



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

Q 3 R E P O R T 2 0 1 9

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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 September 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
OCTOBER 2019

Highlights:

- The SEC issued Rule 102(e) actions against a Big 4 accounting firm for alleged violations of the auditor independence rules of the Commission and the Public Company Accounting Oversight Board (“PCAOB”) for performing prohibited non-audit services for fifteen SEC-registrant audit clients that were improperly characterized to the audit committees as audit services.
- The Juniper Network case featured in our Recommended Reading section illustrates that providing second chances for people who violate company policies and controls can easily backfire, and that business analytics can be a useful internal control tool over financial reporting.
- The SEC released 40 AAERs in Q3 2019, a result that exceeds the average of the prior three quarters by 107%. Seeing a spike in AAERs for the quarter ended September 30th, isn’t a new phenomenon as a similar result occurred in Q3 2018 when the number of releases exceeded the average of the prior three quarters by over 235%. Importantly, September 30th is the end of the SEC’s fiscal year and when the SEC “closes the books” and releases results for its annual activities, including enforcement actions. Similar spikes at the end of a quarter for a public registrant raise concerns for improper revenue recognition; for the SEC, these results may just signify that Q3 is the most opportune time for parties to reach a settlement.

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.

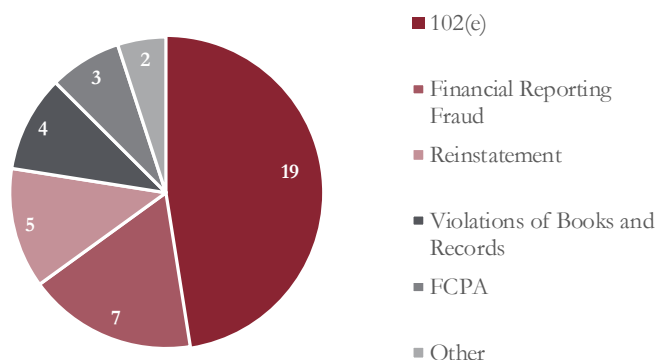
To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, www.sec.gov.

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 (“FCPA”) violations, 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 Q3 2019 AAERs: Summary by Category and Insights from the Releases

The SEC disclosed 40 AAERs during Q3 2019, with SEC Rule 102(e) actions representing nearly half of the total releases.

Q3 2019 AAERs by Category



“Over the next few weeks and months, we at the Commission are going to hear a lot of questions about FY 2019, and many of them will relate to the Division’s statistics. How many Enforcement actions did the Commission bring? What’s the total amount of penalties and disgorgement ordered by the Commission or federal district courts? How many individuals did the Commission charge? Are the numbers up or down over last year.”

Steven Peikin, Co-Director, Division of Enforcement
Atlanta, GA
September 6, 2019
Keynote Speech at Southeastern Securities Conference 2019

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 suspended a CPA for engaging in a fraudulent scheme.** The complaint alleges the CPA, who served as CFO, Controller, and/or Executive Vice President of a financial services company, engaged in a fraudulent scheme that resulted in the company disseminating materially false and misleading information to investors. The complaint further alleges the CPA overstated the value of investors’ accounts and their rates of return on monthly account statements and misrepresented the role of an auditor in the company’s marketing materials and investor account statements. The SEC suspended the CPA from appearing or practicing before the Commission as an accountant.

- ***The SEC imposed remedial sanctions and a cease-and-desist order to a public accounting firm for improper professional conduct.*** The complaint alleges that from 2013 through 2016, a public accounting firm violated the auditor independence rules of the Commission and the PCAOB by performing prohibited non-audit services, including exercising decision-making authority in the design and implementation of software relating to the client's financial reporting and engaging in management functions for the client during the audit and professional engagement period. The complaint further alleges the company mischaracterized non-audit services as audit work, even though the services involved financial software systems that were planned to be implemented in a subsequent audit period, as well as providing feedback to management on those systems – areas outside the realm of audit work. The company was ordered to pay disgorgement, prejudgment interest and a civil penalty.
- ***The SEC imposed remedial sanctions and a cease-and-desist order to the president of a company for multiple violations of the federal securities laws.*** Per the release, a member of senior management, who was also the chairman of the board and the company's largest shareholder, acted to overstate the company's revenues. The complaint alleges this consisted of recognizing fictitious revenue, overbilling a customer and crediting the customer in a later quarter, and authorizing sales practices that were not disclosed to the company's finance department so that certain sales could be recorded in the company's books and records. The complaint further alleges that as a result, the company's reported financial statements were materially false and misleading. The president was denied the privilege of appearing or practicing before the Commission as an accountant and was charged with a civil money penalty.
- ***The SEC instituted public administrative proceedings to a CFO for participating in multiple fraudulent schemes.*** According to the complaint, the CFO drafted public filings and press releases that falsely touted the company's fuel storage depot capacity, and did not correct these inaccuracies after they were brought to the CFO's attention. The complaint also alleges the CFO participated in a fraudulent scheme to induce the company's shareholders to exercise warrants to purchase the company's stock when it was desperate for cash. Furthermore, the CFO, along with others at the company, concocted a plan to have the CFO purchase the company's stock to give the impression that a high-ranking insider was investing its own money in the company. The CFO was temporarily suspended from appearing or practicing before the Commission.

Financial Reporting Fraud

We categorized seven AAERs as Financial Reporting Fraud during the quarter. The following is an example of a release within this category:

- ***The SEC instituted cease-and-desist proceedings against a publicly-traded real estate investment trust.*** Per the release, the company, acting through its senior executives, manipulated and falsely reported its "Same Property Net Operating Income Growth Rate," ("SP NOI") a non-GAAP measure relied on by investors and analysts to assess the company's financial performance. Furthermore, the complaint alleges the company manipulated its SP NOI growth rate using three methods, all of which lacked any proper accounting justification. According to the complaint, the company materially misstated its SP NOI growth rate in all but one of its quarterly filings (Forms 10-Q), each of its annual filings (Forms 10-K), and its related Forms 8-K. The company was fined with a \$7 million civil penalty due to its violations of the antifraud and books and records provisions of the Exchange Act.

"Auditor independence lies at the very foundation of the profession and is necessary to reduce threats to auditors' objectivity and lend credibility to the fair presentation of the financial statements. The objectivity and impartiality of the auditor underpins the reliability of the auditor's audit report that it issues. As a result, I believe that monitoring the independence of the auditor is essential. Auditor independence needs to be understood by company management, audit committees, and audit firms. Each needs to understand the SEC and PCAOB auditor independence rules. Management and audit committees need to be aware of how an auditor independence violation may affect the company's required SEC filings."

Sagar Teotia, Chief Accountant
Washington D.C.
September 9, 2019
Remarks before the AICPA
National Conference on Banks &
Savings Institutions

Reinstatements

There were five releases in Q3 2019 related to reinstatements of CPAs to practice before the SEC. The following is an example of a release within this category:

- ***The SEC reinstated a CPA to appear and practice before the Commission as an accountant.*** The reinstatement relates to a CPA who engaged in improper professional conduct by repeatedly engaging in unreasonable conduct, resulting in a violation of applicable professional standards that indicated a lack of competence to practice before the Commission. The complaint alleges the CPA failed to adequately audit a company's accounts receivables, did not obtain sufficient competent evidential matter regarding collections on certain sales, failed to make adequate inquiries into the company's agreements with customers and failed to exercise due professional care in connection with the audit and reviews. The CPA has complied with the term of the suspension and is therefore reinstated to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filled with the Commission.

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. The details of one of the releases within this category are as follows:

- ***The SEC imposed a cease-and-desist order to a company for engaging in a pull-in scheme to meet publicly-disclosed guidance.*** The complaint alleges the company orchestrated a plan to accelerate, or "pull in," sales that had originally been scheduled for future quarters to the current quarter to close the gap between actual and forecasted revenue, meet publicly-issued guidance, and mask declining sales. The complaint further alleges that the company made materially misleading public statements and omitted to disclose certain facts regarding its financial results. Furthermore, the company also failed to disclose that the pull-ins reduced future sales, thereby making it exceedingly difficult for the company to meet its revenue guidance in future quarters, particularly in a declining market. The company was fined with a civil penalty of \$5.5 million due to this scheme.

FCPA Violations

There were three FCPA-related releases in Q3 2019 resulting in nearly \$33 million in civil money penalties, disgorgement, and prejudgment interest. An example of a release within this category is as follows:

- ***A global provider of oil and gas services was fined more than \$5 million and imposed a cease-and-desist order for engaging in a scheme to pay bribes to oil officials.*** Per the release, from at least 2008 through 2013, the company made nearly \$800,000 in payments to a third-party consultant, which used at least some of those funds to pay bribes to government officials to procure business with state-owned oil companies. Furthermore, the complaint alleges the payments were not accurately reflected in the company's books and records. The corporation's remedial efforts included implementing certain third-party controls, including new financial controls, prohibiting the use of certain third parties, making improvements to its compliance program, enhancing its ethics and compliance policies, and providing additional training for certain third parties and employees.

"Corruption is corrosive. We see examples where corruption leads to poverty, exploitation and conflict. Yet, we must face the fact that, in many areas of the world, our work may not be having the desired effect. Why? In significant part, because many other countries, including those that have long had similar offshore anti-corruption laws on their books, do not enforce those laws. Couple this unique enforcement posture of the U.S. with: (i) the fact that U.S. jurisdiction generally is limited to areas where U.S. and U.S.-listed companies do business; and (ii) the reality that there are countries where the business opportunities are attractive but corruption is endemic, and the potential for undesirable results becomes clear."

Chairman Jay Clayton
New York, NY
September 9, 2019
Remarks to the Economic Club of
New York

Other

We categorized two releases in Q3 2019 as Other. The following is an example of a release within this category:

- ***The SEC charged a CEO with fraud for making materially misleading disclosures in publicly filed reports.*** The complaint alleges the CEO created the false impression to the public that the company had an experienced financial professional involved in its operations and financial reporting as its CFO, when in reality, the company had no CFO. Furthermore, the complaint alleges certain SOX certifications accompanying these filings falsely represented that the CFO had performed an evaluation of the company's internal controls over financial reporting and reviewed the company's annual and quarterly reports. According to the Commission's complaint, the CEO created the false appearance of a CFO by repeatedly affixing the CFO's signature to the company's periodic reports and SOX certifications.

Notable Q3 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. 4069 / August 29, 2019, Administrative proceeding File No. 3-19397, In the Matter of Juniper Networks, Inc.

Juniper Network's Recent SEC Settlement and Observations for Legal Counsel

The United States Securities and Exchange Commission (“SEC”) recently entered into a Cease-and-Desist Order with Juniper Networks, Inc. (“Juniper”) related to violations of the internal controls and recordkeeping provisions of the Foreign Corrupt Practices Act of 1977 (“FCPA”) through its subsidiaries operating in Russia and China. The facts are described in the SEC's Accounting and Auditing Release (“AAER”) No. 4069 issued on August 29, 2019.

Juniper is a Delaware corporation headquartered in Sunnyvale, California and listed on the New York Stock Exchange. Juniper designs, manufactures, and sells networking equipment products – such as routers, switches and security firewalls – and services telecommunication network service providers. Juniper's sales to end-user customers are made through third-party intermediaries known as “channel partners.” These channel partners provide end-user customers with technical expertise, system integration services, and product maintenance and servicing.

The improper conduct occurred in two countries: Russia and China. For the Chinese subsidiary, the problems arose out of sales employees violating the FCPA rules with improper government entertainment expenses that were falsely documented in Juniper's accounting system. Similar to other FCPA cases, Juniper's internal controls were ineffective at detecting the link between the expenses and the sales to governmental entities.

“To be clear, I do not intend to change the FCPA enforcement posture of the SEC. We should, however, recognize that we are acting largely alone and other countries are incentivized to play, and I believe some are in fact playing, strategies that take advantage of our laudable efforts. Taking a step back, this experience, including the FCPA-driven withdrawal of U.S. and U.S.-listed firms from certain jurisdictions, illustrates that globally-oriented laws, with no, limited or asymmetric enforcement, can produce individually unfair and collectively suboptimal results.”

Chairman Jay Clayton
New York, NY
September 9, 2019
Remarks to the Economic Club of New York

In contrast, Juniper's situation in Russia involved a unique scheme to override the company's internal controls over financial reporting for personal gain. These problems arose out of sales employees misrepresenting to senior management the need to discount sales prices to maintain competitive in the market. The reality is that the rogue employees were conspiring with the channel partners to create available funds to use for improper business entertainment purposes, including activities with government officials, in violation of Juniper's policies and the FCPA rules.

Sales discounts are common in many businesses. However, understanding the Russian Juniper scheme provides a different perspective. Generally, management's focus on discounts relates to ensuring satisfactory margins. The facts described below provide lessons and insights for registrants and their legal counsel to be aware of when dealing with rogue employees, and how to improve a company's internal controls for sales transactions when discounted sales pricing is common.

Background

Per the AAER, from 2008 to 2013, sales employees in Juniper's Russian subsidiary misrepresented to senior management the need for increased discounts for sales to channel partners. In fact, the employees knew the discounts were excessive, unnecessary, and would not be passed on to end-user customers. Instead, the employees conspired with the channel partners, who purchased the discounted product and sold it at the usual market price to create a fund with the scheme's profits for their own personal and entertainment use. This excess money was known as "common funds." Once the common funds were established, the employees and channel partners used the off-book funds without having to comply with Juniper's internal controls, policies, or approvals.

The common funds were used to fund trips for end-user customer employees, including trips that were excessive, inconsistent with Juniper's policies, predominantly leisure in nature, and had little or no legitimate business purpose. The trips paid for customers, including foreign officials, to travel to international tourist destinations such as Italy, Portugal, and various U.S. cities, none of which had legitimate business justifications. In some instances, the travel included customers' family members. Of significance, emails existed explicitly discussing entertaining foreign government officials and links to new contracts.

Interestingly, according to the AAER, in 2009, a "member of senior management" learned about the improper discounting and the common funds. As a result, Juniper instructed the employees to stop what they were doing and supposedly implemented remedial efforts to avoid future problems. However, the rogue employees continued their actions, albeit working more diligently to mask their communications and bad acts. Notably, there is no mention of anyone being terminated upon Juniper's discovery of the initial improper acts. That, in and of itself, is a failure to take the most important remedial action.

It appears that the company only conducted its own full and thorough investigation after the problems were the subject of an SEC investigation. During this process, Juniper voluntarily produced and translated documents and provided the SEC with presentations regarding its investigation; factors the SEC viewed favorably as full cooperation.

Juniper's remedial actions included:

- Realigning its compliance function into an integrated unit, with all reporting into a newly created Chief Compliance Officer;
- Implementing an escalation policy to ensure that their Board of Directors was informed of serious issues;
- Requiring pre-approval of non-standard discounts;
- Requiring pre-approval for third-party gifts, travel, and entertainment, channel partner marketing expenses, and certain operating expenses in high-risk markets;
- Conducting additional employee training on anti-corruption issues; and
- Improving its processes for internal investigations of potential anti-corruption violations.

The disgorgement, interest, and penalties payable by Juniper to the SEC exceeded \$11.7 million.

Avoiding Similar Problems and Risks

The greatest benefit of reviewing AAERs published by the SEC is to learn from the errors and failures of public registrants. Lessons learned in this matter include (i) second chances for people who violate company policies and controls is a terrible business decision, and (ii) business analytics can be a useful internal control over financial reporting. Let's look at each lesson closer.

First and foremost, adequate and competent people, with proven integrity, are an essential component of effective internal controls. If people violate company policies and controls, there should not be a second chance. Termination is generally necessary for two reasons. First, to use the old adage "fool me once, shame on you, fool me twice, shame on me," a company's controls are too important to its reputation to allow anyone with a proven lack of integrity to continue in their job. In addition, giving a person who has shown a lack of integrity and ethical values a second chance sends a message to other company employees that strict adherence with controls and policies isn't important. The perception of a company's culture can be quickly impugned by such decisions.

Next, good business analytics can reinforce a company's controls and identify unusual or improper behavior. As mentioned above, businesses often review margins to ensure satisfactory transactional or business level profitability. However, the review is generally used to compare profit margins versus expectations and plans. This same process taken a step further for sales transactions may demonstrate abnormalities by region, by salesperson, by customer, and/or by ultimate end-user customer when a channel partner is involved. This can be a valuable analysis for companies that have foreign governments among their clients and serve as an added layer of FCPA controls in their compliance programs.

As important, business analytics for salesperson spending levels versus budget and target sales are often insightful. Reviewing average spend to revenue generation over time

"Often, the winning team is not just the one with the most individual talent, but the team that coordinates the talent they have most effectively. Because, as those of us who have been lucky enough to be a member of a good team know, teamwork produces incalculable value. Better teams beat better individual talent all the time."

Chairman Jay Clayton
Mount Pleasant, MI
September 13, 2019
Remarks at Central Michigan University

and comparison to peers may highlight missing information as excesses. Companies are frequently focused on overspending compared to budget and paperwork for files, and less concerned with underspending and challenging the documentation for misrepresentations. Similar to the sales practice discussion, thoroughly inspecting salespersons' entertainment documentation for companies with foreign government clients is critical.

The facts in the Juniper release are insufficient to know whether detailed analytics would have detected the risk for common funds and/or whether documentation misrepresentations could have been detected. Of significance, when people know special tests are being performed, the tests themselves can be a deterrent to improper conduct.

Legal Counsel's Role

The facts available in this matter aren't sufficient to identify the role Juniper's legal counsel played related to establishing policies, providing training, and advising management and the Juniper Board of Directors related to the improper activities and poor risk management described above. However, the facts provided in the AAER and the existence of the problems provides for several useful discussion points for how counsel may help their clients avoid similar problems.

Counsel's role often involves proactive risk management, starting with reviewing the company's policies related to internal control procedure violations. Willful violations of such policies should be reported to the company's audit committee, and parties should be held accountable for their actions including termination for egregious violations similar to those described above. Notifying the audit committee allows for the consideration of an independent investigation, in which counsel's involvement may consist of investigative interviews, analytics, etc. Juniper's problems may have been mitigated if it had put in place such a policy the first time this issue was discovered.

Another proactive risk management action for legal counsel for registrants with government clients is involvement with proper FCPA training. This training is critical for salespeople and sends a strong message from legal counsel regarding the penalties for violations.

Finally, legal counsel can play a vital role to help audit committees fulfill their oversight roles. This can include assisting the audit committee and engaging with internal and external auditors to ensure thorough risk assessments are in place for FCPA and all other compliance programs.

When considering the penalties incurred and the reputational harm suffered with the recent FCPA violations, compliance programs and control improvements will always be a worthy investment.

"Among the diverse information available to investors in our capital markets, audited financial statements play a uniquely valuable role. An independent audit provided by an external auditor furthers the credibility of financial statements and reinforces investor trust to improve the fairness and efficiency of our capital markets and increase capital formation."

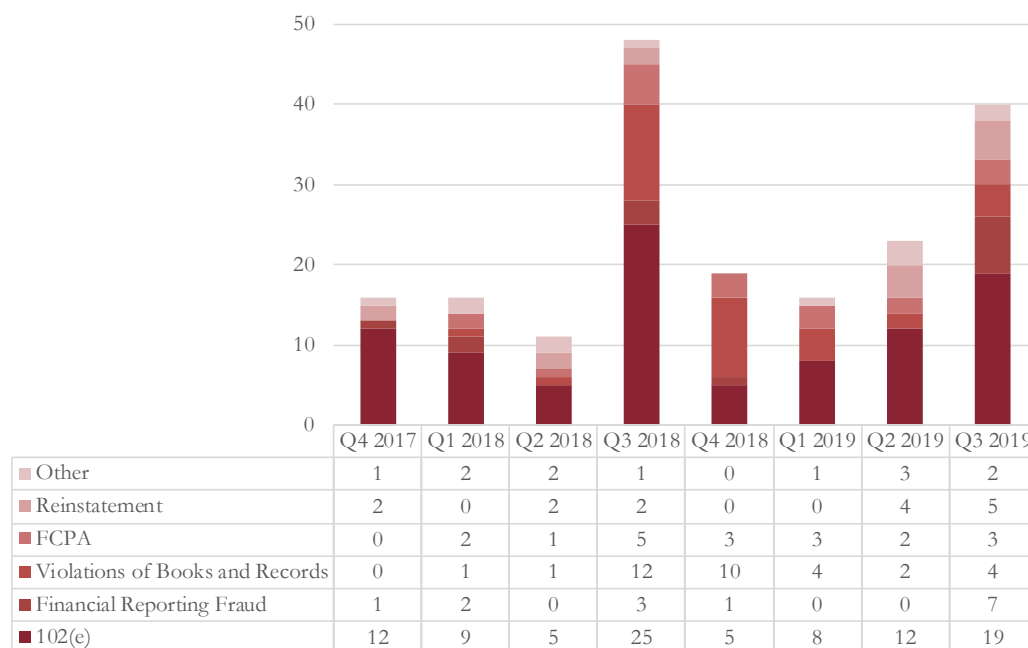
Sagar Teotia, Chief Accountant
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September 9, 2019
Remarks before the AICPA
National Conference on Banks &
Savings Institutions

Prior Period Comparison: Quarter to Quarter

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 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.

The following chart maps quarterly totals for each category over the past 8 quarters.

Quarter to Quarter AAER Comparison
Q4 2017 through Q3 2019



“We work on behalf of the public, and they are entitled to know whether we are doing our jobs and how well we are doing. And quantitative metrics do have some value as a rough measure of our overall activity level.”

Steven Peikin, Co-Director, Division of Enforcement
Atlanta, GA
September 6, 2019
Keynote Speech at Southeastern Securities Conference 2019

Based on this data, we made the following observations:

- Rule 102(e) sanctions continue to be the most common category of AAERs, constituting 48% of the total releases during Q3 2019.
- Q3 saw a drastic increase in AAERs over prior quarters, as the 40 releases exceeded the number of releases in the prior two quarters combined. There was an average of approximately 21 AAERs over the prior seven quarters.
- Following a quarter in which there were no AAERs classified as Financial Reporting Fraud, Q3 2019 had seven such releases.

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ACKNOWLEDGEMENT

We wish to acknowledge the valuable contribution to this analysis by Ryan Brown, Patricia Guggiari, and Daniel J. Terceiro.

For more information, please contact Joseph J. Floyd at 212.867.5848.

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.

New York

555 Fifth Avenue, 6th Floor
New York, NY 10017
212.845.9018

Boston

155 Federal Street, 11th Floor
Boston, MA 02110
617.586.1040