Debevoise & Plimpton

Accounting & Financial Reporting Enforcement Round-Up

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The U.S. Securities and Exchange Commission ("SEC" or "the Commission") in recent years has been increasingly focused on financial reporting issues. With over 100 accountants and significant expertise in the area, we expect the SEC to continue this focus in the coming years. This periodic newsletter is intended to provide brief descriptions of recent SEC actions in the financial reporting space, together with bite-sized analysis about these actions and SEC financial reporting developments in general.

The last few months have seen a reduction in the frequency of financial reporting cases, as the Commission is in transition, with a Chair nominee in waiting and only two commissioners in place. There is still an open question about the future direction of the Commission in terms of corporate penalties. Some commissioners in recent years have voiced the view that corporate penalties are only appropriate when some tangible corporate benefit is shown, viewing penalties as penal to current shareholders if no benefit to the company can be shown from the misconduct. Other commissioners have viewed penalties as being appropriate even if no corporate benefit is demonstrated, with a view that the deterrent effect of penalties overrides any impact on shareholders. Under their view, a broader group of

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factors, including the nature and extent of the conduct, as well as the level of intent, cooperation and remediation, are relevant to the corporate penalty determination. Some of the paucity of recent cases may be attributable to this unsettled difference in philosophical approach. At his hearing, Chair-nominee Jay Clayton suggested that he believed corporate benefit was important in determining whether corporate penalties are appropriate but his views still remain somewhat unclear. In any event, discussed below are four cases against issuers, one of which focused on non-GAAP measures, which has received significant attention recently, and CEO perk disclosure, a topic of other recent enforcement actions; another which demonstrated innovative investigative techniques in uncovering sham revenue; a third focused on software accounting, an issue that has been seen repeatedly in recent years; and a fourth, which raised a host of financial reporting and controls issues, along with associated liability and penalty considerations. Revenue recognition continues to be a focus for enforcement actions, which is consistent with historical trends. But non-GAAP measures promise to occupy a more prominent role in the coming period.

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Foreign Issuer Settles $3.3 Billion Accounting Fraud Action with the SEC

On March 3, 2017, the SEC announced that a homebuilder based in Mexico settled charges arising from allegations that it recorded more than 100,000 fake home sales to increase revenue. The home builder, Desarrolladora Homex S.A.B. de C.V. ("Homex"), was one of Mexico's largest home builders. From 2010 through 2013, the SEC alleged that Homex systematically reported revenue from the sale of tens of thousands of homes each year that it neither built nor sold. Over this three-year period, firm personnel manually entered false sales information into the general ledger system. As a result, Homex overstated revenue by $3.3 billion and overstated its units sold by 100,000. The SEC's complaint in the matter included claims for accounting fraud under Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act, as well as other violations of reporting, and books and records provisions of the federal securities laws.

Key takeaways from the settlement included:

- **No Financial Penalty** – Homex settled the charges by agreeing to a ban from offering securities in U.S. markets for at least five years. No financial penalty was assessed, likely because Homex undertook and emerged from Mexico's equivalent of a bankruptcy reorganization process after the period in which the alleged improprieties occurred.
- **Innovative Investigatory Tactics** – To support its allegations against Homex, the SEC relied upon satellite imagery showing development sites for which revenue had been recorded. The imagery showed that homes had yet to be built on the sites at the time revenue was recognized.
- **Foreign Issuer Status** – Homex was a foreign issuer. The investigation against Homex showed that the SEC is willing to commit investigative resources to develop cases even against companies based abroad that are listed in the United States.
- **Any Charges Against Individuals Remain Outstanding** – The SEC's March 3 release announced Homex's settlement, but did not directly address potential actions against senior executives. Homex's CEO and CFO have been on unpaid leave since May 2016.

The SEC's complaint against Homex can be found here: https://www.sec.gov/litigation/complaints/2017/comp-pr2017-60.pdf.

SEC Charges Company and Executives for Improper Software Revenue Recognition

On February 3, 2017, California-based network testing company Ixia settled administrative proceedings with the SEC relating to alleged improper revenue recognition practices. According to the SEC's settlement order, in October 2012, Ixia's CEO directed the company to split its sales of software and professional services into separate purchase orders, even when the software and services were sold as a package. This practice made the professional service sales appear to be stand-alone sales, which allowed Ixia to recognize the related software sales immediately rather than waiting until the services were subsequently rendered in accordance with the applicable software revenue recognition rules. The SEC alleged accounting fraud under Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act, as well as other violations of reporting, books and records, and internal controls provisions of the federal securities laws.

Key takeaways from the enforcement action include:

- **Individual Liability** – Ixia's former CEO settled Section 10(b) charges in connection with the matter and agreed to a five-year director and officer bar and a civil penalty of $100,000. The five-year bar is the typical length for a Section 10(b) violation. The company's former CFO and director of accounting were also charged and are continuing to litigate the action.
- **Misstatements to Auditors** – The SEC alleged that Ixia's former CEO and CFO concealed the improper revenue recognition scheme from the company's outside auditors by omitting material information from the management representation letters they submitted, which is standard, but less-compelling evidence of auditor misstatements than more specific misstatements. Additionally, the former director of accounting allegedly concealed the scheme in face-to-face meetings with the auditors, which included discussions of related issues.
- **Internal Controls** – The SEC's allegations focused heavily on internal control violations, including the former CEO's false SOX certifications. The SEC further alleged that the former CEO's practice of splitting purchase orders violated the company's internal revenue recognition policies. This is consistent with the SEC's recent focus on internal controls issues, even when no fraud is found.

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- **Voluntary Reporting** – Ixia self-reported this matter to the SEC staff after it came to light during an internal investigation conducted by the company's audit committee. The internal investigation had been initiated to look into whether the company's former CEO misrepresented his educational and professional background prior to joining Ixia. Ixia informed the SEC staff of the internal investigation at its outset and continued to cooperate with the SEC throughout the agency's investigation. This is an example of a structure which has been seen repeatedly in enforcement actions: misconduct found as a result of an internal investigation on unrelated issues.
- **Terms of Settlement Agreement** – The SEC accepted Ixia's settlement offer in which Ixia, while not admitting or denying the findings in the order, agreed to pay a civil penalty of $750,000. This penalty is consistent with other settlements in similar matters, including the SEC's 2014 settlement with JDA Software Group. The SEC also noted that it favorably considered Ixia's cooperation with the Division of Enforcement's investigation in determining the amount of the civil penalty assessed on the corporation.

The SEC's settlement order with Ixia and its former CEO can be found here: https://www.sec.gov/litigation/admin/2017/33-10302.pdf.

The SEC's complaint against Ixia's former CFO and director of accounting can be found here: https://www.sec.gov/litigation/complaints/2017/comp23741.pdf.

Issuer Agrees to Pay $1.5 Million Fine to Settle CEO Compensation, Earnings Disclosure Violations

On January 18, 2017, the SEC announced a cease-and-desist order against MDC Partners Inc. ("MDCA"), a publicly traded marketing firm, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act. The order arises from a settlement agreement entered into by the firm in which the SEC alleged two sets of federal securities law violations. First, MDCA failed to disclose nearly $11.3 million worth of personal expense reimbursements and other compensation the firm paid to its then CEO from 2009 to 2014. Second, MDCA violated non-GAAP disclosure requirements when it failed to afford greater or equal prominence to GAAP measures in earnings releases that contained non-GAAP metrics, and it failed to reconcile the non-GAAP measure "organic revenue growth" to GAAP revenue. MDCA agreed to pay a civil penalty of $1.5 million to settle the SEC's charges.

Key takeaways from the settlement include:

- **Improper Disclosure of Compensation Paid to CEO** – From 2009 through 2014, MDCA disclosed approximately $3.87 million worth of benefits paid to the CEO. However, this disclosed amount excluded nearly $11.3 million worth of personal benefits, including private aircraft usage, cosmetic surgery, yacht-and-sports-car-related expenses and jewelry that properly should have been disclosed as compensation. Cases like this frequently involve internal control deficiencies, where the company fails to have appropriate controls on the reporting of perks and other executive-related compensation. The amount of perks in this matter, which contributed to the higher penalty amount, was significantly higher than in similar recent actions by the SEC, such as Polycom and Musclepharm. Perk disclosure remains a common area of focus for the SEC.
- **Non-GAAP Financial Measure Disclosure Deficiencies** – The SEC alleged that MDCA repeatedly emphasized non-GAAP financial metrics in its earnings statements over a seven-quarter period, including EBITDA, EBITDA margin and free cash flow, without giving equal or greater prominence to the comparable GAAP measures. The SEC's Division of Corporation Finance and Office of the Chief Accountant recently have focused extensively on non-GAAP measures and there have been public reports of an ongoing enforcement sweep. Issuers should be focusing on non-GAAP reporting to ensure it is appropriately presented and used.

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- **Remedial Acts Favorably Considered by SEC** – The SEC limited the civil penalty assessed against MDCA based on the prompt remedial actions undertaken by MDCA, including (i) the formation of a committee of independent board members to conduct an in-depth investigation; (ii) the replacement of the CEO and Chief Accounting Officer; (iii) the collection of more than $21.7 million in repayments from the former CEO; (iv) the addition of three new independent members to the Board of Directors; and (v) the implementation of new internal control and compliance policies and procedures. The SEC is always focused on ensuring that remedial measures are sufficient to ensure that the issues involved in the matter do not recur.

The SEC's full release of the settlement can be found here: https://www.sec.gov/litigation/admin/2017/33-10283.pdf.

CFO, Issuer Settle with SEC over Financial Reporting Misstatements

On March 29, 2017, the SEC entered into separate settlements with Advanced Emissions Solutions, Inc. ("Advanced Emissions") and its former CFO. Both parties' settlements related to Advanced Emissions' SEC filings from 2011 through 2013, which the SEC alleged contained false and materially misleading information in violation of federal securities law. Alleged financial reporting misstatements included: (a) failure to record a large loss contingency for an adverse arbitration ruling; (b) premature revenue recognition for long-term contracts; (c) failure to properly account for warranty accruals; (d) improper evaluation of joint venture consolidation issues; and (e) overstatement of revenue related to a subsidiary.

Key takeaways from the settlements included:

- **Individual Liability for Concurrent Stock Sales** – The SEC held the former CFO liable for gains he realized from trades made during the period in which the alleged financial reporting violations occurred. Advanced Emissions' reporting violations allegedly overstated revenue, which inflated the stock price. The SEC sought to recover the former CFO's gains on shares he sold during the relevant period. Public company officers should be aware that the SEC will pursue gains on their stock sales when it appears that misstatements in corporate financial statements of which they are alleged to be responsible had the effect of inflating the company's stock price. In addition, Section 304 of the Sarbanes-Oxley Act allows actions against CEOs and CFOs that were not directly involved in the misconduct to recover bonus compensation and stock sale profits in the 12-month period following the first public issuance or filing with the Commission of the financial document containing the misstatement, if there is a restatement resulting from misconduct. While this provision has been used in recent years against executives not directly involved in the misconduct, it is likely that the new majority of commissioners will not support such an action.
- **Internal Controls** – The SEC alleged that Advanced Emissions' misstatements were the result of internal control failures. The company appears to have had a lengthy history of internal control issues, including 15 material weaknesses disclosed in 2016 which were "nearly identical" to control weaknesses previously identified. The SEC remains focused on internal controls, and as stated above, a history of material weaknesses is likely to invite enforcement scrutiny. If a material weakness or significant deficiency is identified, every effort should be

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made to remediate quickly.

- **Corporate Penalty** – The SEC's order specifically makes the point that the advanced emissions engaged in two equity offerings during the period when the financials were misstated. This presumably helped the Commission, currently split evenly between Republican and Democratic appointees, to approve unanimously a $500,000 penalty against the firm given Commissioner Piwowar's view that corporate penalties are only appropriate when there is some corporate benefit arising from the misconduct.
- **Loss Contingencies** – As in the recent *RPM* case, the Commission focused on the company's failure to take a reserve for a loss contingency in connection with an arbitration award against the company. Companies must be vigilant to ensure that liabilities that are probable and reasonably estimable are recorded.
- **Percentage of Completion Accounting** – This enforcement proceeding also involved the misstatement of revenues based on a failure to properly account for revenues under percentage of completion accounting. The company failed to include the incurred or projected labor hours of tank manufacturers in calculating the percent by which its contracts were complete, thereby resulting in overstated revenue. Like the CSC case from 2015, percentage of completion accounting remains an area where extra attention is required.
- **CFO Liability** – The former CFO of the issuer was held liable under a negligence theory. The complaint articulates several instances in which the CFO had sufficient information to suggest that the accounting was incorrect but nevertheless did not correct the financial statements. Presumably, the number of issues, coupled with the CFO's clear involvement in the specific accounting judgments, assisted the SEC in obtaining a settlement holding the CFO personally liable. This is consistent with numerous other financial reporting cases, where senior level involvement in the conduct makes holding individuals personally liable more common than in other areas.

The SEC's complaint against the former CFO can be found here: https://www.sec.gov/litigation/complaints/2017/comp23793.pdf.

The SEC's settlement order against Advanced Emissions can be found here: https://www.sec.gov/litigation/admin/2017/33-10329.pdf.

Auditor, Small Accounting Firm Sanctioned for Audit Failures

On February 21, 2017, Edward Richardson, Jr. and his firm, located in West Bloomfield, Michigan, were charged in an administrative proceeding. The proceeding came after an investigation by the Division of Enforcement found evidence that the auditor and his firm violated Sections 4C and 21C of the Exchange Act and Rules of Practice 102(e)(1)(ii) and 102(e)(1)(iii), respectively. At issue are the respondents' alleged failure to obtain engagement-quality reviews as required by PCAOB standards; failure to comply with numerous other PCAOB standards and/or generally accepted auditing standards; and the preparation of client financial statements filed with the SEC in violation of auditor independence requirements.

Key takeaways from the SEC's action include:

- **Multiple Alleged Violations** – The SEC has alleged that Mr. Richardson and his firm failed to obtain required engagement-quality reviews and meet numerous generally accepted auditing standards over a five-year period. The SEC also alleged violations of independence requirements associated with the preparation of client financial statements.
- **Enforcement Trend** – This action appears to be part of an ongoing SEC enforcement trend of focusing on auditor-related cases, relating both to failures to meet auditor standards and independence. The number of accountant proceedings under Rule 102(e), the rule under which accountants practicing before the Commission can be barred from practicing as a result of improper professional conduct, has also been increasing, from 37 respondents in fiscal year 2013 to 76 respondents in fiscal year 2015, including actions against 57 individual accountants and 19 firms.

The SEC's complaint against Mr. Richardson and his firm can be found here: https://www.sec.gov/litigation/admin/2017/34-80103.pdf.

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