Debevoise & Plimpton

Accounting & Financial Reporting Enforcement Round-Up

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Although announcements of significant accounting and financial reporting enforcement cases against public issuers appear to have slowed in recent months, cases against auditors and audit firms have generated headlines. These cases included charges brought by the U.S. Department of Justice ("DOJ") and U.S. Securities and Exchange Commission ("SEC") against former senior-level accountants at a major firm for allegedly misappropriating confidential information related to planned Public Company Accounting Oversight Board ("PCAOB") inspections. Calling the alleged conduct "disturbing," SEC Chairman Jay Clayton issued his own public statement to assure market participants that he did not believe the charges would "adversely affect the orderly flow of financial information to investors and the U.S. capital markets." This action also placed significant focus on the movement of personnel from the government to the private sector and the importance of following the rules that govern such transitions.

In other developments, the SEC Enforcement Division's chief accountant, Michael Maloney, announced his departure in January and a permanent successor has not yet been named. Serving in that role since February 2014, and leading the more than 100 accountants in the Enforcement Division, Maloney's tenure at the SEC included significant accounting and financial reporting enforcement matters – many of which have been the subject of items in prior issues of this Round-Up.

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In addition to the DOJ and SEC actions noted above, this issue of the Round-Up includes discussion of a recent federal appeals court decision overturning PCAOB sanctions against a former audit partner because his request for an accounting expert to attend investigative testimony was denied. This issue also highlights an SEC case against foreign affiliates of major audit firms, along with two SEC actions against public issuers – one regarding an energy company's revenue recognition issues and a second regarding an internal controls material weaknesses found at a pharmaceutical company.

SEC and DOJ Charge Five Former KPMG Employees with Using Leaked Information to Pass PCAOB Inspections

Parallel charges filed by the SEC and DOJ in January 2018 alleged that five senior-level employees at KPMG participated in a scheme to obtain and misuse confidential information about upcoming PCAOB inspections. In particular, while preparing to take a new job with KPMG, Brian Sweet—an Associate Director in the PCAOB's inspections group—downloaded confidential information about upcoming inspections that he later used at KPMG in an effort to help the firm avoid potential audit deficiency findings. He later obtained additional PCAOB materials from other PCAOB staffers who sought jobs at KPMG. According to the federal indictment, the leaked information enabled KPMG "to analyze and revise audit work-papers in an effort to avoid negative findings by the PCAOB."

- **History of PCAOB Deficiencies** – The PCAOB inspects the largest U.S. accounting firms each year by making a selection of the firms' various audits for closer review. The PCAOB does not publicly disclose its selections or areas of focus until shortly before an inspection takes place. After completing an inspection the PCAOB issues an inspection report that includes any negative findings or comments regarding the specific audits reviewed and the selected accounting firm more generally, which the PCAOB shares with the SEC. According to the SEC order, in September 2014, the PCAOB found that 46 percent of the KPMG audits it inspected were deficient. In response, three partners from KPMG's National Office engaged in a concerted effort to improve these results, which included recruiting Sweet and other employees from the PCAOB.
- **Wide-Ranging Allegations** – SEC Chairman Jay Clayton issued a public statement highlighting the severity of the allegations in this case. The alleged facts described a culture of encouraging misconduct in connection with the PCAOB inspection process, both by KPMG and PCAOB employees. For example, the DOJ indictment noted that after joining KPMG, a former PCAOB staffer was told to remember where his "paycheck came from and be loyal to KPMG." The indictment also explained that individuals at KPMG and the PCAOB discussed obtaining "burner" phones and communicating indirectly through their spouses to avoid detection. Notably, KPMG itself was not charged in connection with the alleged misconduct.

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- **Severe Penalties** – Among the six defendants were senior KPMG personnel, including KPMG's former national managing partner for audit quality and professional practice and the firm's former national partner-in-charge for inspections. They all face criminal charges of conspiracy to defraud the United States, conspiracy to commit wire fraud, and wire fraud. Three of the defendants face prison sentences of up to 85 years. Sweet pleaded guilty to the criminal charges and agreed to a settlement with the SEC that, among other penalties, bars him from appearing or practicing before the SEC as an accountant. The remaining defendants have not settled with the SEC.

The SEC settlement order with Brian Sweet can be found here: https://www.sec.gov/litigation/admin/2018/34-82557.pdf.

The DOJ's information against Brian Sweet can be found here: https://www.justice.gov/usao-sdny/press-release/file/1027796/download.

The SEC order against the remaining defendants can be found here: http://www.sec.gov/litigation/admin/2018/34-82556.pdf.

The DOJ's indictment against the remaining defendants can be found here: https://www.justice.gov/usao-sdny/press-release/file/1027801/download.

D.C. Circuit Overturns PCAOB Sanctions, Holds Right to Counsel includes Accounting Expert

A former Ernst & Young LLP ("EY") audit partner's PCAOB sanctions were overturned by the U.S. Court of Appeals for the D.C. Circuit in a March 23, 2018 opinion. The PCAOB had suspended Mark Lacetti from the accounting profession for two years and fined him $85,000 in connection with findings that he failed to exercise due professional care during EY's audit of the 2004 financial statements of an Israeli pharmaceutical company's U.S. subsidiary. The SEC later sustained the PCAOB's findings and sanctions. On appeal, the D.C. Circuit held that the PCAOB infringed Lacetti's right to counsel when it did not permit an EY accounting expert who was part of EY's legal department to attend investigative testimony to assist Lacetti's defense.

Under the PCAOB's rules, investigative testimony witnesses are permitted to be accompanied by counsel. The rules also permit attendance of "other persons" the PCAOB determines "appropriate." The PCAOB argued that it could bar the accounting expert on the basis that the expert was employed by EY and the PCAOB did not want EY personnel present for testimony. However, Lacetti was represented by an in-house EY attorney during testimony, a fact that the D.C. Circuit found to entirely undercut the reasonableness of the PCAOB's justification for excluding the EY accounting expert.

- **Potential for Unaffiliated Accounting Expert Attendance** – The D.C. Circuit also made clear that even if Lacetti had been represented by an attorney unaffiliated with EY, the PCAOB could still not have properly denied his request to also be accompanied by an accounting expert. Although the PCAOB might have been able to reasonably deny an accounting expert employed by EY from attending in those circumstances on the basis that it could prevent EY generally from monitoring the testimony, Lacetti would have been entitled to an accounting expert unaffiliated with EY in order to assist his counsel.
- **Narrow Opinion** – The D.C. Circuit acknowledged that its opinion was narrow. Because the D.C. Circuit based its opinion on the PCAOB's rules, and not constitutional or statutory authority, the PCAOB remains free to change its rules in order to exclude accounting experts from testimony in the future.

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- **Comparison to SEC Practice** – SEC-focused practitioners might draw comparison to the D.C. Circuit's 1985 *SEC v. Whitman* opinion, which similarly permitted a witness's right to counsel to extend to an accounting expert when the witness's attorney determines, in his or her professional judgment, that such assistance is essential to the client's representation. Because *Whitman* was decided on the basis of the Administrative Procedure Act ("APA"), the PCAOB had tried to distinguish the right to counsel in its rules as something less than that provided by the APA. However, the D.C. Circuit found "no meaningful distinction between the right to counsel in the APA and the right to counsel in the [PCAOB's] rules."

The D.C. Circuit's opinion can be found here: https://www.cadc.uscourts.gov/internet/opinions.nsf/56F33A79D5CF078C85258259004D4D87/$file/16-1368.pdf.

The SEC's September 2, 2016 opinion sustaining the PCAOB's findings and sanctions can be found here: https://pcaobus.org/Enforcement/Adjudicated/Documents/Laccetti-SEC-34-78764.pdf.

Foreign Affiliates of Three Major Audit Firms Agree to Settle SEC's Improper Audit Findings

Foreign affiliates of three major audit firms reached settlements related to findings that they circumvented PCAOB oversight. The March 13, 2018 settlement orders highlighted that Zimbabwean affiliates of KPMG and Deloitte audited the majority of assets and revenues of a publicly traded company incorporated in Canada and based in South Africa without registering with the PCAOB. In turn, the company's principal auditors, KPMG's South African affiliate and BDO's Canadian affiliate, settled findings that they improperly relied upon the work of the unregistered Zimbabwean affiliates.

The audit client, which is not named in the orders, was registered with the SEC and filed periodic reports, including on Form 20-F. The principal auditors from KPMG's South African affiliate and BDO's Canadian affiliate were registered with the PCAOB. Disgorgement and civil penalties to be paid by the foreign affiliates totaled almost $400,000.

- **Continued Focus on Foreign Affiliates of Audit Firms** – As has been consistently highlighted in prior issues of the Round-Up, the use of member network firms abroad remains a specific point of regulatory focus. The SEC and PCAOB have clearly signaled their intent to enforce compliance with PCAOB rules, even if the affiliate firm conducting the audit is not based in the United States.
- **Audit Firm Transition** – Although not directly addressed in the settlement orders, it is interesting that two separate audit firm networks failed to identify the PCAOB registration issues raised in this matter. BDO's Canadian affiliate served as the principal auditor from 2006 to 2012 and relied on audit work performed by Deloitte's Zimbabwean affiliate during that time. The SEC found BDO's Canadian affiliate mistakenly considered the relevant issues under Canadian (and not U.S.) auditing standards. KPMG's South African affiliate served as the principal auditor in 2013 and 2014 and relied on audit work performed by KPMG's Zimbabwean affiliate during that time. The SEC found the South African affiliate knew that the Zimbabwean affiliate was not registered with the PCAOB, but was apparently unaware that PCAOB registration might be required in 2013 and only identified the potential issue just before signing its 2014 audit report.

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- **Implications for Public Issuers** – The continued regulatory focus on foreign affiliates of audit firms also presents potential concerns for public issuers. Issuers should work with their auditors to make sure appropriate compliance measures are in place if foreign affiliates are being relied upon for a substantial component of the audit. Violations by audit firms can jeopardize issuers' abilities to make timely filings and, in some circumstances, could ultimately result in the time-consuming and costly process of engaging a new audit firm. In particular, issuer audit committees may consider scrutinizing the use of foreign affiliates of their audit firm as part of their auditor engagement and oversight processes.

The SEC settlement order with BDO's Canadian affiliate can be found here: http://www.sec.gov/litigation/admin/2018/34-82859.pdf.

The SEC settlement order with Deloitte's Zimbabwean affiliate can be found here: http://www.sec.gov/litigation/admin/2018/34-82861.pdf.

The SEC settlement order with KPMG's South African affiliate can be found here: http://www.sec.gov/litigation/admin/2018/34-82860.pdf.

The SEC settlement order with KPMG's Zimbabwean affiliate can be found here: http://www.sec.gov/litigation/admin/2018/34-82862.pdf.

Recidivist Energy Company Agrees to Settle SEC Revenue Recognition Findings

Maxwell Technologies, Inc. ("Maxwell"), a California-based energy company, agreed to settle SEC findings that it issued materially false and misleading statements by improperly recording $19 million in revenue before it qualified for recognition under U.S. GAAP. As found by the SEC, from December 2011 through January 2013, Maxwell consistently touted an aggressive strategy to realize double-digit revenue growth in its ultracapacitor product line. Ultracapacitors are small energy storage and power delivery devices used for consumer products including automobiles, back-up power suppliers, and wireless communications devices. As explained in the SEC's settlement order, growth of Maxwell's ultracapacitor product line was closely tracked by market analysts and was material to investors.

Without admitting or denying the SEC's findings, Maxwell and a former senior sales employee, as well as Maxwell's former CEO and controller, agreed to cease and desist orders. The securities law violations settled by Maxwell and the former senior sales employee included fraud under Section 10(b). Additionally, Maxwell agreed to pay a $2.8 million civil penalty. The individuals also accepted monetary penalties and the senior sales employee agreed to a five-year director and officer bar.

- **Focus on Revenue Recognition** – The SEC found that Maxwell employed multiple fraudulent revenue recognition schemes in order to overstate revenue and outperform analysts' expectations. Indeed, the settlement order explained that Maxwell entered into side deals with customers in order to provide contingent payment terms with a full right of return, as well as channel stuffing, extending payment terms, falsifying sales documents, and asking distributors to order products they did not want or need shortly before quarter-end dates. Improper revenue recognition via fraudulent sales strategies appears to remain a focus of the SEC's financial reporting efforts, despite a perceived downturn in the overall number of actions brought against public issuers in recent months.
- **Recidivist Conduct** – The SEC highlighted that Maxwell was a recidivist actor. In January 2011, Maxwell agreed to settle DOJ and SEC Foreign Corrupt Practices Act charges for $14.3 million. It is likely that the relatively recent settlement of other significant charges colored the SEC's perception of Maxwell during the investigation and could have contributed to the decision to pursue fraud violations under Section 10(b) against the former senior sales employee found to have directed much of the conduct and Maxwell itself. At the same

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time, it is difficult to know how much that recidivism impacted the level of corporate penalty, since the penalty in this matter was lower than the earlier FCPA penalty.

- **"Tone at the Top" and Internal Controls** – The decision to charge Maxwell under Section 10(b) was also likely colored by findings related to the "tone at the top" of Maxwell's organizational structure. The SEC frequently examines the control environment executives cultivate and often views robust control environments as a mitigating factor when settling with defendants. At Maxwell, the tone at the top and control environment probably weighed in favor of a heftier sanction. The former CEO was found to have aggressively pressured the sales department to meet quarterly revenue growth and earnings targets and, in turn, Maxwell was found to have lacked sufficient controls to check sales employees engaging in improper practices in order to meet expectations communicated to them.

The SEC settlement order with Maxwell and the former employees can be found here:
https://www.sec.gov/litigation/admin/2018/33-10472.pdf

Pharma Company and Former Executives Settle SEC Claims of Internal Controls Violations

Akorn, Inc. ("Akorn"), an Illinois-based specialty generic pharmaceutical company, and two former executives settled a March 26, 2018 SEC complaint premised on claims that Akorn overstated its 2014 earnings. Akorn's former CFO and former controller agreed to each pay $20,000 civil penalties to settle the SEC's claims. The SEC did not require Akorn to pay a monetary penalty as part of the settlement.

In 2016, Akorn restated its 2014 earnings after management discovered that the company had overstated its revenue by approximately $38 million by improperly under-accruing rebates and contractual allowances under "gross-to-net" revenue accounting. Akorn sold drug products through pharmaceutical wholesalers and directly to retailers. As is typical of pharmaceutical sales, Akorn negotiated contract prices with both types of customers, which were often discounted from the list prices of the drugs. Occasionally wholesale customers sold Akorn's drug products to retailers at a price lower than the wholesaler's negotiated price with Akorn and would "charge back" the difference to Akorn. Similarly, a retailer might purchase Akorn's product from a wholesaler at a price higher than the retailer's negotiated price with Akorn. The retailer would "bill back" the excess over its directly negotiated price to Akorn.

To account for potential future obligations associated with these price differences, Akorn maintained gross-to-net reserve accounts. Akorn estimated its wholesaler charge-back liability at period-end based on the inventory wholesalers held and the historical percentage of products sold below wholesale acquisition price. Similarly, Akorn accrued for the retailer bill-back liability at period-end using actual invoices received from retail customers and estimates from sales data during the period.

From 2013 to 2015, Akorn management identified and publicly disclosed recurring material weaknesses in the company's controls over its gross-to-net reserve accounts. Akorn failed to design effective controls to validate the completeness and accuracy of the underlying data used to determine the reserves and thus did not have reasonable assurance that accounts were complete and accurate. Akorn attempted to remediate these control failures by implementing manual procedures to calculate reserves, but these new procedures did not sufficiently remediate the risk of material misstatement in the reserve accounts. Akorn restated its 2014 financial statements in 2016.

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- **Internal Controls Remediation Failures** – The restatement of 2014 financial statements in 2016 followed prior disclosures that Akorn had material weaknesses in its internal controls. The SEC's decision to pursue securities law claims against Akorn and its former executives was likely influenced by Akorn's failure to remediate known control weaknesses. The case also is the most recent in a series of cases over the last few years focused on deficient internal controls. Such matters often, but not always, involve a restatement.
- **Overreliance on Manual Controls Processes** – The SEC alleged that overreliance on manual controls processes and failure to use automated systems to identify and estimate reserves at period-end contributed to Akorn's persisting material weaknesses. Automated controls are almost always preferred for routinely performed processes, particularly those that are important to ensuring a company's financial statements are not materially misstated.
- **No Corporate Penalty** – Most prior cases involving deficient internal controls over the last few years have included some sort of corporate penalty. For example, L3 Technologies paid a $1.6 million penalty in January 2017 to settle internal control charges related to an alleged improper revenue recognition scheme. Likewise, in February 2017, network testing company Ixia paid a $750,000 penalty to settle internal control failure allegations arising from its revenue recognition practices. The absence of a corporate penalty in this case may signal that the current Commission will not approve corporate penalties in cases in which there is no corporate benefit to the company from the misconduct. Typically, it can be difficult to trace a corporate benefit to misconduct when the misconduct involved deficient internal controls.

The SEC complaint against Akorn and the former executives can be found here: https://www.sec.gov/litigation/complaints/2018/comp24082.pdf

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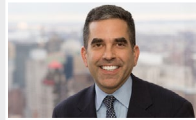

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