

# SEC Accounting Enforcement: Initiatives, Trends & Developments

April 19, 2012

# Agenda

- Introduction
- Presentation
- Questions and Answers — (anonymous)
- Slides — now available on front page of Securities Docket
- Wrap-up

# Panel



**Howard Scheck**

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- SEC Enforcement Activity
- Current Areas of Focus in Accounting Investigations
- Cross Border Enforcement
- Gatekeepers
- Issues Concerning Auditors

# SEC Enforcement Activity, 2007 - 2011

Enforcement Actions by FY	2007	2008	2009	2010	2011
Broker Dealer	89	67	109	70	112
Delinquent Filings	52	113	92	106	121
Financial Fraud/Issuer Disclosure/ FCPA	219	154	143	126	109
Insider Trading	47	61	37	53	57
Investment Adviser, Investment Company	79	87	76	112	146
Market Manipulation	36	53	39	34	35
Securities Offering	68	115	141	144	124
Other	65	21	27	32	31
<b>Total Enforcement Actions</b>	<b>655</b>	<b>671</b>	<b>664</b>	<b>677</b>	<b>735</b>

# Increasing Levels of Enforcement Activity: Broker Dealer, Delinquent Filings, Investment Adviser

Enforcement Actions by FY	2007	2008	2009	2010	2011
<b>Broker Dealer</b>	89	67	109	70	112
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# Decreasing Levels of Enforcement Activity: Overall Financial Fraud/ Issuer Disclosure/ FCPA Totals

Enforcement Actions by FY	2007	2008	2009	2010	2011
Broker Dealer	89	67	109	70	112
Delinquent Filings	52	113	92	106	121
<b>Financial Fraud/Issuer Disclosure/ FCPA</b>	<b>219</b>	<b>154</b>	<b>143</b>	<b>126</b>	<b>109</b>
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# Areas of Focus in Accounting Investigations

- Improper Revenue Recognition
- Understated Expenses
- Financial Crisis – Related Accounting:  
Impairment and Disclosure Issues Related to Loans  
and Securities
- Various Cross Border Shenanigans

# Improper Revenue Recognition Selected Cases

## Life Partner Holdings, Inc.

*Filed January 2012 by Fort Worth Regional Office*

- SEC alleges that CEO, GC and CFO failed to disclose significant business risk, that understated life expectancy estimates risked revenue
  - Apparent sustainable revenue model was illusory
  - Impairment expense understated
  - Revenue prematurely recognized
- SEC alleges illegal insider trading by CEO and GC.
- SEC seeks Section 304 clawbacks.

# Improper Revenue Recognition

## Selected Cases

### Basin Water, Inc.

#### *Filed in June 2011 by Los Angeles Regional Office*

- SEC alleges that former CEO and former CFO fraudulently inflated revenues in Basin Water's 2006 and 2007 quarterly and annual reports
- Sale was not final; no required acceptance from customer; allowed customer to pay nothing until customer resold the water treatment system; insufficient assurance that customer would pay; system not shipped
- SEC also alleges the former CEO sold and donated his own shares before the true financial condition was revealed
- Basin Water restated its results in 2009, then declared bankruptcy, and is now defunct

# Understated Expenses

## Selected Case

### Labarge, Inc.

*Filed in June 2011 by Chicago Regional Office*

SEC alleged:

- Q2FY06 and Q2FY07 reporting violations for overstating net earnings by 7.8% and 8.3%, respectively
- Internal controls, and books and records violations for failing to maintain adequate controls and documentation relating to cost estimates on long-term contracts, which resulted in
- Underestimated completion costs
- Underreported cost of goods sold
- Overstated net earnings
- Settled: non-fraud C&D AP; penalty of \$200,000

# Financial Crisis – Related Accounting

**In addition to disclosure, CDO and RMBS cases being investigated, SEC focus on financial crisis matters has also generated a number of accounting related inquiries.**

- Loan loss and reserve matters
- Timing of reserves, recognition of bad debt expense
- Accounting estimates
- Financial Reporting Release 28 – Systematic methodology in evaluating loan losses
- Other accounting related maneuvers

## Franklin Bank Corp.

### *Filed in April 2012 by Fort Worth Regional Office*

- SEC alleges that CEO and CFO implemented increasingly aggressive loan modification schemes and concealed the deteriorating quality of the loan portfolio
  - Delinquent and non-performing loans were accounted for as performing
  - Non-performing assets understated
  - Net income overstated
- SEC seeks permanent injunctions, disgorgement, penalties, officer-and-director bars, repayment of bonuses (Section 304 clawbacks)

# Financial Crisis – Related Accounting

## **UCBH Holdings, Inc.**

(public holding company for United Commercial Bank (“UCB”), one of the 10 largest bank failures)

### ***Filed in October 2011 by San Francisco Regional Office***

- SEC alleges that UCB CEO, COO, and senior officer concealed loan losses and knowledge of worthless collateral from auditors and investors (litigating)
- SEC alleged that CFO misled auditors and aided in the filing of false financial statements (settled: permanent injunction including fraud; \$150,000 penalty; and Rule 102(e) minimum 5 year suspension)

### ***Filed in March 2012 by San Francisco Regional Office***

- SEC alleged a UCB executive VP misled auditors regarding risks the bank faced on outstanding loans (settled)
- Loan loss reserves understated and interest income overstated

## Thornburg Mortgage Inc.

*Filed in March 2012 by Denver Regional Office*

- SEC alleges that CEO, CFO, CAO overstated income.
- Matter relates to liquidity pressure and margin calls.
- SEC allegations include failure to recognize accounting impairment and misleading auditors.
- CEO and CFO are defending and litigating against the SEC action.

## BankAtlantic Bancorp Matter

*Filed in January 2012 by Miami Regional Office*

- SEC asserts that BankAtlantic and its CEO knew that a large portion of commercial residential portfolio was deteriorating.
- A number of loans kept “current” by extending terms and replenishing interest reserves with increase in loan principal.
- Accounting issues relating to sales of problem loans

# Cross Border Enforcement

- Cross Border Working Group
- Investigating Cross Border Conduct
- Issues Found in Cross Border Investigations

## **AutoChina International Limited**

### ***Filed in April 2012 by Boston Regional Office***

- SEC charged China-based firm and 11 investors, including a director/senior executive and siblings of the Chairman and CEO, with market manipulation to boost trading volume to obtain favorable loan terms
- Using US & HK brokerage accounts and \$60 million, defendants engaged in hundreds of fraudulent trades including “matched orders” and “wash trades”
- “The SEC will hold accountable publicly-traded companies, including foreign companies...” said Robert Khuzami, Director of the SEC’s Division of Enforcement

# Cross Border Selected Cases

## **Puda Coal Inc.**

### ***Filed in February 2012 by New York Regional Office***

- Reverse merger July 2005; NYSE Amex September 2009-August 2011
- SEC charged China-based Chairman and former CEO with defrauding investors into believing they were investing in a Chinese coal company when in fact the company was an empty shell
  - Undisclosed theft of the primary asset / sole source of revenue, a coal mine operating subsidiary , by the Chairman with the former CEO's knowledge and complicity
  - Continued to raise funds from U.S. investors
  - Puda Coal had no ongoing business operations
- After start of SEC Staff investigation, former CEO forged a document that Chairman then provided to SEC Staff to materially mislead the Staff

## Gatekeeper and Auditor Issues

- Robert Khuzami, Director of the Division of Enforcement, at the PLI SEC Speaks 2012 conference, emphasized the importance of corporate executives' commitment to full and accurate disclosure to shareholders.
- Andrew Calamari, Associate Director of the New York Regional Office, stated that cases against “gatekeepers” such as auditors, remain an interest of the SEC. He noted that in the past year, the Commission staff pursued actions against affiliates of three of the “Big Four” firms.
- Audit Committee members, in-house and external counsel are regularly scrutinized during accounting investigations.

## DHB Industries

### *Filed in February 2011 by the Miami Regional Office*

- SEC alleges fraud by 3 former DHB outside directors and audit committee members for their complicity in a massive accounting fraud
  - Willfully ignored numerous red flags signaling accounting fraud, reporting violations, and misappropriation by DHB senior officers
  - Allowed senior management to manipulate reported gross profit, net income, and other key figures in filings
  - Approved and/or signed periodic filings
- “We will not second-guess the good-faith efforts of directors. But in stark contrast [the 3 charged] were directors and audit committee members who repeatedly turned a blind eye to warning signs of fraud and other misconduct by company officers,” said Robert Khuzami, Director of the SEC’s Division of Enforcement.

# Gatekeepers

## Selected Cases

### Syntax-Brilliant Corporation

***Filed in August 2011 (2 director/officers; officer; third party aider and abettor)***

- Overstated results by reporting significant sales of LCD TVs in China that never occurred; engaged in three way round tripping of cash with primary manufacturer in Taiwan and purported customer/distributor in HK; creating fake shipping and sales documents

***Filed in January 2012 (Auditor)***

- Relationship Partner instructed Syntax executives on how to backdate distribution agreements to improperly recognize revenue
- Despite knowledge of fictitious sales, did not object to reissuance of Firm's audit opinion
- Settled: permanent injunction, aiding & abetting fraud etc; Rule 102(e) minimum 5 year suspension

# Issues Concerning Auditors

- Section 10A “Audit Requirements” of the Securities Exchange Act of 1934
- Section 106 “Foreign Public Accounting Firms” of the Sarbanes-Oxley Act of 2002
- Joint Inspections of Global Audits
- Independence

# Section 10A

## Selected Cases

### **Livingston & Haynes, P.C.**

#### ***Filed in June 2011 by Boston Regional Office***

- The Firm, and engagement and concurring review partners charged with violating Section 10A for allegedly failing to
  - include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the financial statements
  - determine whether it was likely that an illegal act had occurred when aware of multiple allegations of illegal acts
  - ensure a high risk area was properly audited when aware of red flags
  - properly plan the audits, adequately test revenue, obtain sufficient evidence, exercise due professional care, apply skepticism, and properly assess risks of material misstatement due to fraud
- Settled: Firm undertakings included restrictions on new engagements, performance of internal reviews, increased training; individuals Rule 102(e) minimum 3 year suspension

# Section 10A

## Selected Cases

### **Chisolm, Bierwolf, Nilson & Morrill, LLC** ***Filed in April 2011 by Fort Worth Regional Office***

- Firm charged charged with violating Section 10A for allegedly failing to
  - adequately plan audits, train and supervise assistants, gather sufficient evidence, exercise due professional care and skepticism, consider qualifications of a specialist, make additional inquiries, perform sufficient alternative procedures, properly prepare audit documentation
  - include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the financial statements
  - have procedures in place to detect fraud and to evaluate the client's ability to continue as a going concern
- Auditor failures were a cause of client's filing false financial statements
- Settled to C&D AP and permanent Rule 102(e) bar

## Section 106 Selected Cases

### Symmetry Medical, Inc.

*Filed in January 2012 by Home Office*

- UK Chartered Accountants sanctioned
- SEC – UK Financial Services Authority cooperation
- SEC alleged UK subsidiary VP of Euro operations, finance director, controller, and management accountant understated expenses, and overstated assets and revenue.
- CFO and former CEO, both uninvolved in and unaware of wrong-doing, agreed to Section 304 clawbacks.

# Section 106

## Selected Cases

### PW India

#### *Filed in April 2011 by Home Office*

- SEC sanctioned 5 India-based affiliates of PwC (“PW India”) for repeatedly conducting deficient audits of Satyam Computer Services Limited’s (“Satyam”) financial statements and enabling massive accounting fraud to go undetected for several years
  - Failed to conduct procedures to confirm Satyam’s cash and cash equivalent balances and accounts receivables
  - Satyam created 6,000 false invoices and forged bank statements to inflate cash balances and appear more profitable; this scheme resulted in \$1B in fictitious cash and cash-related balances
- Audit failures not limited to Satyam; quality control failures throughout PW India
  - PW India replaced almost all senior management responsible for audit matters, suspended Satyam engagement partners from all work, removed from client service all senior audit professionals on the former Satyam audit team

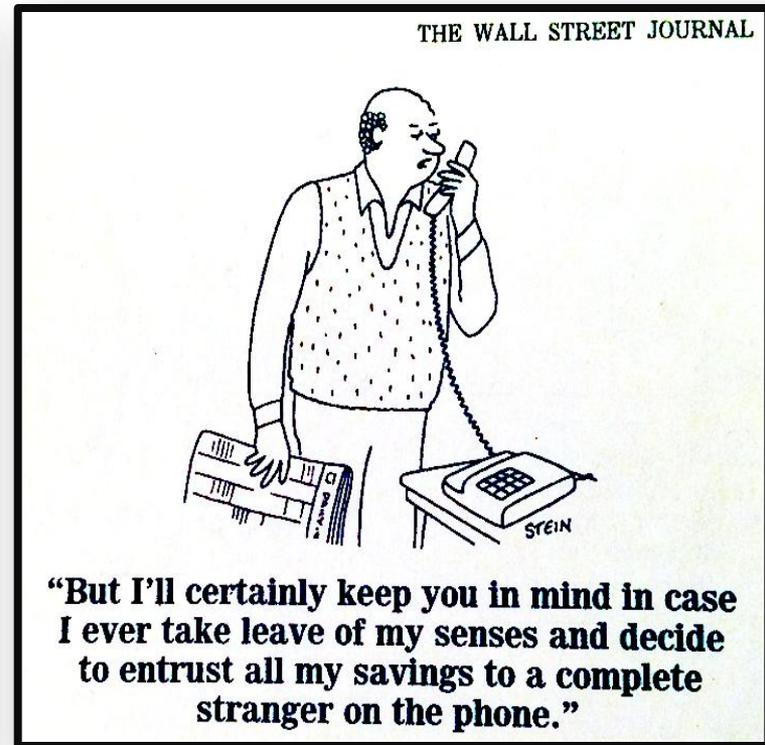
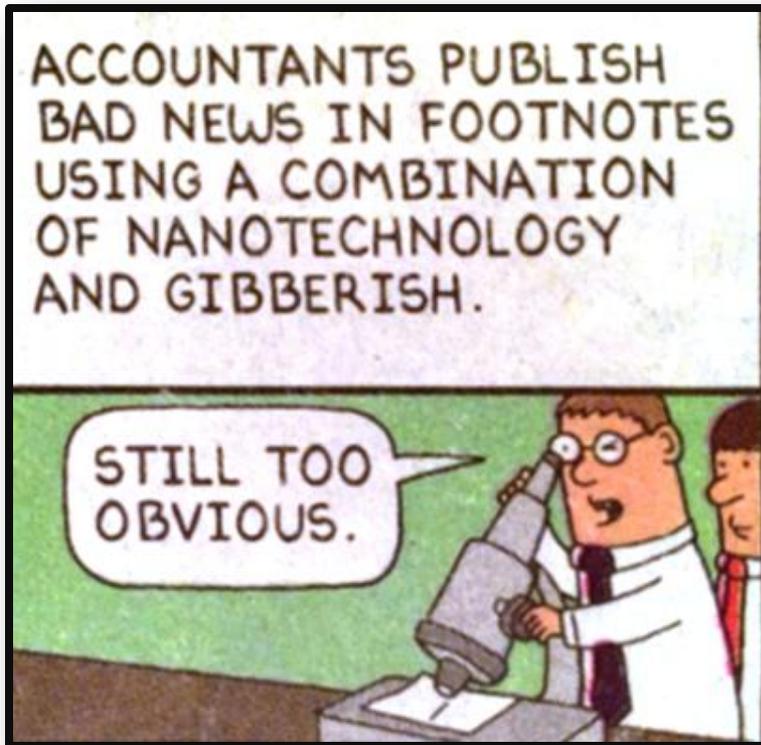
# Auditor Independence

## KPMG Australia

### *Filed in February 2011 by the Home Office*

- KPMG Australia and at least one other KPMG member firm outside Australia rendered secondments to work (e.g. acting CFO) under the direction of the audit client
  - Rule 2-01(c)(4)(vi) prohibits acting, temporary or permanently, as an employee of an audit client
- KPMG Australia received trailing commissions from an acquired subsidiary of an audit client
  - Rule 2-01(c)(3) prohibits direct business relationships with an audit client
- The subsidiaries of an audit client retained a legal practice associated with another KPMG member firm to provide litigation services
  - Rule 2-01 prohibits acting as an advocate for an audit client
- Settled: \$2.8M disgorgement and interest; undertakings including retaining Independent Consultant

# Questions?



# Thank You

## For Attending This Webcast