SEC and PCAOB Accounting and Auditing Enforcement

Observations, Analysis & Insights

Matters Filed in July – December 2019

Introduction

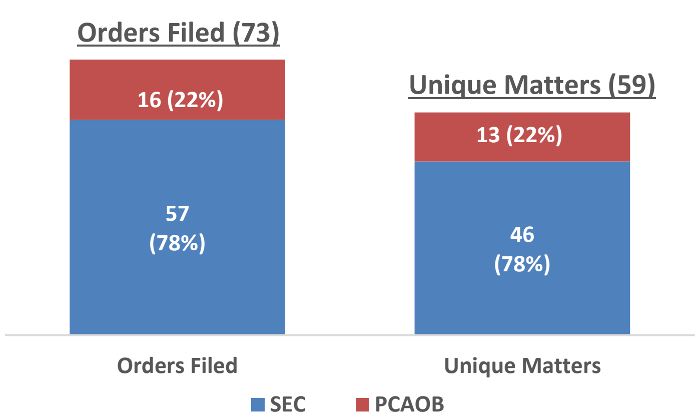
Credibility International is pleased to present our inaugural study of U.S. Securities and Exchange Commission ("SEC") and Public Company Accounting Oversight Board ("PCAOB") enforcement activity related to public-company issuer accounting, disclosure, audit failure, and auditor independence enforcement matters. Our study is based on SEC Accounting and Auditing Enforcement Releases ("AAERs") and PCAOB Disciplinary Orders ("Orders") issued during the period July 1, 2019 through December 31, 2019.

The objective of this study is to provide our readers with informative and useful data analyses and observations regarding SEC and PCAOB enforcement activity involving public-company issuers, their external auditors, and related individuals. We intend to prepare this study on a bi-annual basis in the future, and welcome feedback regarding additional analyses or information that our readers would find useful.

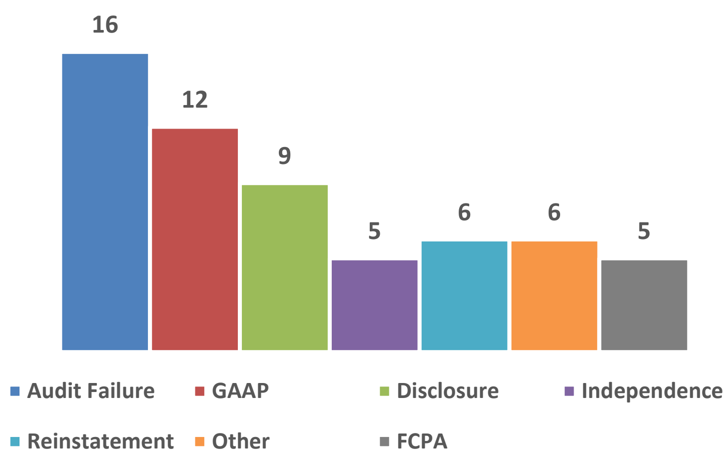
The preparation of this study was led by Credibility International's President Michael Maloney, who served as Chief Accountant of the SEC's Division of Enforcement from 2014 through 2018. Peter Bihl and Bryan Roach of Credibility made significant contributions to the preparation of this study.

Activity Level and Unique Matter Type (SEC and PCAOB Combined)

Activity Level - SEC AAERs and PCAOB Orders



Unique Matter Type (Primary Issue)

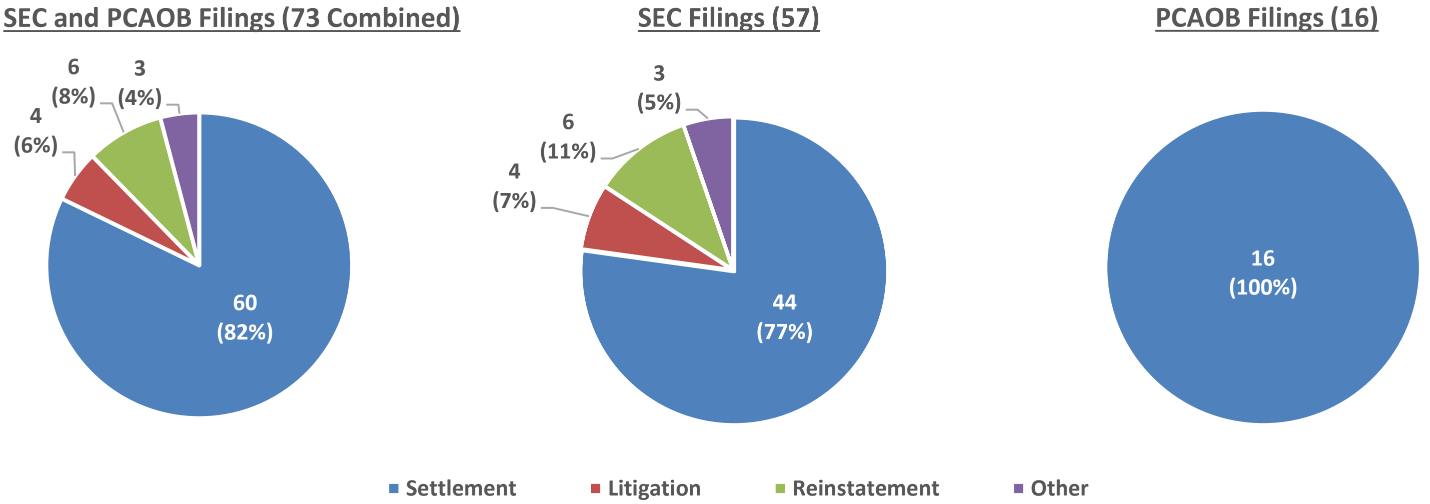


Activity Level (SEC and PCAOB) – Of the 73 filings in the period (covering 59 unique matters), SEC AAERs (accounting and/or auditing) represented approximately three-fourths of the activity, with PCAOB Orders (auditing only) representing the remaining one-fourth. The number of SEC AAERs (57) and PCAOB Orders (16) filed was slightly divergent from the activity levels in the same period in 2018 (69 and 10, respectively).

Unique Matter Type (Primary Issue) – Of the 59 unique matters in the period, Audit Failures were the most common alleged primary issue, followed by both GAAP Accounting and GAAP/SEC Disclosure. Auditor Independence, FCPA, and Accountant/Auditor Reinstatement matters were filed at lower, but consistent frequencies. Audit Failures representing the most common primary issue is not surprising since both the SEC and the PCAOB have authority to pursue auditing matters.

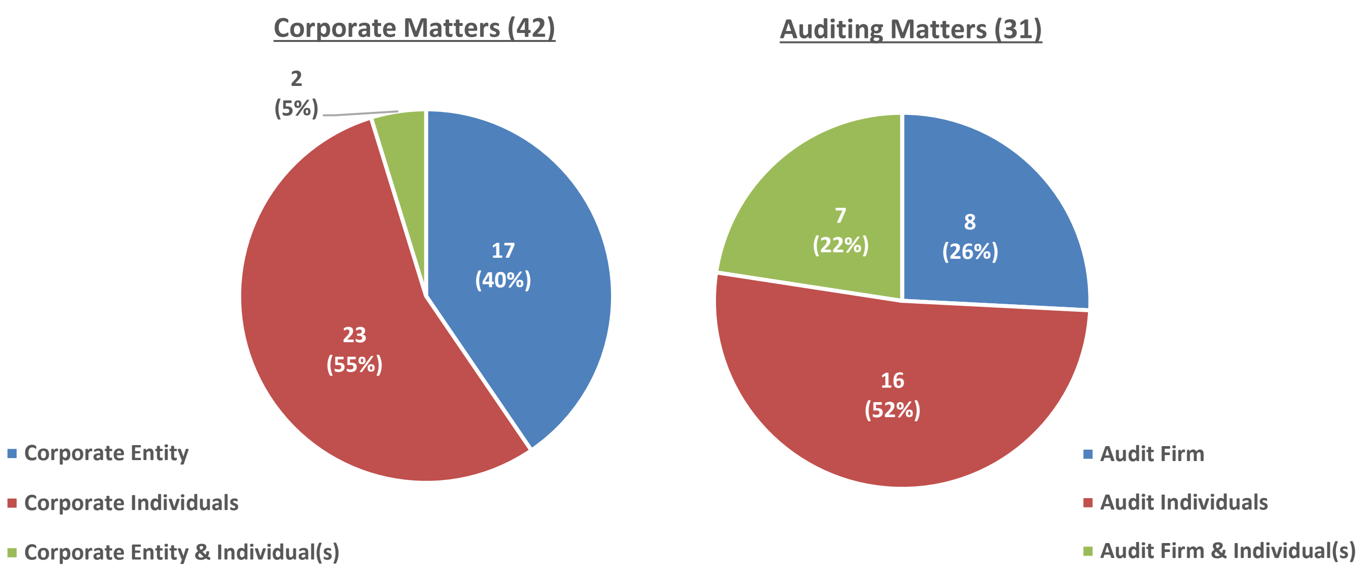
Resolution Type and Respondent Type

Resolution Type (Orders Filed)



Resolution Type (Orders Filed) – On a combined basis, over 80% of the orders filed were resolved through settlement, with only 6% being litigated, reinforcing settlement as the historically predominant resolution type. For the SEC, 77% of the orders filed were resolved through settlement, with 7% being litigated. The remaining SEC orders filed represented either accountant/auditor reinstatements (11%) or other resolution types (5%). All of the PCAOB orders filed were resolved through settlement.

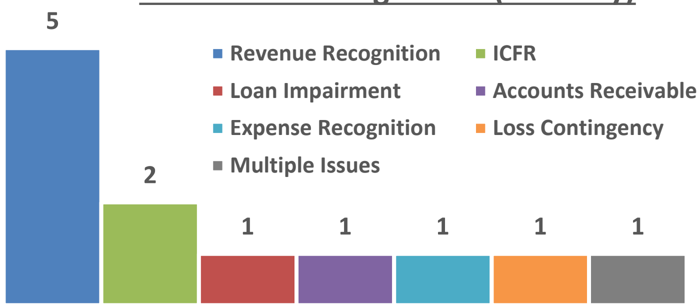
Respondent Type (Orders Filed)



Respondent Type (Orders Filed) – For Corporate Matters, individuals were respondents at a somewhat higher rate (55%) than corporate entities (40%), with only 2 AAER filings combining individuals and the entity. For Auditing Matters, individual auditors were respondents at a higher rate (52%) than audit firms (26%), or for orders combining individual auditors and the audit firm (22%).

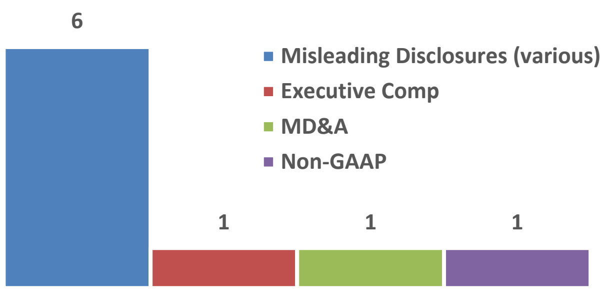
Financial Reporting Matters – Issues and Charging Decisions

GAAP Accounting Issues (SEC only)



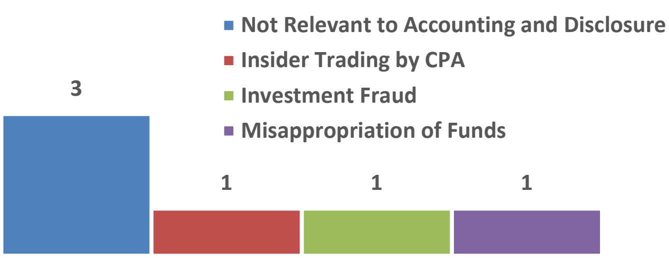
GAAP Accounting Issues - Consistent with historic trends, improper revenue recognition was the most frequent alleged primary GAAP issue (5 matters, all under the previous standard, ASC 605), followed by inadequate internal controls (2 matters). Accounts receivable, expense recognition, loan impairment, and loss contingencies represented the alleged primary GAAP issue in one unique matter each. With a new revenue recognition standard in place since 2018 (ASC 606), SEC cases alleging ASC 606 violations will likely materialize in the near term as post-2018 periods are scrutinized.

GAAP/SEC Disclosure Issues (SEC only)



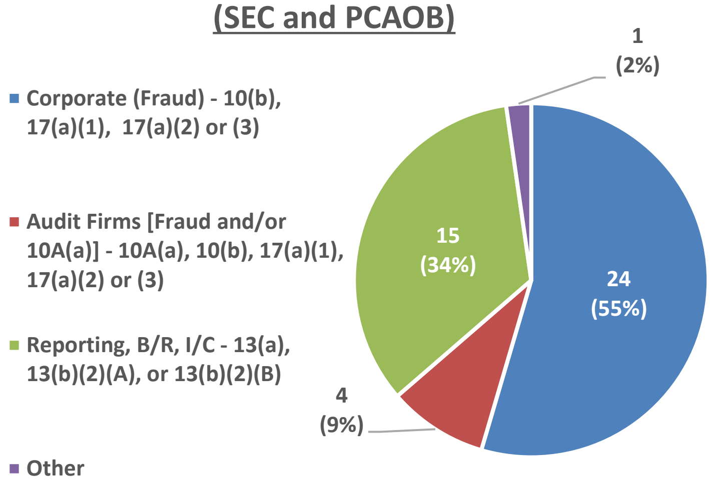
GAAP/SEC Disclosure Issues – Among Disclosure issues, alleged misleading disclosures (on a variety of topics) was the most frequent. Executive compensation, MD&A, and Non-GAAP financial measures represented the alleged primary Disclosure issue in one unique matter each. Although the latter three categories were infrequent this period, they have each represented areas of focus for the SEC in recent years.

Other Financial Reporting Issues (SEC only)



Other Financial Reporting Issues – Investment fraud, misappropriation of funds, and insider trading by a CPA represented the alleged primary issue in one unique matter each. These case types may not always be coded as AAERs by the SEC; accordingly, the low frequency shown here may not represent all such cases filed by the SEC during the period.

Charging Decisions - Financial Reporting Matters (SEC and PCAOB)

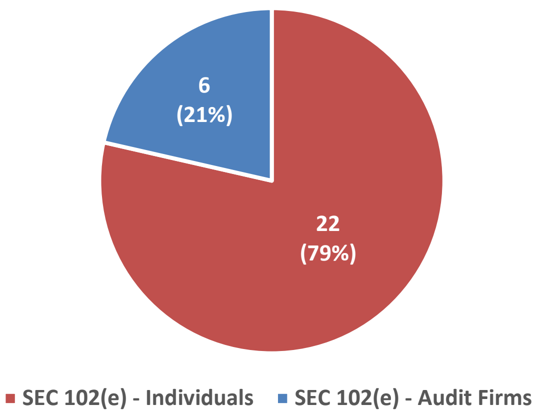


Financial Reporting Charging Decisions - Fraud v. Non-Fraud Matters – For corporate and auditing matters alleging some type of financial reporting violation (44 unique matters), approximately two-thirds included fraud charges [10(b) or 17(a)(1), (2) or (3)] against either corporate entities/individuals (55%), or against audit firms (9%) (including 10A violations against audit firms). Alternatively, approximately one-third (34%) of these matters excluded fraud charges, instead charging some combination of reporting, books & records, or internal controls violations [13(a), 13(b)(2)(A) or 13(b)(2)(B)]. We intend to track these trends going forward; however, as a general observation, the fact that nearly two-thirds of these financial reporting matters included fraud charges is not significantly inconsistent with past trends. At the same time, the critical mass of non-fraud matters (34%) may reflect continued improvement in internal controls and governance over time.

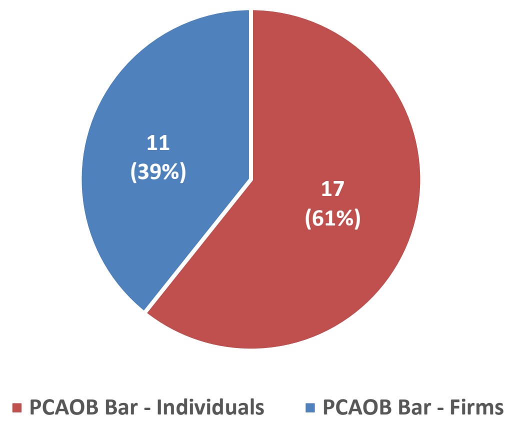
Auditing Matters - SEC 102(e) Suspensions and PCAOB Bars

Individuals v. Audit Firms

SEC 102(e) Suspensions (28)



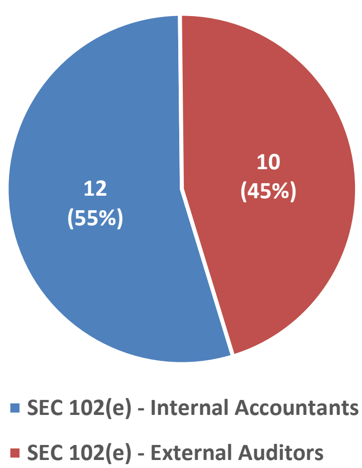
PCAOB Bars (28)



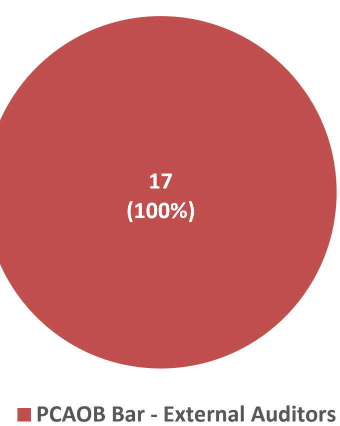
102(e) Suspensions/PCAOB Bars – Individuals v. Audit Firms – A total of 56 suspensions/bars were instituted during the period, split evenly between SEC 102(e) Suspensions and PCAOB Bars (28 each). Nearly 80% of SEC 102(e) Suspensions were of individuals, compared to just over 60% of PCAOB Bars. Conversely, nearly 40% of PCAOB Bars were audit firms, compared to just over 20% of SEC 102(e) Suspensions. The higher relative incidence of PCAOB audit firm bars compared to the SEC may simply reflect the mix of cases filed during the period, or may, in part, reflect a higher incidence of PCAOB matters involving smaller audit firms compared to the SEC, whereby a firm bar may be more likely if firm policies, procedures and systems are less robust or developed.

Individuals: Internal Accountants v. External Auditors

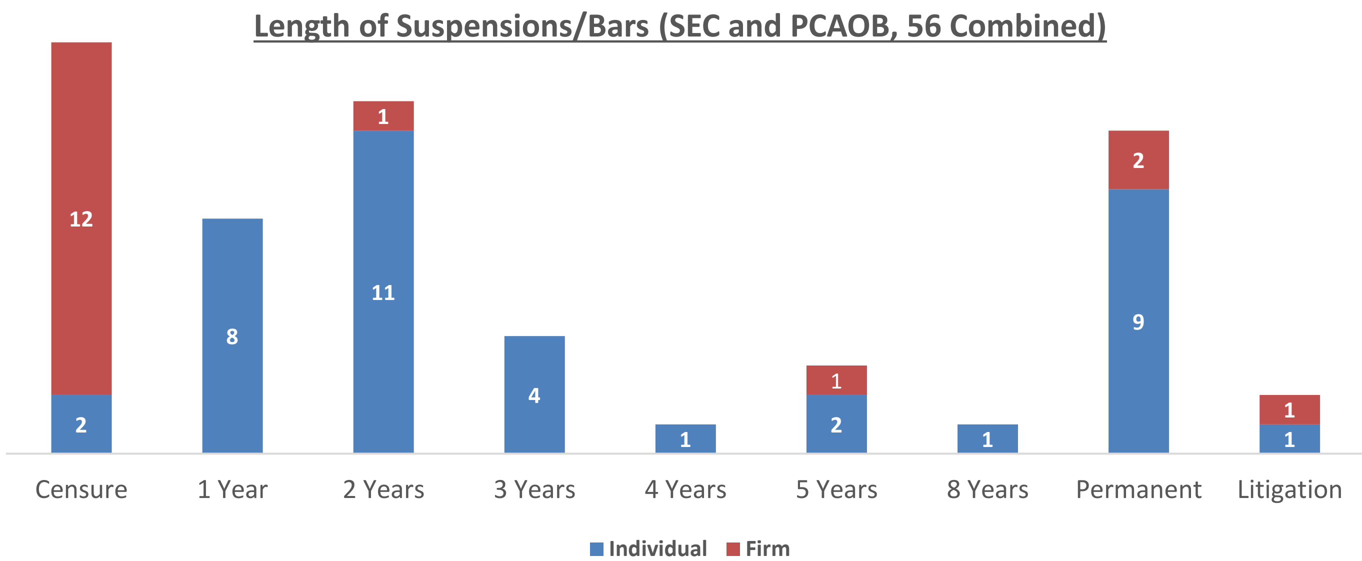
SEC 102(e) Suspensions of Individuals (22)

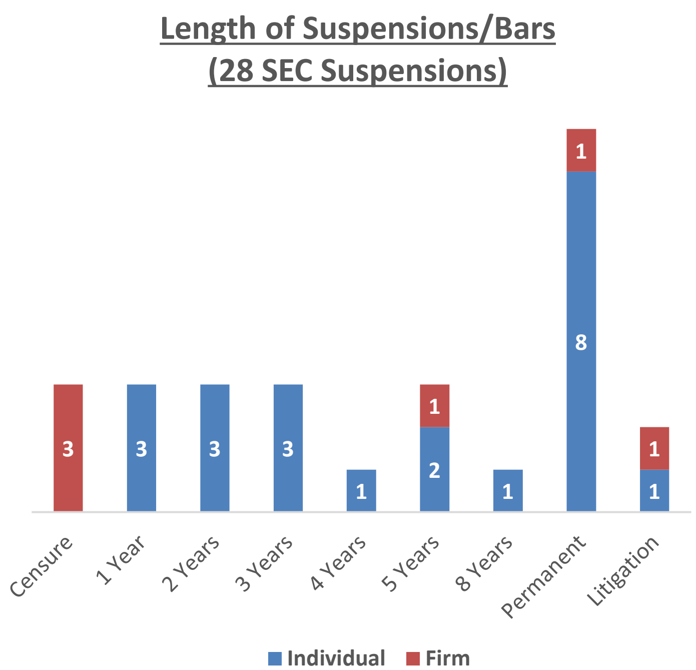


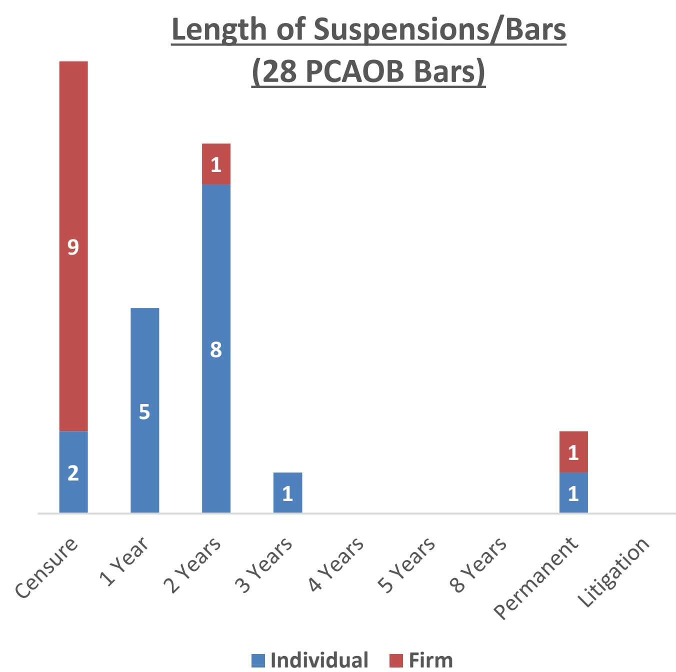
PCAOB Bars of Individuals (17)



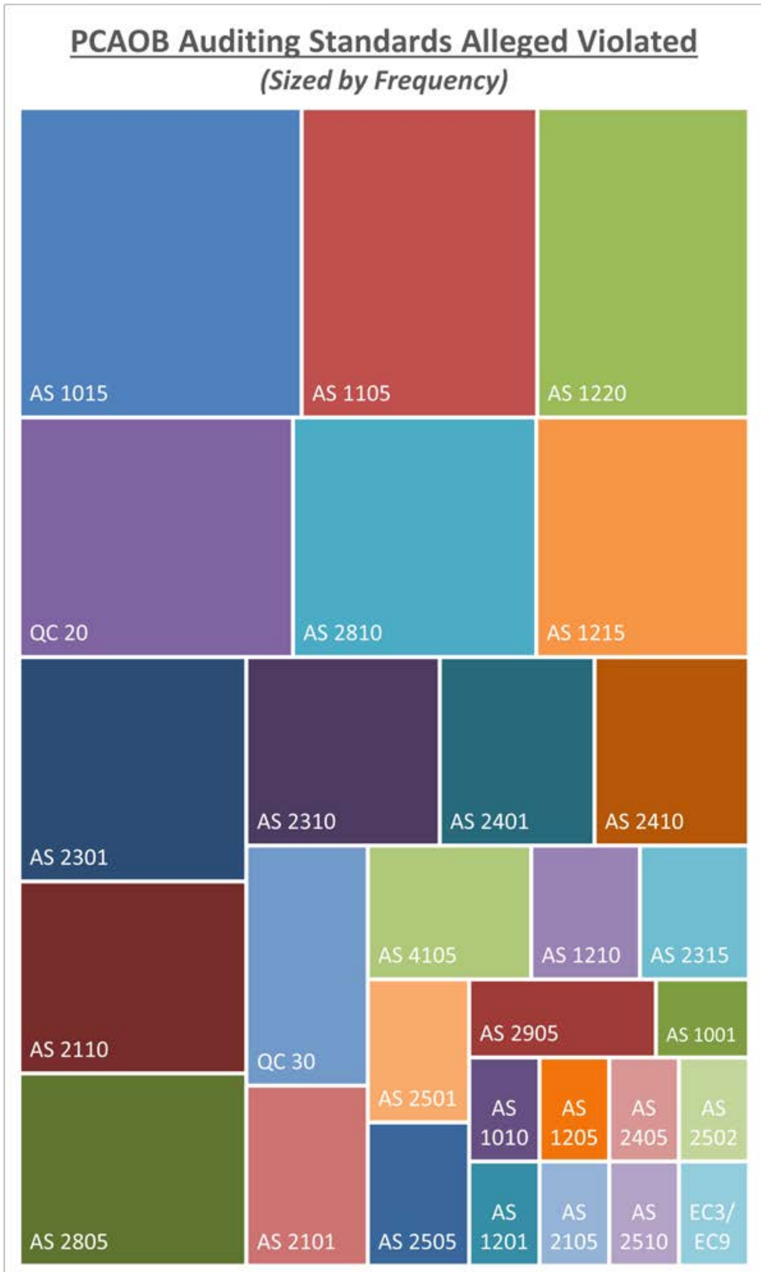
102(e) Suspensions/PCAOB Bars – Internal Accountants v. External Auditors – Of the 56 suspensions/bars filed during the period, 39 (22 SEC, 17 PCAOB) were against individuals as opposed to audit firms. Since the PCAOB only has jurisdiction over external auditors, all of the PCAOB Bars of individuals (17) were against external auditors. The SEC has jurisdiction over both external auditors and internal company accountants; the 22 SEC 102(e) Suspensions involving individuals were split nearly even between internal accountants (12) and external auditors (10). While the SEC considers many factors when instituting a 102(e) Suspension against an internal company accountant, the SEC's focus on internal company accountants is a standard component of its 102(e) program and no doubt will continue.







Length of Suspensions/Bars – Of the 56 SEC 102(e) Suspensions and PCAOB Bars instituted during the period by the SEC and PCAOB, both censures (a time-out period of "zero" years) against firms, and permanent suspensions/bars (no right to re-apply for reinstatement) against individuals, were prevalent during the period. The PCAOB filed the large majority of the censures, while the SEC filed the large majority of the permanent suspensions. For suspensions/bars with the right to re-apply for reinstatement after a discrete time period, the significant majority were against individuals, with 1 to 2 years representing the most common time-out period and 3 to 5 years occurring less frequently. The 1 to 2-year time-outs were predominantly filed by the PCAOB, while the SEC time-based suspensions were fairly evenly split along the 1 to 5-year time-out period. The SEC and PCAOB consider many factors in determining these suspension periods; therefore, the time-outs being at the lower end of the range may not represent any particular trend and could simply reflect less-severe violative conduct during the period. Notably, one SEC 102(e) suspension was an outlier at 8 years, a unique resolution since time-based suspensions beyond 5 years are rare. Finally, two (2) SEC 102(e)s were filed on a litigated basis, demonstrating the SEC's continued willingness to litigate 102(e) suspensions when it deems necessary.



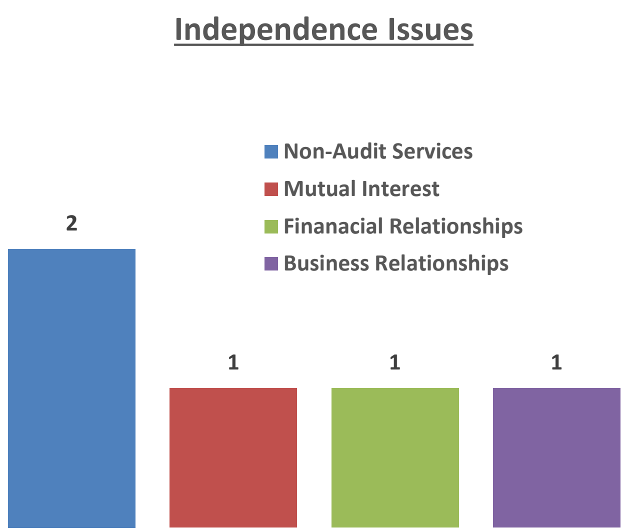
PCAOB Standards Charged (Frequency)	
AS 1015	Due Professional Care in Performance of Work (12)
AS 1105	Audit Evidence (10)
AS 1220	Engagement Quality Review (9)
QC 20	System of Quality Control for a CPA Firm's Accounting and Auditing Practice (9)
AS 2810	Evaluating Audit Results (8)
AS 1215	Audit Documentation (7)
AS 2301	Auditor's Responses to the Risks of Material Misstatement (7)
AS 2110	Identifying and Assessing Risks of Material Misstatement (6)
AS 2805	Management Representations (6)
AS 2310	Confirmation Process (5)
AS 2401	Consideration of Fraud in a Financial Statement Audit (4)
AS 2410	Related Parties (4)
QC 30	Monitoring a CPA Firm's Accounting and Auditing Practice (4)
AS 2101	Audit Planning (3)
AS 4105	Reviews of Interim Financial Information (3)
AS 1210	Work of a Specialist (2)
AS 2315	Audit Sampling (2)
AS 2501	Auditing Accounting Estimates (2)
AS 2505	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments (2)
AS 2905	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report (2)
AS 1001	Responsibilities and Functions of the Independent Auditor (1)
AS 1010	Training and Proficiency of the Independent Auditor (1)
AS 1201	Supervision of the Audit Engagement (1)
AS 1205	Part of the Audit Performed by Other Independent Auditors (1)
AS 2105	Consideration of Materiality in Planning and Performing an Audit (1)
AS 2405	Illegal Acts by Clients (1)
AS 2502	Auditing Fair Value Measurements and Disclosures (1)
AS 2510	Auditing Inventories (1)
EC3/EC9	Ethics Code (1)

Auditing Matters – Auditing Standards Alleged Violated

SEC and PCAOB auditing matters during the period alleged violations of a wide variety of PCAOB auditing and related standards. Summary observations include:

- The long list of individual standards alleged violated during the period indicates the broad scope of SEC and PCAOB enforcement over alleged audit failures. Issues spanned the entire audit process, including audit planning, training and supervision, a wide variety of audit testing issues, and audit reporting – as well as less common issues such as interim reviews, illegal acts, and an ethics code violation.
- Certain of the most frequently alleged violations were in areas often charged, including due professional care, audit evidence, evaluating audit results, and audit documentation. Alternatively, less common issues, including engagement quality review (AS 1220) and the system of quality control for accounting/auditing practices (QC 20), were among the most frequently charged during the period.
- Many of the alleged audit testing violations were in areas often charged, but also included areas less commonly charged, such as the confirmation process (AS 2310), audit sampling (AS 2315), and inquiries of a client's lawyer (AS 2505), among others.

Auditing Matters – Independence Issues



Independence Issues – Auditor Independence is an important area of SEC and PCAOB enforcement activity. While a modest number of cases were filed during the period, scrutiny of the issues involved can signal potential focus areas and/or expand the range of issues the SEC and PCAOB may consider in the future. Two SEC matters filed during the period involved prohibited non-audit services, both involving larger firms and alleging violations across multiple client engagements. A unique PCAOB matter filed during the period involved an alleged improper "mutual interest" related to an audit firm organizing conferences to obtain investor exposure for certain companies, of which several were also audit clients. Additional discussion of these matters is included in the next sections.

Additional Notable Issues and Trends

Revenue Recognition – A range of issues were alleged by the SEC within its revenue recognition enforcement, including, among others: (i) engaging in a variety of practices to falsify and accelerate revenue recognition by top management of a smaller issuer (DS Healthcare: AAERs 4070 and 4071); (ii) using non-monetary transactions to improperly increase revenue recognition (Comscore, Inc.: AAERs 4091 and 4092); and (iii) failing to provide MD&A Item 303 trend and uncertainty disclosures for pulling-in sales scheduled for future periods that would reduce future sales and not be replaced (Marvell Technology Group: AAER 4076).

Other GAAP and Reporting Issues – Beyond revenue recognition, the SEC alleged other GAAP and reporting violations, including, among others: (i) failing to recognize losses on past-due royalties and related practices to hide growing receivable balances (Iconix Brand Group: AAER 4105 and related legal complaint); (ii) failing to record expense accruals and misclassifying certain income from continuing operations (PPG Industries: AAER 4094); (iii) failing to remediate material weaknesses in ICFR after reporting weaknesses for multiple consecutive years (Northwest Biotherapeutics: AAER 4099); and (iv) releasing materially misstated financial results despite known ERP systems issues, key employee departures, and material weaknesses (Calumet Specialty Products Partners: AAER 4102).

Disclosure Issues – The SEC alleged a variety of disclosure issues, including, among others: (i) misleading investors on the number of new vehicles sold, and falsely touting a "streak" of uninterrupted sales growth (Fiat Chrysler: AAER 4095); (ii) failing to provide MD&A Item 303 trend and uncertainty disclosures for material issues concerning two primary cash flow sources —customer sales and short-term borrowings (StoneMor Partners: AAER 4107); and (iii) manipulating and falsely reporting a key non-GAAP financial measure (Brixmoor Property Group: AAER 4061 and related legal complaint).

Audit Failures – Both the PCAOB and SEC were active in audit failure enforcement, alleging a range of auditing standards violations. Alleged issues included, among others: (i) PCAOB matters involving backdating and alteration of audit workpapers by foreign affiliates of global network firms in connection with PCAOB inspections (Releases 105-2019-025 and 105-2019-028); (ii) PCAOB matters involving failures by foreign affiliates of global network firms to disclose reportable events to the PCAOB, including disciplinary proceedings (Releases 105-2019-029 and 105-2019-030); and (iii) the SEC's settlement with an individual related to unauthorized disclosure of confidential information from the PCAOB to a global network firm, allegedly used to improve the firm's annual PCAOB inspection results (AAER 4103).

Additional Notable Issues and Trends (continued)

Auditor Independence – Both the PCAOB and SEC filed matters in alleging auditor independence violations, including, among others: (i) an SEC matter involving a US firm's failure to identify and avoid prohibited non-audit services and employment relationships for at least 15 audit clients (AAER 4066); (ii) an SEC matter involving a US firm's provision of prohibited non-audit services related to software implementation for one client, and failing to obtain audit committee pre-approval for 15 SEC-registrant clients (AAERs 4084 and 4085); and (iii) a PCAOB matter involving covered persons having personal financial relationships with a bank client, inconsistent with SEC independence criteria (Release 105-2019-017).

Reinstatements – In one matter, the SEC reinstated a CPA to appear and practice before the Commission as an accountant responsible for the preparation or review of financial statements required to be filed with the Commission. The CPA did not seek to be reinstated to appear or practice before the Commission as a member of an audit committee, and the reinstatement order indicated the CPA would be required to submit a separate application to be considered for reinstatement in that capacity (AAER 4072).

Case Spotlights – GAAP and Disclosure

GAAP: Mylan Pharmaceuticals (AAER 4096) – The SEC charged Mylan with negligence-based fraud, reporting, books and records, and internal control violations, and assessed a $30 million penalty, for alleged failures to disclose and accrue a loss contingency related to a DOJ probe of Medicaid charges for Mylan's EpiPen product. SEC enforcement cases for ASC 450 loss contingency violations are somewhat infrequent, making this a notable matter. At the same time, the Mylan matter has some similarities to the RPM International matter filed in 2016 (LR 23639) that alleged ASC 450 violations regarding a DOJ legal probe. However, unlike RPM, which focused on information not being shared internally on the status of DOJ negotiations, in Mylan the SEC alleged that executives – including those involved in preparation of the financial statements – were aware of the progress of the DOJ negotiations. In Mylan the SEC also alleged that disclosure was required by Q3 2015 because a loss was "reasonably possible," and further alleged that accrual and disclosure was required by Q2 2016 because the loss was "probable" and "reasonably estimable" by that time, essentially taking a "stair-step" approach to the criteria in ASC 450. The SEC also alleged misleading risk factor disclosures regarding the classification of EpiPen as a generic drug. This matter demonstrates the SEC's willingness to pursue loss contingency matters that can potentially involve complex judgments and fact patterns.

Disclosure: Nissan Motor Co., Carlos Ghosn and Gregory Kelly (AAERs 4086 and 4088) – While much media attention has been given to Mr. Ghosn's detainment and escape from Japanese custody, the SEC's disclosure allegations in the Nissan/Ghosn matter are also worth considering. The SEC charged Nissan, Ghosn and Kelly with scienter-based fraud for alleged failures to disclose over $90 million of approved, but unpaid compensation to Mr. Ghosn from 2009 – 2017. The case alleged a range of steps taken by Ghosn and Kelly to avoid disclosure of the unreported compensation, including payment through related entities, secret contracts to secure payment post-retirement, back-dated long-term incentive payment grants, and an over-$50 million inflation of Mr. Ghosn's pension allowance and related false disclosure to disguise the increase. This matter demonstrates the SEC's continued focus on proper disclosure of executive compensation.

Case Spotlights – Audit Failure and Auditor Independence

<u>Audit Failure: Anton & Chia LLP and A&C Individual Auditors (AAER 4080)</u> – The SEC filed a litigated audit failure matter against Anton & Chia LLP and various A&C individual auditors in late-2017, with A&C settling the case in this September 2019 AAER. In addition to 102(e) proceedings, the matter also included 10(b) fraud charges against A&C. The case highlighted a significant range of alleged audit failures across three microcap public-company audit engagements undertaken by A&C. This matter provides an example of the types of audit failure violations that in aggregate can result in fraud charges against an audit firm, particularly in the microcap space. The SEC has historically filed similar matters involving audit firms, yet the A&C case is notable for the detailed descriptions of the alleged audit failures across three separate public company audits in relatively similar time frames.

<u>Auditor Independence: Marcum LLP and Marcum Bernstein & Pinchuk LLP (Releases 105-2019-022 and -023)</u> – The PCAOB instituted settled disciplinary proceedings against US-based Marcum LLP and MarcumBP LLP, regarding independence violations due to each firm's hosting of an investor conference to present public companies to potential investors while also auditing certain of the featured companies. The PCAOB alleged that Marcum LLP's and MarcumBP's independence was impaired, on 62 and 7 issuer audit clients, respectively. The core of the PCAOB's alleged independence violations centered on both firms' public advocacy for issuer clients as high-quality investment opportunities, creating a mutuality of interest between the firm and the client regarding whether the client's subsequent performance would live up to the firm's billing. These matters represent somewhat unique independence fact patterns and alleged violations, and demonstrate that the PCAOB is willing to aggressively pursue independence matters.

Notes

<u>Sources</u> - SEC AAERs and PCAOB Orders during the relevant period were sourced from the SEC website's "Accounting and Auditing Enforcement Releases" archive and the PCAOB website's "Enforcement" section, respectively. To the extent that an SEC matter related to financial reporting or auditing was not coded as an AAER by the SEC, for whatever reason, any such matter was not included in this analysis.

<u>Assumptions</u> – Assumptions were made in grouping certain data points for purposes of this analysis, including: (i) combining individual SEC AAERs or PCAOB Orders related to the same matter in order to determine the number of unique matters during the period; (ii) selecting a "primary" accounting, disclosure, or auditing issue when multiple issues were alleged in a matter, based on our review of the relevant filings; and (iii) classifying financial reporting and auditing matters into "fraud" and "non-fraud" matters based on the charges alleged. It should be noted that this classification process did not necessarily consider every charge/violation alleged in the matter, only those required to make the classification noted.

<u>Disclaimer</u> – Commentary included in this analysis is based solely on Credibility's review of the allegations and facts presented in the publicly-available SEC AAERs and PCAOB Orders. Further, commentary included in this analysis does not represent conclusions or opinions on the veracity of the allegations or the facts described in the filings by any employee of Credibility International LLC.

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