Floyd Advisory

Summary of Accounting and Auditing Enforcement Releases for the Quarter Ended June 30, 2019

Q2 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 June 30, 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
JULY 2019

Highlights:

- **Of note, two of this quarter's releases related to violations of the Foreign Corrupt Practices Act, resulting in nearly $287 million in disgorgement, prejudgment interest and civil money penalties. Both releases demonstrate the inherent risks of failing to maintain a system of adequate anti-corruption related accounting controls.**

- **The Blue Earth case in our Recommended Reading section illustrates the importance of using "valid reasoning" when supporting one's estimates, judgments, and assumptions underlying financial reporting, as well as factors to consider when relying on a company's publicly traded stock price to value an acquisition.**

- **Finally, we introduce our newest reporting classification for Accounting and Auditing Enforcement Releases: Causation. This new classification will allow us to highlight the most common areas of causation in releases, analyze and report trends over time, and offer commentary to the those involved with financial reporting regarding common problems.**

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.

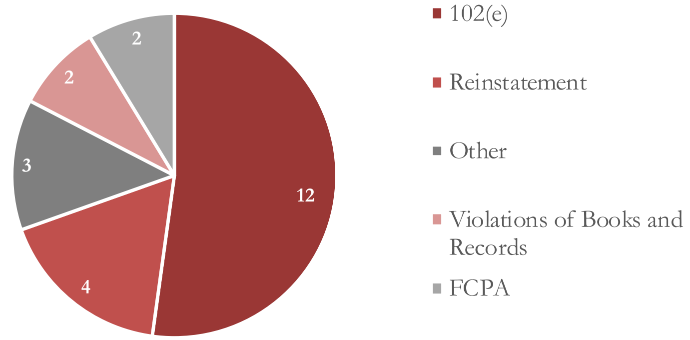
To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, www.sec.gov.

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 Q2 2019 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed twenty-three AAERs during Q2 2019, with SEC Rule 102(e) actions representing over 50% of the total releases.

Q2 2019 AAERs by Category



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.

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

- ***The SEC ordered public administrative and cease-and-desist proceedings for an audit firm and a Certified Public Accountant ("CPA") for engaging in improper professional conduct.*** The complaint relates to a shell factory scheme orchestrated by an undisclosed team of "control persons." The complaint alleges the shell companies were undisclosed "blank check" companies and were created and designed to avoid the corresponding registration and reporting requirements applicable to blank check companies. The SEC alleges the control persons' scheme was to create and sell blank check companies as public companies with operations and register offerings of their securities, without disclosing to the public or the Commission the true purpose or control of the companies. According to the release, the audit firm performed the audits of the financial statements of eight of the blank check companies and the CPA authorized the issuance of the audit reports included in the corresponding Form S-1 registration statements and periodic reports. Additionally, during the audit, the CPA ignored numerous red flags. As such, the underlying audits failed to comply with the auditing standards of the PCAOB and allowed the issuers to file numerous registrations statements and periodic reports with the Commission that were materially false and misleading. The CPA was denied the privilege of appearing or practicing before the Commission as an accountant. Additionally, the SEC fined the parties with disgorgement, prejudgment interest and civil penalties.

> **"A strong enforcement program requires us…to 'put on [our] reasonableness pants.' The SEC ought always to wear reasonableness pants, and I would like to talk today about what those reasonableness pants look like on a regulator. In outlining my views on enforcement in a speech a year ago, I explained that the SEC is not an enforcement agency, but rather a regulatory agency that uses enforcement as one tool. Appropriate enforcement of the rules we have on our books protects investors and the integrity of our capital markets. Most enforcement recommendations the Commission receives from the staff are legally straightforward and not controversial, but a small subset causes me to ask whether we are wearing our reasonableness pants."**
>
> Commissioner Hester M. Peirce
> Rutgers Law School, Camden, NJ
> May 8, 2019
> "Reasonableness Pants"

- ***The SEC ordered public administrative and cease-and-desist proceedings for an audit firm and its two partners for failing to comply with Public Company Accounting Oversight Board ("PCAOB") standards in connection with audits and interim reviews.*** The complaint alleges the audit firm and its two partners conducted deficient audits and interim reviews for five issuer clients for the years ended June 30, 2012 through December 31, 2015 and for the periods ended September 30, 2014 through March 31, 2016. The parties allegedly failed to obtain sufficient appropriate audit evidence to provide a reasonable basis for the company's audit reports, failed to properly evaluate management's accounting estimates, and failed to adequately document the audit procedures performed, among other deficiencies. Specifically, the SEC alleges that for the majority of the procedures listed in the audit program, there is no evidence in the work papers that such audit work was performed. The SEC denied the respondents the privilege of appearing or practicing before the Commission as accountants.

- ***The SEC suspended a CPA for buying speculative call options based on nonpublic information.*** The complaint alleges the CPA learned about a planned acquisition in advance of the deal announcement and purchased over $10,500 of call options on May 20, 2015, five days before the company made its initial offer. After receiving additional information that the deal could be announced in early July, the CPA made a second purchase of $5,000 of call options on June 22, 2015. According to the complaint, after the acquisition was made public on July 1, 2015, the stock opened trading at a 52-week high and the CPA sold all of his options, reaping over $35,000 in profits. The CPA was suspended from appearing or practicing before the Commission as an accountant and was ordered to pay disgorgement, prejudgment interest and civil money penalties.

Violations of Books and Records

This quarter we categorized two 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. The two releases within this category are as follows:

- ***The SEC instituted cease-and-desist proceedings against a New Hampshire-based diversified technology company.*** Per the release, the company and its client entered into a supply agreement in which the company was required to manufacture large scale sapphire glass. The complaint further alleges that the debt agreement required the company's client to advance $578 million in four installments with each installment payment being contingent on the company meeting certain quality and quantity milestones. However, by April 25, 2014 the company's Chief Executive Officer ("CEO") and other officials were aware that the company failed to meet the required quantity, quality, and delivery standards, including a "fourth milestone" in the debt agreement, which resulted in the client withholding its fourth installment payment of $139 million. The company's failure gave the client the right to call back $306 million in debt from the prior installments and, by the second quarter of 2014, the company would have been required to recognize the debt as current and not long-term debt. To avoid recognizing the debt as current, the company, without reasonable basis, formed a position that the client was in breach of a lease agreement, purportedly releasing the company from its performance and milestone obligations under the debt agreement and allowing it to continue to classify the debt as long-term. Furthermore, during an August 5, 2014 earnings call, the CEO represented that the company expected to hit performance targets and receive the fourth installment payment from the client by October 2014. This statement was misleading and created a false impression regarding the company's performance under the contract. Within eight weeks of the second quarter filing and earnings call, the company filed for bankruptcy, which resulted in significant investor harm. As a result of the conduct described, the company agreed to cease and desist from further violations and the CEO agreed to pay more than $140,000 in monetary relief.

"The Division of Enforcement uses a number of tools to identify suspicious trading and abuses perpetrated on retail investors by financial professionals. In one recent case, we charged an investment banker with misusing his access to confidential information. This is a good example of the SEC's use of trading pattern recognition (trading in front of deals advised by a single investment bank) to uncover a scheme."

Chairman Jay Clayton
Washington D.C.
June 4, 2019
Keynote Remarks at the Mid-Atlantic Regional Conference

- ***The SEC ordered cease-and-desist proceedings against a CPA.*** According to the Commission's complaint, a company acquired a private company offering a cloud-based video delivery platform. In early December 2011, prior to the closing of the company's acquisition, the Chief Financial Officer ("CFO") directed the CPA to create contracts between the company and two of its customers. The complaint further alleges these contracts were created to provide a basis for the company to recognize revenue by year-end, but the facts and circumstances did not allow for revenue recognition consistent with Generally Accepted Accounting Principles ("GAAP "). Therefore, these contracts provided a false justification for the company's revenue recognition, which accounted for $4.8 million in the fourth quarter of 2011. The complaint alleges this overstated revenue was reported on the company's 10-K for the year ended December 31, 2011, making the filing materially inaccurate. Per the release, the CPA should have known that the contracts created did not justify the $4.8 million in revenue that the company recognized from these customers. As a result of the misstatement, the CPA was assessed a civil penalty of $15,000.

FCPA Violations

There were two FCPA-related releases in Q2 2019 resulting in nearly $287 million in civil money penalties, disgorgement, and prejudgment interest:

- ***A global retailer was fined nearly $283M and issued a cease-and-desist order for violating the books and records and internal accounting controls provisions of the FCPA.*** Per the release, from in or around July 2000 through in or around April 2011, the company's subsidiaries in Brazil, China, India and Mexico operated without a system of adequate anti-corruption related internal accounting controls. During this period, the release alleges, the company's subsidiaries paid third-party intermediaries to obtain licenses, permits, and other approvals without reasonable assurances that the transactions were consistent with their stated purpose or consistent with the prohibition against making improper payments to government officials. The complaint further alleges that when the company learned of certain anti-corruption risks, the company neither sufficiently investigated the allegations nor sufficiently mitigated the known risks. The company's remedial efforts included making an initial self-disclosure of the potential FCPA violations in Mexico to the Commission's staff, and subsequently, the company voluntarily expanded its investigation and disclosed its findings concerning Brazil, China and India. The company further cooperated by identifying issues and facts that would likely be of interest to the Commission and by adding market anti-corruption directors and anti-corruption compliance personnel to the company's home office and to the company's foreign markets. The SEC and U.S. Department of Justice ordered the company to pay approximately $283 million in combined penalties.

- ***The largest telecommunications company in Brazil was fined more than $4.1M and issued a cease-and-desist order for violating the internal accounting controls and recordkeeping provisions of the FCPA.*** According to the complaint, during the hospitality program that the company hosted in connection with the 2014 World Cup and the 2013 Confederations Cup, the company offered and provided tickets and hospitality to government officials who were directly involved with or in a position to influence legislative actions, regulatory approvals and business dealings involving the company. The complaint further alleges that in total, the company provided tickets and related hospitality to approximately 93 government officials during the World Cup and to approximately 34 government officials during the Confederations Cup. Per the complaint, the company did not accurately reflect the payments for the tickets in its books and records and the company failed to devise and maintain a sufficient system of internal accounting controls. Allegedly, this conduct arose in an environment in which the company failed to adequately enforce its corporate anti-bribery and anti-corruption policies. The company's remedial efforts included enhancing its internal accounting controls and compliance functions and adopting a new anti-corruption policy and compliance structure. This FCPA violation resulted in civil penalties of approximately $4.1 million.

"A company's control environment is a pervasive and vital aspect of getting reporting done right, acknowledging the inherent limitations of any financial reporting process. Ultimately, I believe, it is self-defeating for management to issue materially misstated financial statements, or an auditor to certify those financial statements. For instance, materially misstated financial statements that create false expectations of future results could increase the pressure on management to continue to engage in improper accounting practices when the business performance does not turn around. Unless management addresses the issue, the position becomes untenable and can eventually lead to a restatement. The costs of financial reporting failure can be substantial."

Wesley Bricker, SEC Chief Accountant
New York, NY
May 2, 2019
Remarks before the 2019 Baruch College Financial Reporting Conference: "Aiming toward the future"

Notable Q2 2019 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 the following AAER to highlight.

Accounting and Auditing Enforcement Release No. 4056 / June 28, 2019, Administrative proceeding File No. 3-19225, In the Matter of S. Jeffrey Jones, CPA

The release provides details regarding an auditor's failure to ensure that a public registrant, Blue Earth, Inc. ("Blue Earth" or the "Company"), properly applied generally accepted accounting principles related to the acquisition of another company. Blue Earth, headquartered in Henderson, Nevada during the relevant period, provided a limited range of renewable and energy efficient solutions for commercial and industrial facilities.

In particular, the auditors' alleged improper professional conduct spanned the 2013 and 2014 fiscal year financial statement audits and reviews of the fiscal year 2014 interim financial statements for Blue Earth. The Company has since filed for Chapter 11 bankruptcy.

Blue Earth's financial reporting problem involved the accounting for an acquisition that was financed by Blue Earth's publicly traded stock which, mathematically, resulted in a value greater than the fair value of the assets acquired. The release raises several interesting discussion points, including:

- the reasonableness of relying on a company's publicly traded stock price to determine an acquisition price,
- the need to test and consider whether a company overpaid for an acquisition and whether an immediate impairment should be taken, and
- what evidential matter should be considered as proper support for financial reporting assertions.

Below we will comment on each of these points, after first providing a brief overview of the facts as reported in the release.

Overview of the Facts

Per the release, on July 15, 2013, Blue Earth acquired a company through which it intended to enter into agreements with customers pursuant to which Blue Earth would develop, build, own, and operate combined heat and power plants on land leased from the customer. The plants would generate steam and electricity for the customer at below market rates, and Blue Earth would sell the excess electricity to the local utility. Blue Earth paid for the subsidiary with 15,500,000 shares of restricted Company stock. To determine the purchase price, the Company multiplied the number of shares paid by the share price, resulting in a value of $44,035,500.

Soon after the acquisition, the subsidiary entered into seven non-binding term sheets with a major meat processing company. The term sheets expressly stated that they were non-binding. The meat processing company would be bound only when the parties signed a "definitive agreement" for each facility, with very detailed and specific requirements. No such contract was signed until August 2014, when Blue Earth and the meat processing company executed a definitive agreement for one plant. Blue Earth and the customer signed a second definitive agreement for a smaller plant in December 2014. These definitive agreements were not executed for any of the other plants.

"Despite some of the challenges I mentioned earlier, the Division of Enforcement...have continued to achieve results. As described in the Enforcement Division's FY 2018 report, Enforcement measures its success by asking themselves tough questions:

- **'Are we deterring future harm by bringing meaningful cases that send clear and important messages to market participants?'**
- **'Are we protecting investors and markets by holding individuals accountable for wrongdoing and removing bad actors from the securities markets?'**
- **'Are we acting quickly to stop frauds, prevent future losses, and return ill-gotten gains to harmed investors?'"**

Chairman Jay Clayton
Washington D.C.
June 4, 2019
Keynote Remarks at the Mid-Atlantic Regional Conference

Blue Earth erroneously concluded that because the subsidiary had no revenues and no customer base, no goodwill should be recorded as a result of the acquisition. Furthermore, the Company did not attempt to separately identify intangible assets or obtain the fair market value of any identifiable intangible assets and concluded that the amount of the purchase price in excess of the tangible assets should be allocated to an asset, which Blue Earth incorrectly classified as "Construction in Progress." The Company recorded the $44 million "Construction in Progress" asset on its books and records during the third quarter of 2013. Notably, without executed contracts, the "Construction in Progress" asset is an accounting fiction not based on actual revenues, and an attempt at a placeholder arising out of the value for the stock consideration.

Relying on Acquiror's Stock Price; Fair or not Fair

In fact, Blue Earth's consideration of the value of its stock price when performing its acquisition accounting is supported by the GAAP guidance for business combinations. Although, doing so blindly is not supported, given one must also consider the reasonableness of the fair value of the individual assets involved in the acquisition. If properly performed, this latter test would have demonstrated the overstatement, the apparent excess payment, and the inherent impairment in the acquisition price.

Per Accounting Standards Codification 805 Business Combinations ("ASC 805"), a company should: (a) determine the purchase price which, in the case of a stock-for-stock acquisition, is the fair market value of the shares paid (unless the acquiree's share price is more reliably measured); (b) identify all the assets acquired, including intangible assets; (c) determine the fair value of each asset; (d) allocate the purchase price to each identified asset, offset by the liabilities; and (e) allocate the residual to goodwill.

Of concern, the Company failed to properly assess the fair value of all assets acquired. For purposes of testing the Company's analysis of the $44 million "Construction in Progress" asset for impairment, the audit team obtained from the Company a discounted cash flow ("DCF") analysis related to future revenues from seven sites. However, as described above, the term sheets related to the sites were all non-binding, and no contracts existed as of the acquisition.

Projecting profits from the non-existent contracts, the Company's DCF provided to the audit team reflected a value for the entire enterprise of $42.3 million, whereas the "Construction in Progress" asset was reported on the Company's balance sheet at $44 million.

When the auditors requested the Company to have an independent valuation firm involved, the Company declined, stating that no one was better positioned to value the "asset" than Company insiders. The audit team then retained a valuation firm for the limited purpose of assessing the reasonableness of the discount rate used by Blue Earth in its DCF. The valuation firm's revised DCF arrived at a potential enterprise value of the subsidiary at the time of acquisition of $8.1 million – not the $42.3 million reflected in Blue Earth's DCF. Still, the full value for the acquisition, based on the issuance of the Company's stock as consideration, was relied upon as the transaction value for financial reporting, despite the significant conflicting information.

Reality Check; the Company Overpaid for the Acquisition

Certainly, with the benefit of hindsight, the Company overpaid for the acquisition. No executed contracts existed and per the release, there were no revenues and no customers. The difficult issue for those involved in financial reporting is challenging the general assumption that if there is readily available evidence of value for one side of a transaction, then it must be relied upon. As this fact pattern displays, this is not always true. In addition, using stock as consideration in a transaction, while useful evidence of value, must be particularly scrutinized as the "cost" to the company, especially struggling companies, may be more easily granted than cash which is less available.

Moreover, the accounting guidance's requirements to analyze the individual assets acquired plays a major role in scrutinizing the value for business transactions. If a company cannot identify what it purchased, or the individual parts don't equal the whole, then the company may have overpaid for the acquired business.

As a final point, one can imagine the pressure from management and boards to not admit they overpaid nor that they need to take an immediate or near-term impairment charge. Needless to say, this release sends the message to auditors to stand up to such challenges when the evidence is so undoubtedly overwhelming.

Credibility and Sufficient Evidential Matter

The facts described in the release regarding non-binding agreements and projected cash flows from such "agreements" to support the transaction value is an example of insufficient evidential matter for a financial reporting assertion. How one supports the estimates, judgements, and assumptions underlying financial statement assertions is critical to the credibility of such assertions.

Per the Generally Accepted Auditing Standards ("GAAS"), "Evidential Matter" is defined in PCAOB Standard AU Section 326 as consisting "of the underlying accounting data and all corroborating information available to the auditor." Underlying accounting data includes "the books of original entry, the general and subsidiary ledgers, related accounting manuals, and records such as work sheets and spreadsheets supporting cost allocations, computations, and reconciliations," while corroborating information includes "both written and electronic information such as checks; records of electronic fund transfers; invoices; contracts; minutes of meetings; confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor which permits him or her to reach conclusions through valid reasoning."

Of note, the most important phrase in the guidance is the use of "valid reasoning." Relying on non-binding term sheets as support for the existence of an asset on a financial statement should not pass the valid reasoning standard. Interestingly, if the auditor applied the valid reasoning standard, he might have avoided the suspension levied by the Commission as a result of his conduct.

"Auditors are subject to a system of public regulation, self-regulation, and controls that, taken as a whole, constitutes the regulation of the profession. Attention in this area is premised in the role of an auditor as a vital gatekeeper in financial reporting. Preserving and enhancing confidence in the quality of audit services is essential to the public interest and all Americans."

Wesley Bricker, SEC Chief Accountant
New York, NY
May 2, 2019
Remarks before the 2019 Baruch College Financial Reporting Conference: "Aiming toward the future"

Special Feature
Causation: Our Newest Reporting Category for Accounting and Auditing Enforcement Releases

Of importance to those involved in financial reporting, the SEC identifies and designates certain of the actions from its civil lawsuits and its administrative proceedings as AAERs. The designation is the SEC's way to say to the financial reporting industry "pay attention to these" and "learn from them." Importantly, this is the reason that we invest our time to review, analyze and report on the significant trends, issues, and most significant observations from the AAER population.

We recently held discussions to identify ways to provide new and meaningful information from the AAERs for our report users. From this process, we determined that focusing on the most common areas of causation for the problems encountered by public registrants, and the people who manage them, would be very useful to help others avoid similar issues.

Starting this quarter, we will be adding "causation" as a classification to our database and we will provide a summary of our findings regarding causation in this year's annual report.

Over time, we will be able to display trends and offer other commentary regarding common areas underlying the problems reported in the AAER population.

In fact, based on our experience, we have already identified the most frequent causation categories as:

- Unethical management
- Problems created by inadequate or antiquated accounting systems
- Failure to consider all facts
- Lack of competent personnel
- Decentralized organizational structures
- Need for standardization of policies and forms
- Over-reliance on "materiality"
- Unusual vendors
- Overly complex structures and arrangements
- Inadequate and incomplete disclosures
- Lack of auditor professional skepticism

Even more significant than reporting the number of releases by the type of causes, we will also analyze the releases in each group for common characteristics, further analyses, and reporting.

To demonstrate the benefits of sorting releases into causation categories and, specifically, how these categorizations will create a useful format to extract key observations, below we use the Axesstel, Inc. AAER issued in the third quarter of 2018 as an example, starting with an overview of the allegations and financial reporting problems described in the release.

Overview of Allegations and Reporting Problem

According to the SEC's complaint, Axesstel, Inc.'s (the "Company") CEO and CFO conspired with senior sales personnel to inflate the Company's revenues by improperly recognizing revenue by entering into **undisclosed side agreements** that relieved customers of payment obligations.

Additionally, according to the complaint, the Company's officers **inflated unit prices of products to hit revenue targets** with the agreement that the Company would subsequently **repay the inflated amounts to the customer** as marketing development fees. The SEC alleges that the Company's revenues were overstated by 66% in the fourth quarter of 2012 and 38% in the first quarter of 2013.

Needless to say, this case involved ***unethical management***. In addition, it qualifies for other categories including the ***failure to consider all facts*** and ***unusual vendors***. Plus, while not explicitly stated, enough evidence exists to also categorize the release as ***inadequate or antiquated accounting systems*** based on management's ability to commit the fraudulent acts, especially given their ability to change the prices on invoices.

Once we identify and sort the releases into causation categories, we can easily provide useful commentary for readers on questions to ask and topics to consider, all in a case study format. Below, we provide examples of the types of discussion matters using facts from the Axesstel Inc. release.

Unethical Management

Focusing on the ethics problems first, several lessons and discussion items arise including:

- Did other employees know about the wrongdoing? Were they intimidated to not raise concerns?

- Did the Company have an ethics hotline? Were employees trained and informed on how to use it?
- Did any of the members of the conspiracy have prior work or personal relationships? Could better background checks have been performed?

Failure to Consider all Facts

As to the undisclosed side letters, which qualify as a failure to consider all facts, in addition to being the result of unethical actions:

- Could better credit policies have negated the customers willingness to participate? Such as, any customer with an unpaid balance after 60 days, shall not receive any shipments until cured.
- Did the unpaid aged receivables catch anyone's attention that something was amiss with the documented payment terms?
- Are sales people incentivized to simply ship the product or to collect cash for such shipments? Would penalizing the sales personnel for uncollected receivables act as another control to avoid such agreements?

Unusual Vendors and Inadequate Accounting Systems

Having reviewed hundreds of AAERs, it's fair to say that repaying customers for overstated invoice prices is quite unique.

This scheme raises several subjects for discussion including:

- Who should be able to override or input product prices in the system?
- Who approves the vendor set up, and other diligence regarding the merits of payments?
- Are customers subject to credit checks and background investigations?

Of greatest concern, the Company's customers conspired with management both with regard to the side letters and with the scheme to round trip cash for the payment of overstated invoices. It's easy to understand the customer's motivation when accepting a side letter, and many customers wouldn't have the knowledge, and therefore culpability, to know their supplier had done anything improper anyway.

However, conspiring to overstate a purchase order and receive fabricated marketing development funds raises serious customer integrity issues as well as questions about motivations. An obvious motivation would be, for example, a lack of creditworthiness and the fact that engaging in the fraudulent scheme would be a consideration for overcoming the poor credit.

More likely, although consistent with this theme, the customer would be motivated to engage in the fraudulent scheme for the receipt of extended payment terms, making the side letters that relieved customers from ordinary course terms the root cause of the problem. This brings us back to the discussion and questions above related to the side letters, and ways to stop them from ever occurring.

Without question, a great deal can be learned from the AAERs, and categorizing the releases by the types of causes will enable us to produce useful information for registrants. As always, we are eager for any suggestions to improve our reporting and welcome all feedback.

"The prospect of facing an enforcement action because you did not understand what the rules were keeps many compliance officers, accountants, and in-house lawyers up at night. Our corner of the law is highly complex, not only because our rules interact with one another in interesting ways, but because the markets they regulate also are intricate, intertwined, and ever-changing. To make matters worse, knowing the letter of the law is not enough; our rules come to life through guidance from the Commission or the SEC's staff and judicial decisions, so the regulatory lawyer—already tired from reading through the rulebook—must be on the lookout for relevant guidance and case law."

Commissioner Hester M. Peirce
CARE Conference, Leesburg, Virginia
May 17, 2019
"Sunsets, Russets, and Rule Resets"

www.floydadvisory.com

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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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