



*Summary of Accounting and  
Auditing Enforcement Releases  
for the Quarter Ended  
September 30, 2021*

Q 3   R E P O R T   2 0 2 1

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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, 2021.

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 continue 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 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 2021

# Highlights:

- The SEC released forty AAERs in Q3 2021, the same number of releases as the prior three quarters combined. A significant increase in the number of AAERs released in the third quarter isn't novel, as September 30th marks the end of the Commission's fiscal year and the date in which the SEC "closes the books" and releases results for its annual activities, including enforcement actions.
- Of note, one of this quarter's releases, which was categorized as Financial Reporting Fraud, resulted in over \$62 million in disgorgement, prejudgment interest and civil money penalties, representing almost two-thirds of all penalties imposed this quarter. This release highlights the inherent risks of, and the SEC's focus on, performance-based targets tied to internal metrics.
- We report on the Healthcare Services Group, Inc. case in our Recommended Reading section. The case involves the company's failure to properly accrue for or disclose loss contingencies for potential litigation payouts as required by GAAP. We provide an overview of the company's failure to accrue, summarize the SEC's required disclosure guidance, and raise considerations when assessing the financial reporting treatment for a litigation matter.

## 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 actions that may fit into the definition above.*

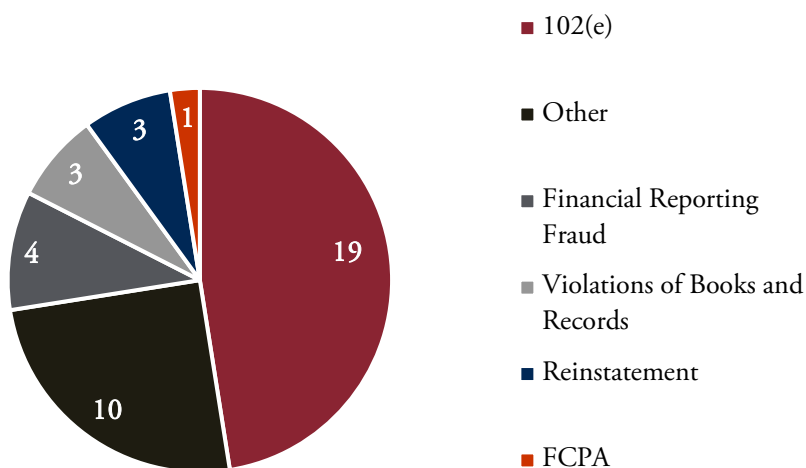
*To meet our objective of summarizing the major items reported in the AAERs, we reviewed those releases identified and disclosed by the SEC on its website, [www.sec.gov](http://www.sec.gov).*

*As part of our review, we gathered information and key facts, identified common attributes, and noted trends. 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 categorized the release by what appeared to be the most significant issue. Based on this process and methodology, we prepared a database of the key facts contained in each release.*

# The Q3 2021 AAERs: Summary by Category and Insights from the Releases

The SEC released forty AAERs during Q3 2021, with Rule 102(e) actions representing nearly 50% of the total releases.

Q3 2021 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

Nineteen AAERs related to Rule 102(e) actions were released during the quarter. Rule 102(e) actions involve the temporary or permanent censure and denial of the privilege of appearing or practicing before the SEC.

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

- The Commission imposed remedial sanctions and a cease-and-desist order against partners of a global accounting firm.*** The complaint alleges members of the Audit Quality and Professional Practice group of an accounting firm used confidential information from the Public Company Accounting Oversight Board ("PCAOB") to improve the results of the PCAOB's annual inspections of the accounting firm's audits. Per the complaint, the accounting firm had experienced a high rate of audit deficiency findings and prioritized improving its PCAOB inspection results. Therefore, as alleged in the complaint, members of the accounting firm obtained confidential PCAOB information on which of the firm's audits would be inspected, and they created and oversaw a program to review and revise audit workpapers after the audit reports had been issued to reduce the likelihood that the PCAOB would find deficiencies in those audits. This resulted in a substantial improvement to the accounting firm's inspection results. The misconduct was discovered by others within the accounting firm and reported to leadership before additional audit workpapers were changed.

"People like predictable and measurable things—things that we can quantify, standardize, and compare with one another. Especially when something is important to us, even when we cannot easily categorize, measure, and identify what is coming, we nevertheless try."

Commissioner Hester M. Peirce  
July 20, 2021  
Chocolate-Covered Cicadas

- ***The Commission suspended a Chief Financial Officer (“CFO”) for issuing materially false statements and omitting material information from annual reports.*** According to the complaint, the CFO’s false statements and omissions concerned the company’s financial wherewithal to construct, own, and operate seven combined heat and power plants for a customer, the nature and value of the assets underlying the projects, and the company’s relationship with its principal customer, a North American meat processing company. The complaint further alleges the CFO prepared and provided materially overstated valuations to the company’s accountants and auditor, which were recorded in the company’s books and records and publicly reported in the company’s financial statements and footnotes. Specifically, the complaint alleges the company’s assets were overstated by over 400% and 125% for the fiscal years ended December 31, 2013 and 2014, respectively. Per the complaint, the company raised funds from investors in private transactions based on the misrepresentations and inflated valuations reflected in the company’s public filings.
- ***The Commission suspended the CFO, the Manager of the Operations department, and the Controller of a Mexico-based homebuilding company for engaging in a multi-billion-dollar financial fraud.*** According to the Commission’s complaint, from 2010 through 2012, the company reported revenue from the sale of more than 100,000 homes that it had neither built nor sold. Per the complaint, the company’s resulting overstatements of its revenue across annual reports filed with the SEC during the three-year period totaled at least MXN \$44 billion (USD \$3.3 billion) or 355%. As detailed in the complaint, annual reports portrayed the company as productive and financially sound, and management certified the accuracy of those reports, when in fact the defendants knew the company was in a dire financial state. The complaint further alleges management created a false second set of books, through which the fraud was perpetrated, and also entered into loan agreements with at least 13 Mexican banks. The company repaid the loans through additional bank borrowing, in a check-kiting fashion, a practice that was hidden from the company’s investors and mischaracterized to the company’s auditor.

### FCPA Violations

There was one FCPA-related release in Q3 2021, resulting in more than \$19 million in civil money penalties, disgorgement, and prejudgment interest. Below is the summary of the release within this category:

- ***The world’s largest advertising group was fined over \$19 million for violating the anti-bribery, books and records, and internal accounting controls provisions of the FCPA.*** According to the complaint, the bribery scheme took place at the company’s majority-owned subsidiary in India, which, through intermediaries, paid as much as \$1 million in bribes to Indian officials to obtain and retain government business. The complaint also alleges the company benefited from other illicit schemes at its subsidiaries, such as a Chinese subsidiary making unjustified payments to a vendor in connection with a Chinese tax audit, a Brazilian subsidiary making improper payments to purported vendors in connection with government contracts, and a Peruvian subsidiary funneling funds through other company entities to disguise the source of funding for a political campaign. Per the complaint, the company failed to implement and maintain sufficient internal accounting controls over vendor management and accounts payable at these subsidiaries, failed to provide reasonable assurances that these subsidiaries were adhering to the company’s anti-corruption policy, lacked sufficient entity level controls over these subsidiaries, and failed to timely and properly manage the company’s response to red flags indicating corruption risks. As a result of these actions, the Commission ordered the company to pay disgorgement and prejudgment interest of approximately \$11.2 million and a civil money penalty of \$8 million.

“The Commission has looked to materiality as our guiding principle when crafting disclosure requirements because it is an objective standard by which we can exercise our statutory authority to decide what is necessary or appropriate in the public interest or for the protection of investors.”

Commissioner Hester M. Peirce  
July 20, 2021  
Chocolate-Covered Cicadas



## Financial Reporting Fraud

We categorized four AAERs as Financial Reporting Fraud during this quarter. Below is one example of a release within this category:

- ***The SEC charged a food processing company and its Chief Operating Officer (“COO”) for engaging in a multi-year expense management scheme.*** The complaint alleges the company’s procurement division engaged in an expense management scheme to improperly reduce the company’s cost of goods sold and achieve cost savings that were externally touted to the market and internally tied to performance-based targets. According to the complaint, between 2015 and 2018, procurement employees negotiated agreements with numerous suppliers to obtain upfront cash payments and discounts in exchange for future commitments. Importantly, per the complaint, procurement employees improperly documented the agreements in ways that caused the company to recognize the expense savings prematurely and improperly. Further, as alleged in the release, the company’s COO, who was also the Global Head of Operations, was presented with several warning signs indicating that expenses were being manipulated. Nonetheless, the complaint alleges the COO imposed pressures on the procurement division to deliver unrealistic cost savings targets and unreasonably approved the company’s financial statements that the COO should have known were materially false and misleading. As a result of the foregoing, the SEC ordered the company to pay a \$62 million civil penalty and the COO to pay \$300,000 in civil penalties and \$14,211 in disgorgement and prejudgment interest.

## Violations of Books and Records

This quarter we categorized three 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. Below is a summary of one release within this category:

- ***The Commission instituted cease-and-desist proceedings against a cloud-based human capital management firm.*** According to the Commission’s complaint, the company overstated reported recurring revenues from 2011 through 2020 as a result of the company “reselling” services (i.e., billing clients for services for which they were already paying). The complaint alleges the company’s client relations representatives identified instances in which clients had been sold and were paying for a service offered by the company but were unaware that they had the service. The complaint further alleges the representatives would then resell the same service to the client and bill an additional fee despite not providing any additional service. As a result of the Commission staff’s investigation, the company identified approximately 269 instances of reselling that occurred across approximately 245 client codes from 2011 to 2018. The complaint indicates the company has returned approximately \$2.8 million in the aggregate to affected clients and that it was ordered to pay a \$250,000 civil money penalty.

## Reinstatement

There were three releases in Q3 2021 related to the reinstatement of CPAs to practice before the SEC. The following is a summary of one release within this category:

- ***The SEC reinstated a Chartered Accountant (“CA”) to appear and practice before the Commission as an accountant.*** According to the Commission’s complaint, the CA, a member of the engagement team at an accounting firm, engaged in professional misconduct during the audit of a company’s financial statements. Of significance, the designation “CA” is used in India by members of the Institute of

“The registration requirements include new counterparty protections, requirements for capital and margin, internal risk management, supervision and chief compliance officers, trade acknowledgement and confirmation, and recordkeeping and reporting procedures. These areas are focused on reducing risk in our markets.”

Chair Gary Gensler  
July 21, 2021  
Prepared Remarks of Gary Gensler, Chair of the Securities and Exchange Commission, Before the American Bar Association Derivatives and Futures Law Committee Virtual Mid-Year Program

Chartered Accountants of India. The complaint specifically alleges the CA accepted money from another accountant who was embezzling funds from the company the CA was auditing. The CA complied with the term of his suspension and was therefore reinstated to appear and practice before the Commission as an accountant.

## Notable Q3 2021 AAER 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 and colleagues. For this quarter, we selected the following AAER to highlight.

***Accounting and Auditing Enforcement Release No. 4244 / August 24, 2021, In the Matter of Healthcare Services Group, Inc., John C. Shea, CPA and Derya D. Warner***

### *Don't Let Advocacy Dictate the Financial Reporting for Litigation Matters*

Whether and when to accrue or disclose potential litigation payouts is among the more difficult judgments made by public registrants when preparing financial statements, especially while maintaining a robust legal defense for the case.

Ordinary accruals involve forming judgments and estimates about conditions existing as of financial statements and recording amounts for future payouts based on historical trends and facts.

Accruals for litigation payouts have added complexities, including questions of law that will impact whether a liability even exists, plus being entangled in the advocacy system where very few want to admit that amounts are owed to the other side.

When it comes to financial reporting judgments and estimates for litigation payouts, legal counsel’s involvement is essential, especially related to the probability of success on questions of law, the likelihood of a settlement and amounts due. To be effective in this role, legal counsel needs to be sensitive to the reporting requirements under Generally Accepted Accounting Principles (“GAAP”) for loss contingencies, especially as they take priority over legal strategy and advocacy.

The consequences of not complying with the GAAP requirements for litigation matters are found in the recently issued Accounting and Auditing Release (“AAER” or “release”) by the United States Securities and Exchange Commission for an action against Healthcare Services Group, Inc. (“HCSG”) and its former Chief Financial Officer and Controller.

Per the release, HCSG failed to timely record loss contingencies for proposed litigation settlement amounts. HCSG, headquartered in Pennsylvania, provides housekeeping, laundry, facility maintenance, and dietary services to healthcare facilities in the United States. HCSG’s stock trades on the NASDAQ Global Select Market. The SEC action resulted in a cease-and-desist order against HCSG, along with Rule 102(e) suspensions for two individuals. HCSG agreed to a \$6 million civil penalty related to its failure to comply with GAAP for the settlement offers.

“I have asked staff to examine whether and how the program could be further strengthened to ensure that misconduct within the remit of the SEC is identified, addressed, and stopped.”

Chair Gary Gensler  
July 30, 2021  
Prepared Remarks for National  
Whistleblower Day Celebration

Below you will find a brief description of the financial reporting problems at HCSG, an overview of the accounting guidance regarding loss contingencies, considerations when making financial reporting judgments for litigation matters, and importantly, thoughts on the differences between advocacy and GAAP requirements.

### *HCSG's Failure to Accrue for Litigation Payouts*

Starting in 2014, class action lawsuits were filed against HCSG on behalf of its employees, alleging that HCSG had violated wage-and-hour labor laws. Over the next several quarters, HCSG agreed to settlements with the plaintiffs in these lawsuits. The settlements were then submitted to the applicable courts for approval.

Per the release, despite having reached settlement agreements with the plaintiffs including expected payouts, HCSG did not make any financial statement disclosure or accrual until the court granted final approval for the amounts. According to the SEC, had HCSG properly recorded the financial impact of the loss contingencies at the time they were probable and reasonably estimable, it would have reported lower earnings and missed analysts' estimates in many of the applicable quarters.

As discussed above, complying with the financial reporting standards for litigation payouts is often complicated by the advocacy system and strategy inherent in defending a litigation case. The common denial of all wrongdoing and refusal to admit any amounts may be owed, up to and including a final determination may be a sound legal strategy, but the approach is not acceptable under GAAP.

### *Overview of Accounting Standards*

The accounting guidance for the identification, assessment, and measurement of loss contingencies relating to litigation payouts is found in the Accounting Standards Codification Topic 450, Contingencies ("ASC 450").

Under ASC 450, a loss contingency is an existing condition, situation or set of circumstances involving uncertainty as to possible loss to an entity that ultimately will be resolved when one or more future events occur or fail to occur. The guidance requires financial statement preparers to use their knowledge, expertise and judgments about uncertain outcomes and events.

Per the guidance, preparers of financial statements must assess the likelihood of whether a loss, and for litigation matters, a potential payout, fits into one of three categories; probable, reasonably possible or remote, each defined under GAAP.

"Probable" means the future event (or events) is likely to occur. Likely to occur is less than a hundred percent certainty. Many consider a threshold of a seventy percent or more chance to warrant a likely to occur classification. Without question, the determination requires careful assessment of the facts, judgment and ideally, experience with similar situations.

Importantly, for financial reporting, when a loss is deemed probable and the amount of the loss can be reasonably estimated, GAAP requires that the estimated loss be accrued and recorded in the financial statements of the company. If a loss is probable but a reasonable estimate of the amount of the loss cannot be made, a company is required to disclose in the footnotes to financial statements the nature of the contingency and provide an estimate of the loss or range of loss or a statement that such an estimate cannot be made.

**"As a Commissioner at the SEC, it is my goal to ensure that our regulatory framework not only functions well during bull markets, but that it also promotes market resilience and delivers investor protections when a destabilizing event or the next contraction occurs."**

Commissioner Caroline A.  
Crenshaw  
September 24, 2021  
Assessing the Unknown



A loss is considered “reasonably possible” when the chance of the future event (or events) occurring is more than remote but less than likely to occur. The reasonably possible category may be the largest category and triggers important required financial reporting disclosures. GAAP also requires that a loss contingency that is reasonably possible be disclosed in the notes to financial statements, and similarly, a company must provide an estimate of the loss or range of loss or a statement that such an estimate cannot be made.

Finally, neither an accrual nor disclosure is required if the loss contingency is remote. Not surprisingly, the remote classification, that “the chance of the future event or events occurring is slight” sounds a great deal like a legal strategy response, and is also how many registrants respond to allegations in legal pleadings.

### *Evaluating the Financial Reporting for Litigation Matters*

Below you will find a list of questions to consider when assessing the financial reporting treatment for a litigation matter.

#### **Assess the Nature of the Litigation**

Is the litigation claim frivolous?

If so, then there would be a valid position to categorize as remote.

Does the claim have merit, but is defensible?

If so, proceed to the next levels of assessment.

#### **Gather Expert Advice on Expected Outcomes and Quantification**

Has counsel provided an unbiased probability of success or loss estimate?

Have you considered having an independent counsel review the case for the loss contingency assessment?

Have you considered hiring a financial consulting expert to make such an early-stage damages assessment?

#### **Consider the Outcomes for Comparable Events**

Have you taken into consideration the company’s experience in similar cases?

Do you have a pattern of settling similar cases?

What can be learned from how the settlement number was determined?

While facts may differ, what can be learned from other related court decisions?

#### **Document the Criteria Involved and Case Assessment Conclusions**

Have you reviewed your internal control over financial reporting requirements for making judgments and estimates?

Do your requirements include formal documentation in memo format?

Well-prepared memos generally include a summary of the facts, GAAP citations, procedures undertaken and conclusions (probable, reasonably possible and remote as well as the ability to reasonably estimate damages).

**“The basic bargain is this: investors get to decide what risks they wish to take. Companies that are raising money from the public have an obligation to share information with investors on a regular basis.”**

Chair Gary Gensler  
July 28, 2021  
Prepared Remarks Before the  
Principles for Responsible  
Investment “Climate and Global  
Financial Markets” Webinar

## Evaluate the Progress of the Case

For example, have you lost on summary judgment?  
If so, the potential for an adverse outcome may be greater.

Has the court ruled for the plaintiffs on important motions?  
Similarly, the potential for an adverse outcome may be greater.

Update the case assessment memo periodically to reflect changes in the original assessment.

## Make Your Reporting Match Your Negotiations and Internal Discussions

Are you preparing for mediation with a mindset to resolve the case, or actively quantifying a settlement offer? If so, ensure your financial reporting judgments are consistent with your current case assessment.

Have settlement offers been made or contemplated?

Are your financial reporting judgments and disclosures consistent with the estimates and outcomes discussed internally?

## *Recognize the Differences Between Advocacy and Financial Reporting*

Finally, when helping make these assessments, recognize where the process may put legal counsel in an uncomfortable position.

For starters, making a public admission that a loss is even possible, leaving aside that it could be probable, may not be consistent with legal defense strategies nor aspects of the attorney work product privilege. Next, GAAP differs from certain aspects of the American Bar Association (“ABA”) guidance related to assessing litigation.

Per the ABA Statement of Policy Regarding Lawyer’s Responses to Auditors’ Requests for Information, “[i]n view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either ‘probable’ or ‘remote.’” The policy describes “probable” as “extremely doubtful and the prospects for success by the client in its defense are judged to be slight.” These definitions differ from GAAP, and the “reasonably possible” level described above is not even a consideration in the ABA guidance. Therefore, it is critical that management fully understand legal counsel’s assessment when determining whether to accrue or disclose potential litigation payouts.

**“But all of us, regulators and market participants alike, have a role to play in the stability of markets.**

**Given the increasing market complexity and interconnectedness, which can increase and amplify risks, we must all remain vigilant.”**

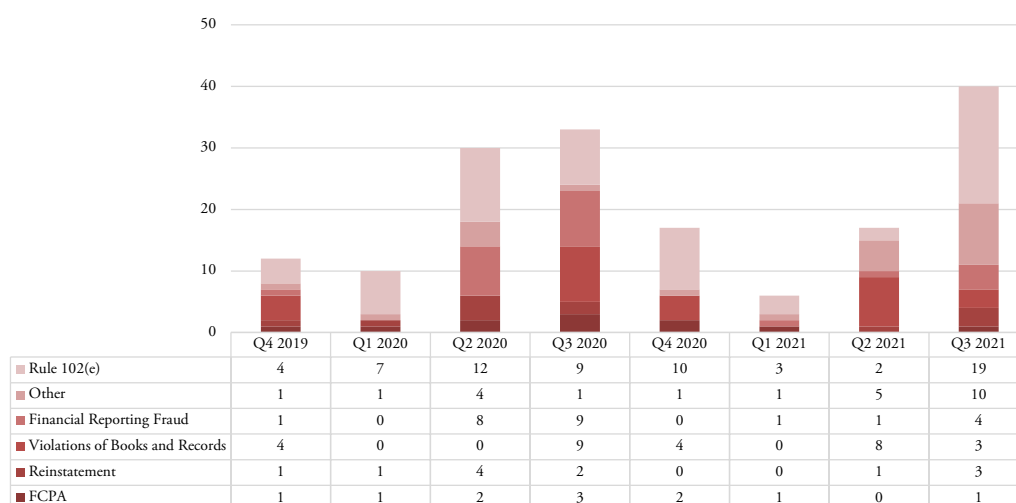
Commissioner Caroline A.  
Crenshaw  
September 24, 2021  
Assessing the Unknown

# 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 AAER category over the past eight quarters.

**Quarter to Quarter AAER Comparison**  
Q4 2019 through Q3 2021



“Since the last major economic downturn, our financial markets have experienced unprecedented growth, even as sectors of the real economy have not always kept pace, as in the early stages of the global pandemic.”

Commissioner Caroline A. Crenshaw  
September 24, 2021  
Assessing the Unknown

Based on this data, we made the following observations:

- Rule 102(e) actions, consistently the most common type of AAER in recent periods, account for nearly 50% of this quarter’s releases. Accountants that are penalized under Rule 102(e) typically violate professional standards or federal securities laws, and, as a result, temporarily or permanently lose the privilege to practice or appear before the Commission.
- Of significance, the SEC released four AAERs categorized as Financial Reporting Fraud this quarter, following a year of minimal activity. The Financial Reporting Fraud releases this quarter resulted in over \$68 million in civil money penalties, disgorgement, and prejudgment interest collected by the Commission.
- The SEC released forty AAERs this quarter, the same number of AAERs released in the previous three quarters combined. Interestingly, despite the decreased volumes of releases in the SEC’s first three fiscal quarters of 2021, we note that total releases for the fiscal year ended September 30, 2021 totaled 80 AAERs, a slight 6% decrease over FY 2020. In addition, despite the perceived impact of the COVID-19 pandemic on the SEC’s enforcement activity between March 2020 and September 2021, we also note that total AAERs in both FY 2020 and FY 2021 were only 13% below the historical eight-year average.

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For more information, please contact LeeAnn Manning at 617.586.1076 or Ryan Brown at 646.449.7273.

#### **ABOUT Floyd Advisory**

Floyd Advisory is a consulting firm providing financial and accounting expertise in areas of SEC reporting, transaction advisory, investigations and compliance, litigation services, as well as business strategy and valuation.

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