integrity and independence of transactions gained from negotiated arm's length transactions is lost when related parties decide on a deal's terms and price.

Recognizing these risks, there are well defined accounting and auditing requirements set forth to identify and disclose facts for related party transactions so that financial statement users are on notice as to their existence and can assess and inquire as to their impact on reported results.[1] For legal counsel advising clients on these matters, understanding the accounting definition and treatment for related party transactions is important. In addition, having an appreciation for the role of the auditor to identify and test for such transactions as well as the role of the audit committee is also very useful.

How are Related Parties Defined?

Disclosures regarding related party transactions enable financial statement users to compare and benchmark an entity's financial results and position with those of prior periods or of other companies, thereby allowing them to identify and evaluate potential differences.

1 The accounting guidance for related party transaction disclosures is included in the Financial Accounting Standards Board's Accounting Standards Codification Topic 850, *Related Party Disclosures.* The auditing standards for related party transactions are detailed in the PCAOB's Auditing Standard 2410, *Related Parties.*

Generally accepted accounting principles define related party transactions as those between:

a. A parent entity and its subsidiaries
b. Subsidiaries of a common parent
c. An entity and trusts for the benefit of employees, such as pension and profit-sharing trusts managed by or under the trusteeship of the entity's management
d. An entity and its principal owners, management, or members of their immediate families
e. Affiliates (defined generally as having common control characteristics)

Common related party transactions that occur in the normal course of business are:

a. Sales, purchases, and transfers of real and personal property
b. Services received or furnished, such as accounting, management, engineering, and legal services
c. Use of property and equipment by lease or otherwise
d. Borrowings, lendings, and guarantees
e. Maintenance of compensating bank balances for the benefit of a related party
f. Intra-entity billings based on allocations of common costs
g. Filings of consolidated tax returns

Although certain related party transactions may not be given accounting recognition, they should still be considered. For example, a company that receives services from a related party without charge and does not record receipt of the services, may be required to disclose the transaction.

What Needs to be Disclosed about Related Party Transactions and Where?

Information on related party transactions that would make a difference in a financial statement user's decision making, other than compensation arrangements and expense allowances, should be disclosed so that financial statement users can evaluate their significance. The disclosures should include the nature of the relationships involved and descriptions of the transactions, even those to which no amounts were assigned, along with other information necessary to understand the effects on the financial statements. The dollar amount of the transactions must also be reported, along with the effects of any change in the method of establishing the terms from those used in prior periods. Additionally, amounts due from or to related parties must be revealed with the terms and manner of settlement and any notes receivable from officers, employees, or affiliated entities should be disclosed separately, rather than under a general heading such as "notes receivable."

In certain instances, grouping related party transactions by type is appropriate. The relationship between the parties may be substantial enough that the disclosure of the relationship alone is acceptable. The name of a related party should be disclosed if it's relevant to the understanding of the relationship between the parties.

Transactions involving related parties cannot be presumed to have been carried out on an arm's length basis. Transactions involving related parties that were viewed by management as having been conducted as arm's length transactions, and disclosed as such, need verification by auditors. The auditor should corroborate such statements with the evidence obtained regarding those assertions. If the auditor cannot obtain sufficient evidence to validate management's claims, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.

"[A]n important objective of our disclosure framework is to allow investors to see the company through the eyes of management. I encourage companies to consider their disclosure on all emerging issues, including risks that may affect their long-term sustainability. And as they do so I would suggest they ask themselves whether their disclosure is sufficiently detailed to provide insight as to how management plans to mitigate material risks and how their decisions in the area of risk could be material to the business and their investors."

William Hinman, Director, Division of Corporation Finance
London, England
March 15, 2019

"Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks"

How Does an Auditor Test for Related Party Transactions?

Auditors attest to the fairness of management's financial reporting, and for the identification and disclosures of related parties. Auditors find themselves in the role of quasi-investigators for information that may not be readily apparent. Needless to say, the auditor's job with regard to undisclosed related parties can be very challenging. Per auditing standards, "the objective of the auditor is to obtain sufficient appropriate audit evidence to determine whether related parties and relationships and transactions with related parties have been properly identified, accounted for, and disclosed in the financial statements."

Auditors must perform procedures to obtain an understanding of the company's relationships and transactions with its related parties that might reasonably be expected to affect the risk of material misstatement of the financial statements. The procedures performed include gaining an understanding of the company's process, performing inquiries, and communicating with the audit engagement team and other auditors.

To evaluate whether the company has properly identified its related party transactions, the auditor should test the accuracy and completeness of those transactions identified by the company, taking into account information gathered during the audit. As part of this evaluation, the auditor should read minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. The auditor must evaluate whether related party transactions have been properly accounted for and disclosed in the financial statements. This includes evaluating whether the financial statements contain information regarding related parties that is essential for a fair presentation in conformity with the applicable financial reporting framework.

What are an Audit Committee's Responsibilities for Related Party Transactions?

As with all financial statement assertions and disclosures, management bears the primary responsibility for compliance with accounting standards. However, the oversight of the audit committee is essential to ensure well designed and operating internal controls over financial reporting, including for related party transactions. Approvals, tests for fairness on financial statement presentation, and appropriate disclosures are all matters requiring controls.

It's also essential for audit committees to have open communication with auditors, helping them understand a company's significant relationships and related party transactions. The audit committee should express any concerns regarding related parties and should explain the substance of those concerns.

Further, the audit committee should be aware of the auditor's identification of related party transactions and should inquire about any significant concerns arising from the audit. Such discussions may include related party transactions that were previously undisclosed to the auditor, not approved in accordance with company's procedures, and any exceptions to the company's policies. The audit committee should confirm that auditors obtained evidence to support or contradict assertions that related party transactions were conducted at arm's length and should ask if any transactions appear to lack a business purpose.

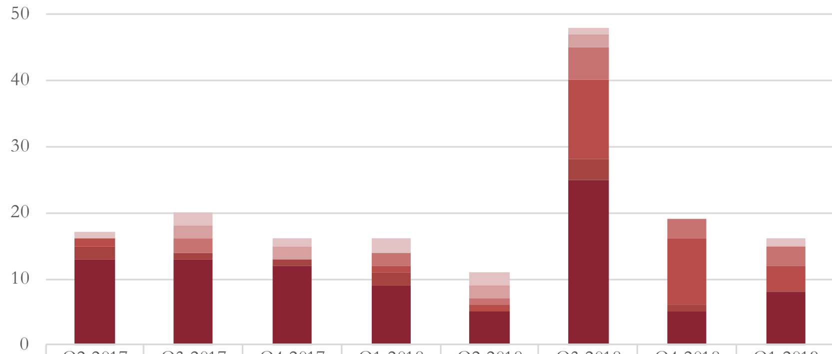
It's critical that related party transactions are properly disclosed in financial statements, as such information is necessary for financial statement users to properly assess and understand the impact of these transactions on reported results. Auditors must not solely rely on management's representations of related party transactions. They should perform independent testing of the related party transactions and form their own conclusions regarding proper disclosures.

Prior Period Comparison: Quarter to Quarter

As described in the section titled "Our Process and Methodology," AAERs are intended to highlight certain actions and they do not represent an exhaustive and complete compilation of all actions that fit into the definitions provided by the SEC for the various AAER classifications. That said, comparisons of the number of AAERs between periods can be a useful gauge of the SEC's activities.

The following chart maps quarterly totals for each category over the past eight quarters.

Quarter to Quarter AAER Comparison
Q2 2017 through Q1 2019



	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019
Other	1	2	1	2	2	1	0	1
Reinstatement	0	2	2	0	2	2	0	0
FCPA	0	2	0	2	1	5	3	3
Violations of Books and Records	1	0	0	1	1	12	10	4
Financial Reporting Fraud	2	1	1	2	0	3	1	0
102(e)	13	13	12	9	5	25	5	8

Based on this data, we made the following observations:

- Rule 102(e) sanction is the most common classification of AAER's for each of the last eight quarters, except for Q4 2018.
- Q1 2019 shows a similar trend when compared to Q1 2018: of the sixteen releases this quarter, none fell under the category of Financial Reporting Fraud or Reinstatement. Q1 2018 saw only two Financial Reporting Fraud releases and no Reinstatement actions.
- The percentage of AAERs categorized as Violations of Books and Records has risen steadily over the last three quarters, comprising 25% of AAERs in Q1 2019, as compared to only 6% in Q1 2018.

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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, Transaction Analysis, and Litigation Services.

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