Accounting & Financial Reporting Enforcement Round-Up

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In the weeks leading up to the federal government's fiscal year-end on September 30, there was a notable increase in accounting and financial reporting enforcement actions brought by the U.S. Securities and Exchange Commission ("SEC" or "Commission"). During just the two weeks prior to its fiscal year-end, the SEC announced ten enforcement actions – resulting in civil penalties totaling more than $100 million – against companies and auditing firms for alleged violations involving accounting and financial reporting issues. This issue of the Round-Up highlights a number of these cases, as well as other notable accounting and financial reporting-related enforcement actions brought by the SEC during 2019, several of which involved parallel criminal charges brought by the U.S. Department of Justice ("DOJ").

Cases against auditors and audit firms have continued to generate headlines, including four recent actions against major firms. Three of these cases included allegations related to auditor independence, a perennial area of focus for the SEC. At the recent Securities Enforcement Forum in Washington, DC, Matt Jacques, chief accountant for the SEC's Division of Enforcement, described auditor independence as an issue that is near and dear to his heart, referring to his experience as an auditor in public accounting. Jacques cautioned that the SEC will continue to investigate "anything that is close to the line" in terms of auditor independence. The Commission also brought charges in 2019 against a major audit firm, alleging that former senior-level accountants at the firm misappropriated confidential information related to planned Public Company Accounting Oversight Board ("PCAOB") inspections. Five individuals have pleaded guilty or been convicted on criminal charges in connection with the matter. Separately, the SEC in December 2017 appointed new members to all five of the PCAOB board

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seats, and, subsequently, a number of senior level staffers, including the Director of Enforcement, departed. In early October, the SEC announced that, instead of reappointing one of those board members, it would be replacing her with former White House aide Rebekah Goshorn Jurata, suggesting that the PCAOB will likely continue to undergo changes.

This issue of the Round-Up also highlights cases reflecting the SEC Enforcement Division's continued focus on financial reporting issues such as non-GAAP reporting, revenue recognition, and impairment accounting. In 2019 alone, the SEC has brought more than five enforcement actions alleging violations based on fraudulent revenue recognition practices and related disclosures. Additionally, a recent case involving a REIT's reporting of non-GAAP measures highlights the SEC's continued scrutiny of such practices, especially in industries where non-GAAP measures are most commonly used and followed. This is the second SEC enforcement action involving a REIT's use of industry-specific non-GAAP measures, and both cases resulted in parallel criminal charges against the individuals involved with the underlying conduct.

The bottom line appears to be that while there was some drop off in financial reporting enforcement activity during much of the year, financial reporting does seem to continue to be an area of focus for the SEC. Steven Peikin, co-director of the SEC's Division of Enforcement, told practitioners during the recent Securities Enforcement Forum that the SEC will continue to focus on accounting fraud and issuer disclosure cases. Peikin noted that such cases are incredibly important to the SEC because it views financial disclosures as the bedrock of our financial system.

Court Orders Cryptocurrency Firm to Pay $6.8 Million for Falsifying Revenue and Fraudulently Securing NASDAQ Listing

On September 26, 2019, the U.S. District Court for the Southern District of New York entered a default judgment against Longfin Corp. ("Longfin"), a defunct fintech company that promoted cryptocurrency, holding it liable for more than $6.8 million after missing a deadline to respond to SEC allegations that the company and its CEO, Venkata Meenavalli, engaged in offering fraud and falsified Longfin's revenue in SEC filings. The SEC's action against Meenavalli and a parallel criminal action filed by the U.S. Attorney's Office for the District of New Jersey are ongoing. Longfin drew regulatory scrutiny in early 2018, which led to the company's decision to voluntarily delist from NASDAQ in May 2018 and ultimately cease operations last November.

- **Falsification of Revenue** – The SEC alleged that Longfin engaged in a large-scale accounting fraud in which it reported over $66 million in sham revenue, representing nearly 90% of the company's total reported revenue for 2017. According to the SEC's complaint, the scheme involved fictitious purchases and sales of bills of lading for the shipment of physical commodities, such as coal, copper, zinc, and nickel, for which Longfin never held title or ownership interests. Longfin made the revenue from these transactions appear legitimate by forging contracts and recording round-trip transactions that it entered into with entities controlled by Meenavalli, who signed several false contracts and invoices that were used in the transactions. Given this brazen fraud with completely sham revenue, it is no surprise that the criminal authorities determined this was an appropriate criminal action.
- **Fraudulent NASDAQ Listing** – According to the SEC's complaint, Longfin obtained qualification for a Regulation A+ offering in November 2017 after falsely representing in SEC filings that it was principally managed and operated in the United States and was therefore entitled to sell shares pursuant to Regulation A+. Although Longfin was incorporated in Delaware, the firm was managed entirely from Singapore. After qualifying under Regulation A+, the company realized that it could not sell enough shares to meet NASDAQ listing requirements, so it distributed shares to company insiders and affiliates to create the false appearance that it had a sufficient public float to proceed

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Court Orders Cryptocurrency Firm to Pay $6.8 Million for Falsifying Revenue and Fraudulently Securing NASDAQ Listing

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with a NASDAQ listing. The insiders and affiliates never paid for the stock and therefore could not be properly included in the public float.

- **Prior Proceedings** – In a separate prior action, the SEC charged Longfin, Meenavalli, and other Longfin insiders and affiliates in connection with the subsequent sale of more than $33 million of unregistered Longfin stock that the company had distributed to meet NASDAQ listing requirements. Those charges resulted in a preliminary injunction freezing more than $27 million in allegedly illegal trading proceeds. Three individuals affiliated with Longfin have agreed to pay roughly $26 million to settle the SEC's prior charges. Presumably the current charges resulted from the continuing investigation following those earlier charges.

The SEC's complaint against Longfin and Meenavalli can be found here: https://www.sec.gov/litigation/complaints/2019/comp24492.pdf

The SEC's prior complaint against Longfin, Meenavalli, and other insiders and affiliates can be found here: https://www.sec.gov/litigation/complaints/2018/comp-pr2018-61.pdf

Media Analytics Firm and Former CEO Settle Revenue Recognition Charges

On September 24, 2019, Comscore, Inc. ("Comscore") agreed to pay $5 million to settle SEC charges stemming from a fraudulent revenue recognition scheme that the company's former CEO allegedly directed from February 2014 through February 2016. Comscore provides media measurement and analytics data to enterprises, media advertising agencies, and publishers. According to the SEC's order, Comscore overstated its publicly reported revenue by approximately $50 million and made false and misleading statements about key performance metrics, which enabled the company to exceed analyst targets in seven consecutive quarters. The company's former CEO also agreed, as part of a separate settlement with the SEC, to a ten-year director-and-officer bar, a $700,000 civil penalty, and to reimburse Comscore the $2.1 million he made from the sale of the company's stock and incentive-based compensation.

- **False and Misleading Disclosures** – The SEC alleged that in 2014 and 2015, Comscore included disclosures in its SEC filings and its former CEO made similar statements during quarterly earnings calls, which conveyed a consistent increase in net new customers added when in fact the company's customer base was declining. Also during earnings calls, Comscore and its former CEO allegedly disclosed inflated revenue growth percentages for one of the company's flagship data analytics products. In both instances, the company's former CEO approved and implemented changes to the methodologies that Comscore used to calculate the misleading figures. Comscore's failure to disclose these changes in methodologies made the inflated growth figures misleading. The allegations relating to net new customers follow other recent cases focused on misleading statements about key performance indicators.
- **Non-Monetary Transactions** – The SEC alleged that Comscore's former CEO directed the company to improperly recognize revenue resulting from certain non-monetary transactions ("NMTs") through which it agreed to exchange sets of data with its counterparties without providing cash consideration. The company valued these NMTs, and their resulting revenue, based on the fair value of the transferred data. According to the SEC's order, Comscore instead should have valued the transactions based on the book value of the assets transferred (which was zero) because the NMTs lacked commercial substance and the fair value of the related assets could not be determined within reasonable limits. The SEC also alleged that Comscore improperly increased the revenue it recognized

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Media Analytics Firm and Former CEO Settle Revenue Recognition Charges

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from the NMTs by including data in the transactions that its counterparties had not requested.

- **Linked Transactions and Side Agreements** – According to the SEC's order, Comscore accounted for two related and linked monetary transactions as separate transactions, which enabled the company to improperly recognize $9.4 million of revenue in 2015. Similarly, in connection with his negotiation of two data delivery contracts, Comscore's former CEO negotiated separate side agreements that concealed the company's future data delivery obligations and enabled it to recognize each transaction's full revenue stream in a single quarter, rather than spread it across multiple periods, as required under GAAP.
- **Auditor Misrepresentations** – The SEC's order against Comscore's former CEO alleges that he made misrepresentations and omissions to internal accountants and outside auditors. In particular, the independent auditors were told that customers wanted certain data provided by Comscore, despite the fact that customers had no use for, and did not request, the additional data. The former CEO relayed similar misrepresentations about the true nature of Comscore's agreements to the company's internal accountants, leading the SEC to allege that data was provided to customers for the purpose of recognizing additional revenue. These misrepresentations resulted in an alleged violation of SEC Rule 13b2-2, which prohibits directors and officers from causing another person to state or to omit state a material falsehood.
- **Repayment of Profits and Incentive-Based Compensation** – As noted above, in connection with the settlement, Comscore's former CEO agreed to reimburse the company $2.1 million, representing incentive-based compensation and profits from the sale of Comscore stock that he received during the 12 months following the company's filing of the inaccurate financial statements that it later restated. Section 304 of the Sarbanes-Oxley Act requires CEOs and CFOs of public companies to make such repayments when the company files a restatement as a result of misconduct. In recent years, the SEC has only pursued Section 304 violations against CEOs and CFOs who were also charged in connection with the underlying misconduct that led to the restatement. However, under prior administrations, the SEC brought a number of stand-alone clawback actions against executives who were not alleged to have participated in the misconduct.

The SEC's settlement order with Comscore can be found here:
https://www.sec.gov/litigation/admin/2019/33-10692.pdf

The SEC's complaint against Comscore's former CEO can be found here:
https://www.sec.gov/litigation/admin/2019/33-10693.pdf

SEC Charges PwC and Partner with Violating Auditor Independence Rules

On September 23, 2019, PwC agreed to pay approximately $8 million to settle SEC charges related to auditor independence violations and improper professional conduct. In particular, the SEC's order states that PwC violated the SEC's auditor independence rules through its involvement with the design and implementation of software relating to an audit client's financial reporting. PwC also allegedly failed to obtain proper audit committee approval prior to performing non-audit services for fifteen SEC-registered audit clients from 2013 through 2016. According to the SEC's order, PwC's independence violations were caused by Brandon Sprankle, a partner at the firm who also agreed to settle SEC charges in exchange for a $25,000 penalty and a four-year suspension from appearing and practicing before the SEC as an accountant.

- **Independence Violations** – The SEC's order states that Sprankle violated the Commission's auditor independence rules[1] by negotiating and supervising two non-audit engagements involving the design and implementation of the client's software related to financial reporting while PwC was conducting an audit of the client. Sprankle was a member of the audit engagement team for the client and, according to the SEC's order, was aware that PwC's independence policies prohibited the firm from providing such non-audit services but nevertheless informed the client that PwC was "absolutely permitted" to implement the software.
- **Individual Misconduct** – In addition, Sprankle allegedly mischaracterized the nature of these non-audit services when drafting the related engagement letters, and in one instance described the services as an extension of the client's existing audit engagement to avoid concerns that had been raised by PwC's Risk Assurance Independence group. As a result of Sprankle's mischaracterization, the engagement was not subject to the firm's normal review to determine whether it included prohibited non-audit services. The SEC also alleged that Sprankle regularly disclosed confidential client information to third parties when pursuing non-audit work with the client.
- **Failure to Obtain Proper Audit Committee Pre-Approval** – The SEC's order also states that PwC violated PCAOB Rule 3525, which requires auditors to

[1] Rule 2-01 of Regulation S-X, which provides the independence requirements for accountants practicing before the SEC, states, in part, that auditors are generally prohibited from engaging in the design and implementation of an audit client's financial information systems.

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SEC Charges PwC and Partner with Violating Auditor Independence Rules

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accurately and fully describe proposed services to audit committees so that the committees can make informed decisions about independence. The order states that PwC failed to obtain proper audit committee pre-approval per PCAOB rules on nineteen engagements involving fifteen SEC-registrant audit clients. For example, PwC allegedly mischaracterized non-audit services as audit work on numerous engagements. The order further states that PwC's violations were, in part, the result of breakdowns in its independence-related quality controls.

The SEC's settlement order with PwC can be found here: https://www.sec.gov/litigation/admin/2019/34-87052.pdf

The SEC's settlement order with the PwC partner can be found here: https://www.sec.gov/litigation/admin/2019/34-87053.pdf

Bancorp and Two Executives Settle Charges Related to Loan Impairment Allowances

On September 20, 2019, The Bancorp, Inc. ("Bancorp"), a Delaware bank holding company, agreed to pay a $1.4 million civil penalty to settle an SEC enforcement action alleging violations of the reporting, books and records, and internal controls provisions of the Exchange Act and the rules thereunder based on accounting failures related to the company's allowance for loan and lease losses ("ALLL") and its provision for loan and lease losses ("PLLL"). Bancorp's chief credit officer, Donald McGraw, Jr., and former chief risk officer, James David Hilty, were charged with causing certain of Bancorp's violations. The SEC alleged that Bancorp failed to properly classify certain loans and failed to take charges in appropriate periods for individually impaired loans, as reflected by its decision in April 2015 to restate its previously issued financial statements for fiscal years 2012 and 2013 and for the first three quarters of 2014.[2] The restatement resulted in an aggregate adjustment to Bancorp's PLLL of approximately $138.6 million. McGraw and Hilty each agreed to pay $50,000 to settle the SEC's charges.

As reported in a previous issue of the Round-Up, in December 2017, Bancorp's auditor, Grant Thornton, agreed to a $1.5 million settlement with the PCAOB as a result of its alleged failure to obtain sufficient audit evidence concerning the reported value of Bancorp's net loans, the effectiveness of ALLL-related controls, and the reasonableness of Bancorp's ALLL estimates.

- **Failure to Properly Identify Distressed Loans** – According to the SEC's order, Bancorp "relied too heavily on borrowers' and guarantors' reputations," failed to downgrade risk ratings in its portfolio when confronted with negative information, and repeatedly extended more credit to delinquent borrowers. Bancorp's ALLL and PLLL accounts were driven by a risk-weighted assessment of the loan portfolio, in which individual loans were assigned a score of 1-8. Because Bancorp failed to identify the distressed borrowers, it had underweighted the attendant risks and therefore materially understated its PLLL from 2010 to 2013 and ALLL from 2010 to 2014.
- **Identifying Troubled Debt Restructuring** – As part of its internal controls over financial reporting, Bancorp had a committee of employees that were charged

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2 Pursuant to ASC 310, a loan becomes impaired when, "based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." Additionally, when a loan is modified, ASC 310 requires companies to consider whether the modification amounts to a troubled debt restructuring ("TDR"), which would also render the loan impaired. ALLL is a contra-asset balance sheet account that offsets against gross loan balances, representing the current estimate of the aggregate probable loss inherent in a loan portfolio. PLLL is the corresponding expense account that reflects the income statement impact of loan impairments in a given period.

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Bancorp and Two Executives Settle Charges Related to Loan Impairment Allowances

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with identifying troubled debt restructuring ("TDR") loans. However, according to the SEC's order, from at least March 2012 to October 2013, the company failed to properly identify loans as TDRs, including a $44 million relationship in which the guarantor had a criminal conviction. These failures resulted in a significant deficiency in internal controls, which Bancorp reported multiple times to its audit committee.

- **Individual Accountability** – The SEC alleged that Bancorp's chief credit officer McGraw had ultimate responsibility for maintaining appropriate and current credit files. The order states that McGraw, among other things, failed to ensure that the credit files contained timely appraisals and negative information concerning borrowers and guarantors, and also failed to include references to delinquencies in credit requests. The SEC's order further states that Hilty, while serving as Bancorp's chief risk officer, caused the company's violations by using risk ratings and impairment decisions that he knew or should have known were not fair and accurate to estimate Bancorp's ALLL and PLLL.

The SEC's settlement order with Bancorp can be found here: https://www.sec.gov/litigation/admin/2019/34-87036.pdf

The SEC's settlement order with McGraw can be found here: https://www.sec.gov/litigation/admin/2019/34-87038.pdf

The SEC's settlement order with Hilty can be found here: https://www.sec.gov/litigation/admin/2019/34-87037.pdf

Marvell Technology Pays $5.5 Million to Settle SEC Charges of "Pull-In" Scheme

On September 16, 2019, Marvell Technology Group, Ltd., a producer of semiconductor components used in hard drives, mobile phones, and network devices, agreed to pay $5.5 million to settle SEC charges that it failed to disclose its practice of accelerating, or "pulling in," sales scheduled for future quarters into current quarters in order to close the gap between its actual and forecasted revenues. According to the SEC order, Marvell pulled in a total of $165 million in revenues across three quarters without disclosing the impact of that practice on the company's revenues. Although no individuals have been charged by the SEC to date, it remains to be seen, given the nature of the misconduct alleged, whether the agency will ultimately decide to take further action against Marvell's senior management.

- **Declining Market Conditions** – The SEC order emphasizes that Marvell's senior management was aggressively focused on meeting revenue guidance at a time when the company was losing market share in an already declining market. The company's sales personnel warned senior management that, given the declining market, the company's reliance on pull-ins "made it all but impossible" for the company to meet its future revenue targets. However, senior management ignored these warnings and directed the employees to continue using pull-ins by shipping "anything and everything possible."
- **Concealment of Pull-Ins** – The SEC also alleged that Marvell's senior management ignored concerns raised by employees that the company's use of pull-ins misrepresented the market demand for its products. In particular, one employee with responsibilities related to Marvell's accounting and financial disclosures cautioned senior management that the use of pull-ins could trigger disclosure obligations, citing prior SEC enforcement actions that targeted unusual sales practices. In response, the employee was directed to send an email to senior management indicating that there were no issues with the pull-ins. The SEC order also states that Marvell's senior management concealed their use of pull-ins from the company's disclosure committee, board of directors, and independent auditor by deleting references to pull-ins from the board and committee materials.

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Marvell Technology Pays $5.5 Million to Settle SEC Charges of "Pull-In" Scheme

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- **Misleading Disclosures** – Notably, the SEC did not allege that Marvell's use of pull-ins violated the revenue recognition rules under GAAP. Instead, the SEC's charges focus solely on the company's disclosures. According to the SEC order, Marvell's failure to disclose its use of pull-ins misled investors by: (i) giving the false impression that the company was able to meet its revenue guidance organically; (ii) masking the adverse impact that pull-ins had on revenue in future quarters; and (iii) masking the company's declining sales and market share. The SEC alleged that, without this information, investors were unable to evaluate Marvell's financial results across periods and judge the company's ability to meet future guidance. This is a good example of how compliance with GAAP does not protect a company against a claim that their financial disclosures were misleading.

The SEC's settlement order with Marvell can be found here: https://www.sec.gov/litigation/admin/2019/33-10684.pdf

RSM Settles Auditor Independence Violations

In August 2019, public accounting firm RSM US LLP agreed to pay $950,000 to settle SEC charges that it violated the agency's auditor independence rules by providing non-audit services to, or having an employment relationship with, affiliates of at least 15 audit clients between 2014 and 2015. The SEC alleged that RSM US and associated member firms of the RSM International network provided non-audit services to affiliates of RSM US audit clients, which violated independence rules. In addition to agreeing to pay the civil money penalty, RSM US agreed to engage an independent consultant to evaluate existing quality controls for complying with auditor independence requirements for non-audit services. RSM issued a public statement in response to the settlement noting that the violations related to deficiencies in its independence controls and that the SEC did not find that the firm's objectivity or impartiality were impaired.

- **Prohibited Services and Relationships** – According to the SEC order, RSM provided prohibited non-audit services,[3] including "corporate secretarial services, payment facilitation, payroll outsourcing, loaned staff, financial information system design or implementation, bookkeeping, internal audit outsourcing, and investment adviser services," to affiliates of audit clients during its work on more than 100 audit reports between 2014 and 2015. Additionally, a tax partner from RSM's Australian member firm served on a voluntary basis as a non-discretionary member of the board of an affiliate of an RSM audit client.
- **Inadequate Independence Controls** – The SEC order alleges that RSM failed to detect certain of these independence violations until at least 2016 due to deficiencies in its system of quality controls around auditor independence. For example, certain RSM engagement teams failed to properly enter information about client relationships in the firm's central database, and some engagement teams failed to utilize the database to identify affiliates of audit clients. In each instance of RSM's independence violations, the relevant audit engagement teams were unaware of the prohibited non-audited services or relationships.
- **Potential Audit Client Implications** – The SEC order also finds that RSM's independence violations caused its audit clients to violate their obligations to have their financial statements audited by independent public accountants.

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[3] Rule 2-01 of Regulation S-X sets forth a non-exhaustive list of non-audit services that will impair an auditor's independence if provided to an audit client or its affiliates. The rule also lists three broad categories of auditor-client relationships that violate the independence rules: employment relationships; financial relationships; and business relationships.

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RSM Settles Auditor Independence Violations

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The SEC, however, has not to date filed any enforcement actions against these clients, and it is not clear whether they would pursue such actions absent some knowing involvement by the client in the violation or other aggravating factors.

The SEC's settlement order with RSM can be found here: https://www.sec.gov/litigation/admin/2019/34-86770.pdf

SEC and DOJ Charge REIT and Four Former Executives with Manipulating Non-GAAP Measures

The SEC and DOJ filed charges in August 2019 alleging that four former executives of the publicly-traded real estate investment trust ("REIT") Brixmor Property Group Inc. ("Brixmor"), manipulated the company's same property net operating income ("SP NOI") metric to meet consistent growth targets in public filings with the SEC between the third quarter of 2013 and the third quarter of 2015. SP NOI is an industry-specific, non-GAAP measure that is designed to more accurately reflect the profitability of income-generating real estate investments. The SEC filed charges against Brixmor and its former CEO, CFO, chief accounting officer, and senior vice president for management accounting. Brixmor agreed to settle the SEC's charges by paying a $7 million civil penalty and complying with certain undertakings. The DOJ has also announced parallel criminal charges against the four former executives, two of whom have pleaded guilty.

- **Focus on Consistent Earnings** – The charges filed by the SEC and DOJ emphasize that Brixmor's former CEO and CFO touted the company's steady and consistent SP NOI growth from its inception as a public company, when in reality Brixmor's actual SP NOI was volatile and fell above or below the company's publicly issued guidance ranges. To ensure consistency with the company's guidance, the former executives manipulated the SP NOI growth rate by: (i) using an account referred to internally as a "cookie jar" to improperly delay or accelerate revenue recognition; (ii) including lease termination income in the calculation of SP NOI, contrary to the company's public disclosures; and (iii) manually reducing the SP NOI in prior periods to make the current period's SP NOI appear higher. The SEC's complaint notes that the executives described these adjustments to SP NOI as "mak[ing] the sausage."
- **Parallel Criminal Proceeding** – In a parallel proceeding, the U.S. Attorney's Office for the Southern District of New York also filed criminal charges against the former executives. The company's former chief accounting officer and senior vice president for management accounting each pleaded guilty to one count of conspiracy to commit securities fraud and make false filings with the SEC, and one count of securities fraud. The company's former CEO and CFO also face similar criminal charges, to which they pleaded not guilty.

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SEC and DOJ Charge REIT and Four Former Executives with Manipulating Non-GAAP Measures

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- **Non-GAAP Measures in REIT Disclosures** – This case illustrates how the use of non-GAAP measures in the REIT industry has recently come under scrutiny. REITs routinely report non-GAAP metrics in their financial statements because they are said to help users of financial statements better understand the REIT's core operations, often by reflecting only income and expense items that are incurred at the property level. In June 2017, the former CFO of American Realty Capital Partners was convicted on criminal charges stemming from his role in manipulating the company's adjusted funds from operations ("AFFO"), another common non-GAAP measure used in the REIT industry.

The SEC's settlement order with Brixmor can be found here: https://www.sec.gov/litigation/admin/2019/34-86538.pdf

The SEC's complaint against the former Brixmor executives can be found here: https://www.sec.gov/litigation/complaints/2019/comp-pr2019-133.pdf

The DOJ's indictment against Brixmor's former CEO and CFO can be found here: https://www.justice.gov/usao-ndil/press-release/file/1184911/download

Engine Manufacturing Executives Charged in Fraudulent Revenue Recognition Scheme

Parallel charges filed by the SEC and DOJ in July 2019 alleged that the former CEO and two former sales executives of Power Solutions International, Inc. ("PSI"), a publicly traded engine manufacturer, fraudulently inflated PSI's revenue by recording sales of products that were not complete, that the customer had not agreed to accept, and for which the price was falsely inflated. The SEC also alleged that PSI recorded sales from improper "bill and hold" arrangements and that the executives misled and concealed information from PSI's internal accountants and external auditors in an effort to meet the company's revenue targets. The executives are no longer employed by PSI, which is said to be cooperating with the investigation. In May 2019, PSI restated its financial statements for fiscal years 2014 and 2015, which reflected a reduction in revenue of approximately $25 million. To date, the government has not brought charges against PSI in connection with the matter.

- **Emphasis on Meeting Revenue Targets** – According to the SEC's complaint, demand for PSI's products was tied to the price of oil because many of PSI's largest customers purchased engines to be used in the oil and gas industry. When the price of oil was depressed in 2015, it became increasingly difficult for PSI to meet its revenue targets, which led the executives to engage in aggressive accounting practices. The order describes "end-of-quarter drives to hit revenue targets" in which the executives incentivized customers to place orders for products that they did not need, and to accept products earlier than desired. For example, during the first quarter of 2015, PSI recorded revenues of approximately $7.8 million "for the purported sale of engines to a customer that was given an indefinite, open-ended right to return the engines if it did not need them."
- **Concealment of Fraudulent Accounting** – The SEC's complaint alleges that the PSI executives concealed their fraudulent revenue recognition practices from the company's internal accounting team and external auditors by not informing them of key information regarding certain sales transactions, including the existence of side agreements and right of return arrangements with customers. In many instances, the management representation letter that the company's CEO signed for the external auditor falsely stated that such arrangements had been shared with the auditor – likely a key factor in the government's decision to

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Engine Manufacturing Executives Charged in Fraudulent Revenue Recognition Scheme

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bring criminal charges. When the revenue recognition practices were reported to the audit committee and board, PSI commenced an internal investigation in the summer of 2016. The SEC alleged that the CEO's misconduct continued during the internal investigation – both by characterizing the basis for the investigation as meritless and by making false statements regarding the merits of the accounting practices to PSI's chief legal officer, which were ultimately shared with the company's auditors.

The SEC's complaint can be found here:
https://www.sec.gov/litigation/complaints/2019/comp24544.pdf

The DOJ's indictment can be found here:
https://www.justice.gov/usao-ndil/press-release/file/1184911/download

SEC Charges Six Individuals with Misrepresenting and Overvaluing Clean Energy Projects

In June 2019, the SEC charged four former executives of Blue Earth Inc. ("Blue Earth"), a now-bankrupt energy company, alleging that the executives overvalued a construction in progress ("CIP") asset that purportedly reflected seven combined heat and power plant projects that it claimed would transform the company from an unprofitable venture to a profitable one. The SEC also alleged that the executives repeatedly misrepresented the company's construction, ownership, and operation of the projects when in it had only secured contracts for two power plants and had limited prospects of actually performing those contracts or obtaining additional contracts. In addition to charging the former Blue Earth executives, the SEC instituted related settled administrative proceedings against a former accounting consultant to the company and its external auditor. Both individuals have been suspended from appearing and practicing before the SEC as accountants, and one of them also agreed to pay a $70,000 penalty.

- **Inflated CIP Valuation** – Blue Earth valued the CIP asset at $44 million, which according to the SEC's complaint, was inflated by more than 400% and made up more than half of the company's balance sheet. This valuation was based on a discounted cash flow analysis prepared by the company's former CFO, which reflected a number of false assumptions, including that Blue Earth had entered into definitive agreements to construct all seven plants and that it had secured full financing to construct and operate the seven plants. The SEC alleged that the company's former CFO further manipulated other inputs, including the discount rate and forecasted overhead expenses, to arrive at a higher valuation. The former CFO also failed to adjust the analysis to account for subsequent developments that would have reduced the valuation.
- **Failure to Allocate Goodwill** – The SEC alleged that Blue Earth improperly recorded the entire $44 million asset to CIP when most of the asset should have been allocated to goodwill, where it should have been periodically tested for impairment, because the valuation was based solely on indefinite future cash flows, and not any identifiable assets. According to the SEC order, Blue Earth should have tested the asset for impairment after it experienced a "triggering event," namely when subsequent developments materially increased the risk that contracts would not be signed for the construction of additional plants.

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SEC Charges Six Individuals with Misrepresenting and Overvaluing Clean Energy Projects

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- **Focus on Individual Accountability** – The SEC's complaint includes charges against four former Blue Earth executives, including the CEO, CFO, president and chief operating officer, and vice president of corporate development and investor relations. The SEC seeks permanent injunctions, civil penalties, and penny stock and officer and director bars from each defendant. Notably, as of the date of this writing, the SEC has not brought charges against the company, presumably because it is bankrupt.

The SEC's complaint against the former Blue Earth executives can be found here: https://www.sec.gov/litigation/complaints/2019/comp24522.pdf

The SEC's settlement order with Blue Earth's former accounting consultant can be found here: https://www.sec.gov/litigation/admin/2019/34-86239.pdf

The SEC's settlement order with Blue Earth's former external auditor can be found here: https://www.sec.gov/litigation/admin/2019/34-86240.pdf

KPMG Agrees to $50 Million Settlement for Using Stolen PCAOB Data and Cheating on Training Exams

In June 2019, KPMG agreed to pay a $50 million civil penalty to settle SEC charges alleging that KPMG employees participated in a scheme to obtain and misuse confidential information about upcoming PCAOB inspections. The SEC's order states that, in an effort to avoid potential audit deficiency findings, KPMG altered its documentation of past audit engagements after obtaining information leaked by PCAOB staffers who sought jobs at KPMG. The order further states that KPMG employees cheated on training exams mandated by a prior SEC order by improperly sharing answers and manipulating test results. In connection with the settlement, KPMG agreed to extensive undertakings, which include, among other things, retaining an independent consultant to review and assess the firm's quality controls and its response to investigative findings, enhanced ethics and integrity training requirements for all of the firm's audit professionals, and an annual certification related to KPMG's assessment of its policies and procedures related to ethics and integrity.

- **Misuse of PCAOB Data** – According to the SEC order, in September 2014, the PCAOB found that 46% 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 employees from the PCAOB to help the firm improperly obtain and misuse confidential PCAOB information, including lists of specific audits the PCAOB planned to inspect, the criteria used to select the audits for inspection, and the focus areas of the inspections. According to the SEC, the former KPMG partners sought this information to enable KPMG to review and revise its audit engagement work papers in an effort to avoid negative inspection findings by the PCAOB.
- **Cheating on Training Exams** – In August 2017, the SEC ordered KPMG's audit professionals to complete a minimum of 12 hours of continuing education training, including fraud training, as part of the firm's settlement of charges that it failed to properly audit the financial statements of an oil and gas client. According to the SEC's June 2019 order, a number of KPMG audit professionals, including certain lead audit engagement partners, sent and solicited answers to help the firm's audit professionals pass these training exams. The order also states that certain KPMG employees manually lowered the required score for

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passing the training exams by altering numbers that were embedded in the firm's hyperlinks to the exams.

- **Individual Liability** – KPMG's settlement came approximately six months after the SEC and DOJ filed parallel charges against six former KPMG and PCAOB employees in connection with the matter. Three of those individuals have been sentenced to prison, while the remaining three await sentencing. In August 2019, Cynthia Holder, a former PCAOB inspections leader and KPMG executive director, was sentenced to eight months in federal prison after pleading guilty in October 2018. David Middendorf, KPMG's former national managing partner for audit quality and professional practice, was sentenced to one year and one day in prison in September 2019 after he and former PCAOB inspections leader Jeffrey Wada were convicted by a Manhattan jury of wire fraud and conspiracy to commit wire fraud in March 2019. Wada was sentenced to nine months in prison on October 11. The other individual defendants – Brian Sweet, a former PCAOB employee and KPMG partner; Thomas Whittle, KPMG's former national partner in charge of inspections; and David Britt, KPMG's former banking and capital markets group co-leader, have all pleaded guilty and are awaiting sentencing.

The SEC's settlement order with KPMG can be found here:
https://www.sec.gov/litigation/admin/2019/34-86118.pdf

Deloitte Japan Settles Auditor Independence Allegations

In February 2019, Deloitte Japan agreed to pay $2 million to settle SEC charges that it violated the agency's auditor independence rules by issuing audit reports for an audit client at a time when a number of the firm's partners and audit engagement team members maintained bank accounts with the audit client's subsidiary. Under the SEC's auditor independence rules, auditors are not considered to be independent if they maintain a bank account balance with an audit client that exceeds the amount insured by the FDIC or a similar insurer. The SEC also charged Deloitte Japan's former CEO as well as the firm's reputation and risk leader and director of independence, both of whom agreed to a settlement and have been suspended from appearing and practicing before the SEC as accountants.

- **Inadequate Staffing** – In March 2014, in connection with one of Deloitte Japan's routine independence inspections, the firm's former CEO provided materials indicating that he had held bank account balances with an audit client that exceeded the amount insured by the Deposit Insurance Corporation of Japan after he received lump-sum deposits of partnership compensation from the firm. The firm's office of independence acknowledged that this was an independence violation but failed to complete the former CEO's inspection until November 2014 due in part to inadequate staffing. The SEC order states that in March 2014, Deloitte Japan's office of independence had 7.8 full-time equivalent employees, who dedicated approximately half of their time to independence matters.
- **Inadequate Reporting** – When Deloitte Japan completed the former CEO's independence inspection, the firm's office of independence reprimanded him via email and notified the relevant audit engagement team of the violation. However, the office did not identify the former CEO by name and led the engagement team to incorrectly conclude that the independence violation was not committed by someone within the chain of command who might affect the audit process. As a result, the existence of the former CEO's independence violation was not fully disclosed to the relevant audit client until July 2015.
- **Remedial Efforts and Cooperation** – In July 2015, Deloitte Japan voluntarily disclosed to the SEC independence violations committed by the former CEO and other individuals. The firm also hired an outside law firm to conduct an internal investigation into the issue, which uncovered eighty-eight Deloitte

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Deloitte Japan Settles Auditor Independence Allegations

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Japan partners and audit engagement team members with personal financial relationship violations with respect to the audit client. Those individuals included the firm's former CEO and its reputation and risk leader and director of independence. The SEC order notes that Deloitte Japan's office of independence has since revised its policies and now identifies violators by name. The order further acknowledges that the office has "more than tripled" its staffing and it also describes Deloitte Japan's cooperation efforts, including that the firm voluntarily shared the results, details, and documents related to its internal investigation, provided translations of key documents, and facilitated the voluntary testimony of overseas witnesses, all of which the SEC noted as having "reduced the time and resources necessary for the Commission staff to conclude the investigation."

The SEC's settlement order with Deloitte Japan and the two executives can be found here: https://www.sec.gov/litigation/admin/2019/34-85115.pdf

Accounting & Financial Reporting Enforcement Round-Up

AFR Enforcement Round-Up
is a publication of
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