Accounting & Financial Reporting Enforcement Round-Up

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The new fiscal year ushered in a continued era of change at the U.S. Securities and Exchange Commission (the "SEC" or "Commission"), more generally and in the financial reporting space. Two new Commissioners were sworn in bringing the Commission to five members for the first time in over two years. In addition, on December 12, 2017, the SEC announced the unprecedented appointment of new Public Company Accounting Oversight Board ("PCAOB") members to all five of the PCAOB board seats. Primarily tasked with overseeing public company financial statement auditors, the PCAOB maintains a broad range of responsibilities including standard-setting, registration, and inspection of audit firms, as well as an enforcement role. A complete transition of the board members at a single point in time has not previously occurred at the PCAOB, which was established in 2002.

The decision to replace all five board members at once suggests additional change might be forthcoming at the PCAOB. Continued monitoring of enforcement actions brought by the PCAOB in the coming months, in addition to other announcements, will likely yield greater clarity surrounding the new board members' priorities and approach to enforcement. This issue of the Round-Up includes two PCAOB enforcement actions announced shortly before 2017 calendar year-end: one against a foreign Deloitte network firm and the other against Grant Thornton.

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Meanwhile, accounting and financial reporting-related criminal and civil enforcement actions brought by the U.S. Department of Justice ("DOJ") and the SEC have continued, but with some drop-off in activity. This issue of the Round-Up highlights actions that suggest a continued focus on earnings manipulation, transparent disclosure of executive perks, and auditor diligence. One issue that still remains unclear is the future approach to penalties, and whether the Commission will limit imposition of corporate penalties to instances where the issuer received some corporate benefit as a result of the misconduct. Commissioner Michael Piwowar has previously endorsed that view, and we believe that Commissioner Hester Peirce is likely to share it as well; Chair Jay Clayton's view on that issue still remains unclear, though the Co-Directors of Enforcement have suggested in public comments that corporate benefit may not be required in every case for a penalty to be imposed. This issue likely has some significance for the Enforcement Division's priorities in the financial reporting space, since cases involving solely internal controls rarely involve some corporate benefit to the issuer, meaning we could see more instances of no-penalty cease and desist orders going forward if Chair Clayton ultimately subscribes to Commissioner Piwowar's position and requires corporate benefits.

Former Bankrate CFO Faces Criminal Charges in Alleged "Cookie Jar" Accounting Scheme

A recently unsealed criminal indictment provides further evidence that federal criminal authorities continue to aggressively pursue individuals with potential culpability for alleged wrongdoing concerning accounting and financial reporting issues. While most SEC financial reporting cases are SEC-only actions, the SEC has shown that it will work with criminal authorities when the evidence is strong enough to justify criminal charges. As reported in a prior issue of this Round-Up, the SEC brought a case against Bankrate, Inc. ("Bankrate") and certain of its former executives as part of a long-running enforcement action; Bankrate settled that action for $15 million, while the individuals settled, including former CFO Edward DiMaria, who agreed to pay more than $231,000 in penalties, disgorgement, and interest. On December 19, 2017, an indictment in the U.S. District Court for the Southern District of Florida was unsealed charging DiMaria. This timing was interesting since defendants rarely settle SEC actions before being charged criminally. DiMaria was the second former Bankrate executive to be criminally indicted in connection with this matter. There are several aspects of this case that sound themes often seen in criminal cases.

- **Alleged Fraudulent Conduct Charged Criminally** – One thing that seems clear from the charging document is that the evidence is the kind of graphic evidence you often see in criminal cases. The indictment alleges that Bankrate maintained an explicit "cushion" or "cookie jar" expense account which effectively served as a reserve containing accrued expenses unnecessarily—and improperly—recorded in prior periods. DiMaria allegedly directed others to release amounts from this reserve as gains when needed to achieve analyst earnings estimates. According to the indictment, DiMaria and his alleged coconspirators tracked the unsupported expense accruals on a spreadsheet they referred to as "Ed [DiMaria]'s Cushion." The indictment also states that DiMaria referred to having "money stashed in a lot of places."
- **Misrepresentations to Auditors** – The indictment also alleges that DiMaria hid information from, and made misrepresentations to, Bankrate's auditors. Indeed, the indictment quotes from an email in which DiMaria allegedly stated that if the auditors discovered improper accounting treatment for certain items, "we can say it was a mistake." Again, criminal cases often contain such evidence of explicit misrepresentations to outside auditors since such misrepresentations are necessary to get around auditors' sign-off on the original accounting.

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Former Bankrate CFO Faces Criminal Charges in Alleged "Cookie Jar" Accounting Scheme

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- **Cooperation of Another Former Bankrate Executive** – The case against DiMaria was likely built in part based on cooperator testimony by Bankrate's Ex-VP of Finance Hyunjin Lerner, who pleaded guilty pursuant to a cooperation agreement. Criminal cases typically have a cooperator who can tell the story of the case and provide testimony about his or her culpable state of mind at the time of the offense.
- **Cooperator Receives Jail Time** – Despite cooperating with the Government and pleading for leniency, Bankrate's Ex-VP of Finance Lerner recently was sentenced to the maximum five-year prison sentence for his role in Bankrate's fraud. Lerner argued that he should receive a sentence below the statutory maximum 60-month sentence because he acted on the instructions of DiMaria, but the judge was unswayed. Presumably Lerner will be able to make a Rule 35 motion for a reduction in his sentence in the future based on his cooperation in the case against DiMaria.

The criminal indictment against DiMaria can be found here: https://www.justice.gov/opa/press-release/file/1019726/download.

The Justice Department's press release announcing Lerner's sentence can be found here: https://www.justice.gov/criminal-vns/case/hyunjin-lerner/update.

Failure to Disclose Executive Perks Subjects Company and Executives to SEC Scrutiny

The SEC's offensive against undisclosed executive perks—as seen in prior cases against Musclepharm and MDC—continued in its recent action against Provectus Biopharmaceuticals, Inc. ("Provectus") and two company executives. The SEC found that Provectus executives used corporate funds that were advanced for business travel and expenses on personal travel, cosmetic procedures, meals, and entertainment. Provectus, a Tennessee-based development-stage biotechnology company with no reported revenue, reached a no-penalty settlement with the SEC on December 12, 2017 under which it agreed to remediate internal control weaknesses. According to the SEC, from around 2011 to early 2016, Provectus paid then-CEO Dees $3.2 million in business travel advances and expense reimbursements. Dees apparently submitted fraudulent cash advance requests and false expense reports supported by little, no, or fabricated documentation. Similarly, from at least 2013 to 2015, Provectus was found by the SEC to have advanced payment for 130 days of business travel to former CFO Culpepper, out of which he used $103,000 for personal overseas travel, meals, and spa services.

In addition to the internal control failures that allowed Dees and Culpepper to be improperly reimbursed, the SEC cited Provectus for violating Regulation S-K for failure to properly disclose executive compensation.

- **Focus on Travel and Entertainment Expense Reimbursement Controls** – The SEC acknowledged that Provectus had sufficient internal controls governing the reimbursement of personal funds used to cover corporate expenses, but these controls could not cure insufficient internal controls governing travel and entertainment expenses. Travel and entertainment expense reimbursement is ripe for manipulation and has been a repeated target of SEC investigations. As was the case here, an effectively designed but ineffectively operating general personal expense reimbursement control was not enough to prevent the SEC from finding material weaknesses in the company's internal controls.
- **Executives' Personal Liability** – The SEC alleged personal violations by Dees and Culpepper for fraudulently obtaining a collective $3.4 million from the company till. Without admitting or denying the SEC's allegations, Culpepper reached a separate settlement with the SEC in which he agreed to a cease-and-desist order, to be suspended from appearing and practicing before the SEC as an accountant for three years, to pay $152,376 in disgorgement and

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Failure to Disclose Executive Perks Subjects Company and Executives to SEC Scrutiny

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interest, and to pay a civil penalty of $40,535. The SEC filed a claim against Dees in the U.S. District Court for the Eastern District of Tennessee based on its allegation that he personally violated Section 17(a) of the Securities Act and Sections 10(b), 13(b)(5), and 14(a) of the Exchange Act; and for aiding and abetting Provectus's corporate financial reporting violations and internal control material weaknesses. The SEC's complaint seeks, among other things, disgorgement, penalties, and a director and officer bar.

The settlement order with Provectus can be found here: https://www.sec.gov/litigation/admin/2017/34-82292.pdf.

The settlement order with Culpepper can be found here: https://www.sec.gov/litigation/admin/2017/34-82293.pdf.

The complaint against Dees can be found here: https://www.sec.gov/litigation/complaints/2017/comp-pr2017-229.pdf.

Microcap Company and its Chairman Allegedly Misled Investors

Illinois-based healthcare technology company Accelera Innovations, Inc. ("Accelera") and its founder and Chairman Geoffrey J. Thompson, as well as its CFO John Wallin, were charged in federal district court by the SEC with engaging in accounting fraud and disclosure violations after the company improperly consolidated revenue from the target of a failed acquisition. In 2013, Accelera reported to investors that it acquired Behavior Health Care Associates ("BHCA"). Immediately thereafter and until 2015, Accelera began consolidating BHCA's revenue and assets in its financial statements, boosting Accelera's previously reported revenues by up to 90%. But there was a problem: Accelera allegedly neither owned nor controlled BHCA and was prohibited under GAAP from consolidating its earnings and assets. The two companies in fact are alleged to have entered into a purchase agreement that transferred ownership to Accelera upon payment for BHCA's shares, but Accelera never paid for a single share—leaving the acquisition unconsummated. The SEC alleges that Accelera intentionally misled investors when it overstated its revenue by including revenue from an entirely separate company that it did not own or control. In addition to fraudulently overstating its revenue, the SEC found that Accelera misled investors in its annual filings when it touted proprietary software technology that did not exist.

- **CFOs Must Exercise Diligence** – Ignorance is no defense. Once again, the SEC affirmed that the CFO title matters and the responsibility of signing the financial statements carries with it an affirmative responsibility to exercise diligence. The SEC alleged violations by John Wallin, the nominal CEO and CFO until April 2017, for aiding and abetting Accelera in its wrongdoing. The SEC alleges that Wallin signed Sarbanes-Oxley certifications without reviewing them. Wallin allegedly admitted that he did not know who drafted Accelera's financial statements and made no efforts to confirm whether BHSA's revenue was properly consolidated. That Wallin received no salary from Accelera and never exercised any stock options did not shield him from personal liability for signing fraudulent financial statements and for falsely certifying Accelera's public filings, including its Forms 10-K and 10-Q.

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Microcap Company and its Chairman Allegedly Misled Investors

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- **Penalties Sought** – Among other things, the SEC is seeking director and officer bars against Thompson and Wallin. Additionally, the SEC is seeking civil penalties against Accelera, Thompson, Wallin, and Synergistic Holdings, LLC (a holding company that was the majority shareholder of Accelera common stock during the relevant period).

The Accelera complaint can be found here: https://www.sec.gov/litigation/complaints/2017/comp23969-accelera.pdf.

The Wallin complaint can be found here: https://www.sec.gov/litigation/complaints/2017/comp23969-wallin.pdf.

SEC Claims California Audit Firm Willfully Violated Anti-Fraud Provisions

Recent enforcement actions against a California-based audit firm and certain individual auditors demonstrate the SEC's continued focus on auditors who fail to apply the diligence expected of the accounting profession. On December 4, 2017, the SEC initiated administrative proceedings against Anton & Chia LLP, as well as against its co-owners, a former partner, and a former audit manager for serial violations of the federal securities laws and improper professional conduct. A current partner and another former partner also reached settlements in connection with the matter on December 4, 2017.

The SEC alleges that Anton & Chia ignored many potential indications of fraud by three microcap audit clients, including Accelera Innovations, Inc. ("Accelera")—which is discussed in the prior item in this Round-Up. The SEC's order instituting administrative proceedings cited egregious deviations from audit standards and claimed that the firm ignored numerous red flags of material misstatements by the microcap companies. Among other things, the SEC claimed that Anton & Chia failed to appropriately staff the engagements, failed to retain sufficient and appropriate audit evidence, failed to maintain an adequate system of quality controls for audits and interim review, and failed to make adequate inquiries of management.

- **Auditor Responsibility** – This enforcement action demonstrates once again that the SEC remains committed to pursuing auditors who fail to fulfill their responsibilities to investors. Here, the SEC actually charged the audit firm and one of its owners with violations of Section 10(b) with respect to their audit of Accelera (which as noted included another company's financials in its own financial reporting—even though it did not own that company—and thereby inflated revenue by 69% to 90% over a two-year period). Grounded in what the SEC describes as particularly egregious conduct, willful fraud claims against an auditor are somewhat rare and represent a strong stance by the SEC against auditors that fail to exercise due care in their audit responsibilities.
- **Importance of Audit Evidence** – In addition to its audit of Accelera, Anton & Chia audited another microcap company that recorded assets at inflated values. The SEC found that Anton & Chia failed to obtain sufficient audit evidence that would support the client's valuation for 75% of its reported assets. The SEC's order alleged Anton & Chia did not properly exercise due care and professional skepticism when they failed to obtain the appropriate audit evidence.

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SEC Claims California Audit Firm Willfully Violated Anti-Fraud Provisions

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- **Client Restatement Considerations** – The SEC also alleged that Anton & Chia ignored the potential that a third microcap client's write-down of a significant asset from $35 million to $8 million suggested a restatement of prior periods might also have been necessary. This finding reiterates that auditors must continue to consider the impact of newly discovered circumstances on prior-period financial statements.

The order instituting administrative proceedings against Anton & Chia and certain individual auditors can be found here: https://www.sec.gov/litigation/admin/2017/34-82206.pdf.

The settlement order with a current Anton & Chia audit partner can be found here: https://www.sec.gov/litigation/admin/2017/34-82207.pdf.

The settlement order with a former Anton & Chia partner can be found here: https://www.sec.gov/litigation/admin/2017/34-82208.pdf.

Biotech Company and Executives Charged in Fraudulent Revenue Recognition Scheme

The DOJ and SEC continue to pursue parallel actions in accounting fraud cases that involve particularly egregious conduct. On November 2, 2017, the former CFO of Maryland-based biotechnology company Osiris Therapeutics, Inc. ("Osiris") pleaded guilty to making misrepresentations to Osiris's auditors about a fraudulent revenue recognition scheme that involved the use of inflated prices and backdated documents to meet quarterly revenue goals. The former CFO, Philip Jacoby, faces up to 20 years in prison and a maximum fine of $5 million. Osiris agreed to pay a $1.5 million penalty to settle a related civil lawsuit with the SEC, which also targets Jacoby and three other Osiris executives, including the former CEO. The three other executives are expected to litigate the SEC's claims.

According to the SEC complaint, Osiris is alleged to have routinely overstated company performance over a two-year period. The SEC alleges that Osiris prematurely recognized revenue in periods before sales had been made or finalized, recognized revenue using pricing data known to be false, and prematurely recognized revenue upon delivery of products to be held on consignment.

- **Focus on Revenue Goals** – The corporate culture at Osiris was an important aspect of the criminal and SEC cases. Both the DOJ and SEC emphasized Osiris's focus on reporting consistent quarter-over-quarter revenue growth. The SEC's complaint noted that this culture was set by the former CEO, who circulated an "absolute minimum" revenue target in December 2014. In an effort to meet this target, Jacoby allegedly tried to convert $1.1 million of consigned inventory but was unable to close the transaction until January 2015. Rather than record this revenue in the proper period, he allegedly backdated the agreement and recognized the resulting revenue in the fourth quarter of 2014. The SEC alleges that Jacoby also used similar tactics with two other customers, in one case recognizing revenue based on the list price of products that he knew had actually been sold at a discount. In its press release announcing the settlement, the SEC reiterated that the fraudulent scheme, misstatements, and omissions were the result of Osiris's aggressive culture.

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Biotech Company and Executives Charged in Fraudulent Revenue Recognition Scheme

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- **Misrepresentations to Auditors** – Once again, this criminal case involved alleged misrepresentations to outside auditors. For example, when the auditors requested additional documentation in connection with a PCAOB inspection, Jacoby wrote an accounting memorandum that falsely represented that the $1.1 million of revenue described above was related to a 2014 transaction. Additionally, Jacoby created a customer letter that memorialized the transaction and was backdated to December 2014. Using his personal email account, he then asked the customer to send the letter back to him "in an email saying you had this in your file from late last year, and just came across it . . . write a wonderfully warm and convincing email, please." The customer complied and the backdated letter was ultimately forwarded to the auditors. Like other criminal cases, the email trail in this case appears to be compelling and very incriminating.

The Justice Department's information against Jacoby can be found here: https://www.justice.gov/usao-sdny/press-release/file/1008431/download.

The SEC's complaint can be found here: https://www.sec.gov/litigation/complaints/2017/comp-pr2017-207.pdf.

Grant Thornton Settles Quality Control Violations and Audit Failures Matter for $1.5 Million

In keeping with the SEC's broader focus on audit quality, the PCAOB announced a $1.5 million settlement with Grant Thornton LLP ("Grant Thornton") for quality control violations related to two separate 2013 financial statement audits out of its Philadelphia office. After investigation, PCOAB found that Grant Thornton assigned two Philadelphia-based partners with known audit quality concerns to serve as engagement partners without proper supervision. The PCAOB also found that Grant Thornton's 2013 audit of The Bancorp, Inc. ("Bancorp") financial statements, led by engagement partner David M. Burns, failed to comply with PCAOB rules and standards.

The PCAOB focused on the 2013 Bancorp audit and the alleged audit failures surrounding Bancorp's allowance for loan and lease losses ("ALLL"), which the PCAOB described as a known significant risk and significant accounting estimate. Grant Thornton, among other things, failed 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. On April 1, 2014, Bancorp announced that the previously issued financial statements for FY 2012 and 2013 should no longer be relied upon because certain provisions for commercial loan losses were taken in incorrect periods. The restatement prompted by the improper reporting of the loan losses resulted in a $141 million reduction to Bancorp's reported loan losses.

- **Emphasis on Supervision** – This settlement highlights the importance of two forms of supervision: (i) the audit firm's supervision of its partners; and (ii) the partners' supervision of the audit staff. Grant Thornton had concerns about the proficiency and technical competence of Burns and a second, unnamed audit partner prior to the 2013 audits, leading the firm to place the unnamed partner on a performance improvement plan and to develop remedial plans to improve audit quality. However, Grant Thornton allegedly failed to take sufficient steps to support or monitor either partner and thereby violated multiple PCAOB rules. These sorts of supervision issues at Grant Thornton were also apparent in a prior SEC enforcement action against Grant Thornton, where the SEC found that the firm had failed to adequately supervise a partner whose competency had been called into question.

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Grant Thornton Settles Quality Control Violations and Audit Failures Matter for $1.5 Million

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- **Personal Liability** – In addition to sanctioning the audit firm, the PCAOB individually sanctioned the Bancorp engagement partner, Burns, for failing to properly supervise the engagement team; failing to exercise due professional care, including exercising appropriate professional skepticism; and failing to obtain sufficient appropriate audit evidence to properly test Bancorp's ALLL and related controls. Because he failed to perform the audit in conformity with PCAOB standards, he lacked the proper basis to authorize the issuance of an unqualified audit opinion. Specifically, the PCAOB found that Burns failed to adequately account for the knowledge, skill, and ability of each engagement team member when assigning work. This was particularly true because in the 2013 audit at issue Burns had a relatively inexperienced engagement team. The PCAOB censured Burns and barred him from associating with a registered public accounting firm for one year. The PCAOB's order further provides that if Burns is later permitted to associate with a registered public accounting firm he will be under a two-year bar from, among other things, serving as an engagement partner (or equivalent role) or engagement quality reviewer; signing an audit report; and supervising auditors. He was also ordered to pay a $15,000 civil monetary penalty. This settlement agreement is notable in that it bars an audit partner from serving as an audit engagement partner or supervising other auditors in addition to the bar from associating with a registered public accounting firm.

The settled disciplinary order against Grant Thornton can be found here: https://pcaobus.org/Enforcement/Decisions/Documents/105-2017-054-GT-Bancorp.pdf.

The order against David M. Burns can be found here: https://pcaobus.org/Enforcement/Decisions/Documents/105-2017-055-Burns.pdf.

The SEC's 2015 settlement order with Grant Thornton can be found here: https://www.sec.gov/litigation/admin/2015/34-76536.pdf.

PCAOB Sanctions Deloitte Turkey for Altering Audit Workpapers

The PCAOB settled its second recent action alleging that a Deloitte member firm altered audit documentation in advance of a PCAOB inspection. In December 2017, DRT Bagimsiz Denetim ve Serbest Muhasebeci Mali Musavirlik A.Ş. ("Deloitte Turkey") agreed to pay a $750,000 civil penalty to settle findings that it failed to cooperate with a PCAOB inspection and violated quality control, ethics, and audit documentation standards. The settlement comes just over a year after the PCAOB announced a similar settlement with Deloitte's Brazil affiliate, which also involved altered documents and resulted in the PCAOB's largest-ever civil penalty of $8 million. In both cases, the PCAOB also sanctioned individual audit partners who were involved in the misconduct. The recent settlement with Deloitte Turkey emphasizes that the PCAOB would have imposed a significantly larger monetary penalty and more severe sanctions had the firm and its former partners not provided "extraordinary cooperation."

According to the order, the PCAOB notified Deloitte Turkey in 2014 that it would be conducting its first inspection of the firm and identified three audit engagements that would be inspected. Following this notification, four of the firm's senior partners allegedly devised a plan to offer the engagement teams an opportunity to modify their audit workpapers, which had already been archived. In particular, the senior partners allegedly warned one engagement partner about deficiencies in the workpapers that "would lead the PCAOB to issue negative comments that could affect her career and lead to monetary sanctions and reputational damage to the [f]irm." As a result, this engagement partner took them up on the offer. With help from one of the firm's technology supervisors, one of the senior partners provided the engagement partner with a laptop that was disconnected from the firm's network so that the laptop's system with data could be backdated to avoid detection of the improper alteration. The engagement partner then altered several workpapers relating to acquisition accounting, goodwill impairment, litigation, and the use of information technology specialists in the audit. These workpapers were subsequently provided to the PCAOB's inspection team without informing the inspectors of the improper alteration.

- **Foreign Member Firms** – This settlement, coupled with last year's Deloitte Brazil settlement, illustrates the continued regulatory scrutiny of foreign member audit firms, particularly for the Big Four audit firms. U.S. affiliates of the Big Four likely now view foreign affiliates as a real risk to their own reputations and standing, which will likely result in more of a global focus on quality control. Global network firms will need to remain vigilant with respect

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PCAOB Sanctions Deloitte Turkey for Altering Audit Workpapers

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to the implementation of strong oversight and quality control standards both domestically and abroad. Additionally, audit clients should carefully evaluate foreign member firms when selecting an auditor if the audit engagement may require assistance from a member firm.

- **Personal Liability** – The PCAOB's settlement order identifies five Deloitte Turkey partners and the firm's technology officer as being involved in the alleged misconduct. All of these individuals were placed on administrative leave and have since left the firm. Two of the partners were also sanctioned by the PCAOB. Berkman Özata, who served as the Deloitte Turkey's National Professional Practice Director, was censured and barred from associating with a PCAOB-registered public accounting firm for two years. Şule Firuzment, the engagement partner who allegedly altered the audit workpapers, was censured, barred from associating with a PCAOB-registered public accounting firm for one year, and restricted from serving as an engagement partner or engagement quality reviewer for an additional year. These types of sanctions are relatively consistent with those announced in connection with the PCAOB's earlier settlement with Deloitte Brazil; however, that case involved far more individual culpability. Twelve Deloitte Brazil audit partners and other personnel were identified as being involved in the alleged misconduct, all of whom were censured. Additionally, eleven of those individuals were either barred or suspended from associating with a PCAOB-registered public accounting firm.
- **Extraordinary Cooperation** – As noted above, the PCAOB credited Deloitte Turkey, Özata, and Firuzment for extraordinary cooperation, which included conducting an internal investigation, voluntarily and timely self-reporting the misconduct, sharing the results of the internal investigation, and implementing enhancements to the firm's quality control policies and procedures. The firm also separated the individuals who were responsible for the misconduct.

The settled disciplinary order against Deloitte Turkey can be found here: https://pcaobus.org/Enforcement/Decisions/Documents/105-2017-050-DRT.pdf.

The order against Berkman Özata can be found here: https://pcaobus.org/Enforcement/Decisions/Documents/105-2017-051-Ozata.pdf.

The order against Şule Firuzment can be found here: https://pcaobus.org/Enforcement/Decisions/Documents/105-2017-052-Firuzment.pdf.

Accounting & Financial Reporting Enforcement Round-Up

AFR Enforcement Round-Up
is a publication of
Debevoise & Plimpton LLP

919 Third Avenue
New York, New York 10022
+1 212 909 6000
www.debevoise.com

Washington, D.C.
+1 202 383 8000

London
+44 20 7786 9000

Paris
+33 1 40 73 12 12

Frankfurt
+49 69 2097 5000

Moscow
+7 495 956 3858

Hong Kong
+852 2160 9800

Shanghai
+86 21 5047 1800

Tokyo
+81 3 4570 6680

Andrew J. Ceresney
Co-Editor-In-Chief
+1 212 909 6947
aceresney@debevoise.com

Jonathan R. Tuttle
Co-Editor-In-Chief
+1 202 383 8124
jrtuttle@debevoise.com

Matthew E. Kaplan
Co-Editor-In-Chief
+1 212 909 7334
mekaplan@debevoise.com

Arian M. June
Co-Editor-In-Chief
+1 202 383 8053
ajune@debevoise.com

John T. Chisholm
Member
+1 202 383 8176
jtchisholm@debevoise.com

Mark D. Flinn
Member
+1 202 383 8005
mflinn@debevoise.com

Anne M. Croslow
Member
+1 202 383 8077
amcroslow@debevoise.com

Please address inquiries regarding topics covered in this publication to the editors.