Debevoise & Plimpton

Accounting & Financial Reporting Enforcement Round-Up

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As the federal government's fiscal-year end nears on September 30, there has been an uptick in U.S. Securities and Exchange Commission ("SEC") enforcement actions, including accounting and financial reporting matters. Of particular note, we understand from court filings that the SEC enforcement staff reached a proposed settlement-in-principle with two former executives of the bankrupt, for-profit education company ITT Educational Services Inc. ("ITT"). However, according to public reports, the Commission—currently consisting of Chairman Jay Clayton and Commissioners Michael Piwowar and Kara Stein—appears to have rejected the settlement. This rare rejection of a settlement reached by the staff—soon after Congressional inquiries regarding the matter—might be viewed as a signal that the staff is still trying to determine the Commission's expectations for settlement remedies and that the Commission may demand harsher remedies in individual actions, particularly those that have been the subject of public focus.

Other cases highlighted in this issue of the Round-Up touch on the relevance of market analyst projections to SEC enforcement actions and the continued focus on individual accountability. Additionally, this issue highlights a recent criminal conviction arising from the reporting of non-GAAP measures, which has become a significant area of focus for the SEC over the last year. Two cases against Big 4 audit firms are also highlighted, one of which was brought by the Public Company Accounting Oversight Board ("PCAOB"), which serves as a reminder of the PCAOB's focus and its role as a key component of the accounting and financial reporting regulatory infrastructure.

SEC Rejects Staff-Proposed Settlement with Former For-Profit Education Executives

After inquiries from Congress and media outlets, the SEC reportedly rejected a proposed settlement with two former executives of a bankrupt for-profit education company on August 11. The company, ITT Educational Services Inc. ("ITT"), reached a settlement with the SEC in June.

ITT allegedly failed to disclose to its investors the performance of two student loan programs. ITT partially guaranteed the programs' loans in order to attract investors to the potentially risky investments. As alleged by the SEC, however, ITT did not adequately disclose its exposure to the loan programs as projected losses began to mount and it made payments on delinquent loans to avoid triggering its guarantee obligations. When ITT eventually made more fulsome disclosures in 2014, the company's stock price declined by approximately two-thirds.

The SEC's June settlement with ITT contained no civil monetary penalty and the company was not required to admit the allegations against it. On the same day as ITT's SEC-approved settlement was announced, however, Senators Richard Durbin and Sherrod Brown wrote to new SEC Chairman Jay Clayton demanding a stringent penalty for the CEO and CFO. Although at the time of the letter it appears the SEC enforcement staff had already negotiated the terms of a proposed settlement with the former CEO and CFO (the staff informed the Court soon thereafter that a settlement-in-principle had been reached), the Commission itself—currently consisting of Chairman Clayton and Commissioners Michael Piwowar and Kara Stein—ultimately took the rare step of rejecting the enforcement staff's proposed agreement. The SEC's claims against the two former ITT executives remain outstanding and the civil case will continue.

- **Rejection of Proposed Settlement with Executives** – Commission rejection of a proposed settlement negotiated by the enforcement staff is rare. The terms that were rejected are not public. A similar rejection reportedly occurred at the start of Chair Mary Jo White's tenure in the Falcone matter. The rejection suggests that the SEC staff is still trying to determine the contours of settlements that will be acceptable to the Commission, particularly in high profile cases. Furthermore, the circumstances suggest individual executive responsibility for corporate actions remains a priority.

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- **No Monetary Penalty for the Company** – The SEC's approval of the June settlement with ITT, which includes no civil monetary penalty, stands in contrast with the SEC's rejection of the former executives' proposed settlement a few weeks later. However, ITT remains in bankruptcy and appears to be a defunct entity. The SEC may have determined that a monetary penalty against a bankrupt company would have no value.

The SEC's 2015 complaint against ITT and the two former executives can be found here: http://www.sec.gov/litigation/complaints/2015/comp-pr2015-86.pdf.

Former REIT CFO Faces Prison after Accounting Fraud Conviction

Perhaps serving as a reminder that accounting and financial reporting-related securities fraud claims can also be brought as criminal actions when intent is present, a former REIT executive was recently convicted on criminal charges stemming from non-GAAP disclosure issues. On June 30, a New York federal jury found Brian Block, former CFO of the real estate investment trust ("REIT") American Realty Capital Partners Inc. ("ARCP"), guilty of manipulating the company's adjusted funds from operations ("AFFO") metric in public filings with the SEC. AFFO is an industry-specific, non-GAAP measure that is designed to more accurately reflect a REIT's ability to pay dividends. The jury convicted Block after an 18-day trial on all counts, including securities fraud, conspiracy to commit securities fraud, making false filings with the SEC, and submitting false certifications to the SEC. The conspiracy charge carries a maximum prison term of 5 years, while the other charges each carry a maximum term of 20 years.

- **Parallel Proceedings** – Block's conviction follows parallel criminal and civil proceedings brought by the Department of Justice and the SEC in September 2016. Lisa McAlister, ARCP's former chief accounting officer, was also named as a defendant in the proceedings. McAlister pled guilty to the criminal charges, agreeing to cooperate with the government's investigation, and entered into a settlement order with the SEC on August 15. After Block's criminal conviction, the SEC submitted a request to the court to move for summary judgment, which was denied until after Block is sentenced on October 26.
- **Focus on Non-GAAP Measures** – The government's case against Block focused on his role in reporting ARCP's AFFO metrics, including AFFO per share, after discovering the company's calculation of these metrics was erroneously inflated. According to the government, Block continued to report AFFO incorrectly in the second quarter of 2014 by "plugging" unsupportable numbers into the calculation to match what had been reported in the prior quarter and meet analyst expectations. As noted above, AFFO is an industry-specific non-GAAP measure. We previously noted in the Round-Up that non-GAAP measures have become a significant area of focus for enforcement authorities, including the SEC's Division of Corporation Finance and Office of the Chief Accountant. Additionally, there have been public reports of an enforcement sweep based on violations relating to non-GAAP measures. Block's conviction is a reminder that issuers need to focus on non-GAAP measures to ensure that they are appropriately presented and used.

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- **Materiality Issues** – Block argued that there was an immaterial difference between the AFFO numbers he reported and the numbers that the government alleges he should have reported. He argued that this difference was less than 4% of total AFFO per share, whereas the government claimed it was approximately 5%. The specific percentage is significant because SEC Staff Accounting Bulletin No. 99 ("SAB 99"), which provides the SEC staff's guidance on interpreting materiality with respect to financial statements, states that deviations of less than 5% are likely to be immaterial. However, SAB 99 does not expressly reference non-GAAP metrics, which leaves an open question as to whether such guidance would have even been applicable. Additionally, materiality is assessed from both quantitative and qualitative standpoints and, indeed, courts have rejected "bright-line" statistical materiality tests (e.g., *Matrixx Initiatives, Inc. v. Siracusano* and *Litwin v. Blackstone Group, L.P.*). Ultimately, the question of materiality was left for the jury to decide, as materiality is typically an issue of fact for the fact-finder to determine.

The Justice Department's indictment against Block can be found here: https://www.justice.gov/usao-sdny/file/890466/download.

The Justice Department's press release announcing Block's conviction can be found here: https://www.justice.gov/usao-sdny/pr/former-chief-financial-officer-american-realty-capital-partners-arcp-found-guilty-after.

The SEC's complaint against Block and McAlister can be found here: https://www.sec.gov/litigation/complaints/2016/comp-pr2016-180.pdf.

The SEC's settlement order with McAlister can be found here: https://www.sec.gov/litigation/admin/2017/34-81397.pdf.

SEC Concludes Long-Running Inquiry of Former Bankrate Executives

Almost two years after the SEC reached a settlement with Bankrate, Inc. ("Bankrate") over an alleged scheme to improperly inflate earnings in order to meet market analyst forecasts, Bankrate's former CFO and director of accounting reached settlements with the SEC on August 22. The SEC's findings focused on the second quarter of 2012 and alleged that the two former executives inflated revenue and avoided recognition of certain expenses in order to overstate earnings for the period. Furthermore, the CFO allegedly traded the company's stock at an artificially inflated price.

- **Relationship to Analyst Forecasts** – As originally alleged by the SEC staff, the CFO reviewed Bankrate's preliminary second quarter 2012 financial results, noted that the preliminary results fell short of analyst estimates, and directed certain Bankrate divisions to book additional revenue. This settlement should serve as a reminder that the SEC will scrutinize adjustments and other modifications to financial statements that have the effect of allowing the company to meet analyst forecasts. While such cases were certainly more common before Sarbanes-Oxley, they remain a regular feature of financial reporting cases and a company consistently meeting such expectations can serve a red flag for the SEC.
- **Focus on Individuals** – As we have stressed before, the SEC remains focused on individual culpability for alleged securities law violations. The SEC staff continued to pursue claims against the two former Bankrate executives for almost two years following the settlement with Bankrate. Additionally, a third former Bankrate executive who already settled with the SEC was criminally indicted in the Southern District of Florida earlier this year and charged with wire and securities fraud, among other charges. While it is unclear whether criminal charges will be filed against the settling defendants, it seems unlikely those defendants would have agreed to settle if there was a prospect of criminal enforcement against them.
- **Penalty and Disgorgement Amounts** – The SEC ordered the CFO to pay more than $200,000 in disgorgement, civil penalties, and prejudgment interest, while the director of accounting incurred a $60,000 civil penalty. The reasons for the disparate treatment were likely twofold: (a) the CFO settled scienter-based

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Section 10(b) and 17(a) fraud claims, while the director of accounting did not settle claims requiring scienter; and (b) the CFO's alleged stock trade at an artificially inflated price suggested a greater likelihood of direct personal benefit from the alleged scheme, as well as additional misconduct.

- **Professional Practice Bars** – The CFO accepted a five-year bar from serving as an officer or director of an SEC-registered company, the usual time frame for a Rule 10b-5 settlement. Both the CFO and director of accounting accepted five-year and three-year suspensions, respectively, from appearing or practicing before the SEC as accountants.

The settlement order with the former CFO can be found here: https://www.sec.gov/litigation/admin/2017/34-81451.pdf.

The settlement order with the former director of accounting can be found here: https://www.sec.gov/litigation/admin/2017/34-81452.pdf.

The original, September 2015 settlement order with Bankrate can be found here: http://www.sec.gov/litigation/admin/2015/33-9901.pdf.

SEC Charges Penn West with Improperly Shifting Operating Expenses to Improve Key Industry Reporting Metrics

The SEC remains focused on foreign issuers, even those who do not report in accordance with U.S. accounting standards. On June 28, the SEC filed accounting fraud claims against Penn West Petroleum Ltd. ("Penn West"), formerly one of the largest oil and gas producers in Canada, and the company's former CFO and two accounting and finance managers. The SEC alleged that Penn West artificially reduced its operating expenses in order to meet key financial reporting metrics from 2012-2014. Specifically, the SEC alleged that the individuals ensured the company met its reporting targets by reclassifying operating expenses into capital expenditure and royalty accounts and delaying the write-off of certain operating expense accruals in order to make the expenses appear more consistent throughout the year. As alleged, Penn West's operating expenses were understated by at least 16% in each period subject to the SEC's complaint. The SEC's case follows a $38 million settlement that Penn West agreed to pay in 2016 to settle similar shareholder claims, which arose after the company restated its prior financials in 2014.

- **Foreign Issuer** – Penn West is a Canadian issuer with shares listed on both the Toronto Stock Exchange and the New York Stock Exchange. The company reports its financial results in accordance with International Financial Reporting Standards. Canadian regulators conducted their own investigation of Penn West and did not bring any charges against the company. The SEC's complaint alleges that the company's financial reporting was not in accordance with international accounting standards. The SEC's case against Penn West shows that the agency will commit resources to investigate and litigate cases against foreign issuers involving international accounting standards, even in situations where foreign regulators chose to not take action.
- **Relationship to Industry-Specific Financial Metrics** – The SEC's complaint emphasizes that the allegedly fraudulent accounting practices, referred to internally at Penn West as "reclass to capital," "reclass to royalty," and "accrual softening," were designed to reduce Penn West's "operating expense per barrel of oil equivalent," which is a financial reporting metric that is relied upon heavily in the oil and gas industry. The SEC will often focus on such industry-specific metrics to which investors attach importance.

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- **Focus on Individuals** – As noted above, the SEC's complaint names three former Penn West employees as defendants. One of these individuals is cooperating with the SEC and has agreed to a settlement without admitting or denying the SEC's allegations, which includes permanent injunctions, an officer-and-director bar, and a permanent suspension from appearing and practicing before the agency (as well as a deferred determination of the amount of any penalty). The remaining two individuals, including the company's former CFO, continue to litigate the case.
- **Clawbacks** – The SEC is seeking a clawback of incentive-based compensation awarded to Penn West's former CFO, who at a pretrial conference recently challenged the SEC's ability to establish a motive for the alleged fraud, arguing that he would have received higher bonuses if the company's restated financials had been correct in the first place. Additionally, two former Penn West CEOs — who were not charged — have reimbursed the company for certain compensation they received during the period at issue in the case, even though the SEC's investigation found no individual misconduct by them. This is the latest in a number of recent actions where executives, likely facing clawback claims under Section 304, have decided to "voluntarily" reimburse the company portions of their incentive compensation.

The SEC's complaint against Penn West and its former employees can be found here: https://www.sec.gov/litigation/complaints/2017/comp-pr2017-120.pdf.

KPMG Pays $6.2 million to Settle Audit-Related Findings

The SEC continues to aggressively pursue actions against audit firms and engagement partners, even Big 4 firms. In August, KPMG paid over $6.2 million to settle findings related to its audit of the financial statements of Miller Energy Resources ("Miller Energy") just months after accepting the oil and gas company as a new client. The SEC's settlement focuses on KPMG's audit of the valuation of certain leases covering unproven exploratory oil and gas prospects in Alaska, which Miller Energy purchased in late 2009 for approximately $4.5 million and subsequently reported at an inflated value of $480 million (the "Alaska Assets"). KPMG's audit partner in charge of the engagement also settled findings with the SEC. The case serves as a reminder that auditors should carefully assess prospective clients by developing a thorough understanding of each company's risk profile and prior audit history. It also suggests that decisions to significantly mark up assets need to be carefully assessed. KPMG reached a settlement without admitting or denying the SEC's findings.

- **Flawed Client Acceptance and Engagement Staffing** – The SEC found that at the time KPMG accepted Miller Energy as a new client, the audit firm did not have sufficient policies and procedures in place for assessing new clients, and did not staff the engagement team with an audit partner or senior manager who had sufficient experience with oil and gas companies. The experience of audit personnel, or lack thereof, has been a theme in several recent actions against auditors and audit firms.
- **Insufficient Assessment of Prior Audits** – The SEC's order also focuses on KPMG's assessment of the work performed by Miller Energy's predecessor auditor. As required under Generally Accepted Auditing Standards, this step would have included analyzing the prior audit's impact on the opening balances subject to KPMG's audit. Although the KPMG engagement team did conclude that the predecessor auditor had not documented sufficient evidence over Miller Energy's valuation of the Alaska Assets, the SEC took issue with the fact that KPMG did not explain these findings in its own workpapers.
- **Penalties and Remediation** – In connection with the settlement, KPMG's partner in charge of the audit agreed to a $25,000 penalty and a two-year suspension from appearing or practicing before the Commission. KPMG agreed to pay $5.2 million in disgorgement and interest for all the audit fees

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it received from Miller Energy, as well as a $1 million penalty. Additionally, KPMG agreed to a number of undertakings to enhance its quality control system, including internal and third-party reviews of the firm's policies and procedures relating to client acceptance and its audit procedures over fair value measurements and disclosures.

- **Audit Firm Cases** – The SEC typically reaches a decision to pursue an audit firm when it detects a systemic issue. Here, the client acceptance and staffing issues likely contributed to the SEC's decision to expand the case from one against an individual engagement partner to include claims against the audit firm.

The SEC's settlement order with KPMG can be found here: https://www.sec.gov/litigation/admin/2017/34-81396.pdf.

SEC Settles Alleged Fair Value Overstatements Case Against Investment Adviser

The SEC signaled its intent to continue its focus on alleged overstatements of fair value estimates. Enviso Capital, LLC ("Enviso Capital"), a registered investment adviser at the time of the alleged violations, and two of its executives reached a settlement with the SEC on July 19 without admitting or denying the SEC's findings. Each agreed to pay $50,000 civil monetary penalties and the executives accepted two-year bars from the securities industry (in addition to one executive accepting a two-year suspension from appearing or practicing before the SEC as an accountant).

The SEC's claims focused on alleged failures to use reasonable revenue projection assumptions in the valuation of a portfolio company held by two funds and to consider the impairment of a loan held by one of the funds. As described in the SEC order, these valuation issues caused the funds' financial statements to be out-of-compliance with GAAP. The portfolio company at issue represented 51-88% of one fund's total assets from 2011-2013 and the loan represented 25-40% of the other fund's total assets during the same period.

- **Focus on Valuation Assumptions** – Enviso Capital used a discounted cash flows model to determine the fair value of a portfolio company for the purposes of investor disclosures. The SEC found that Enviso Capital did not use reasonable cash flow assumptions in the model. Specifically, the model allegedly included cash flow projections for a renewable energy project that was not yet under construction and for which there was no financing in place or potential purchasers under contract to buy the energy. As noted in the SEC's settlement order, GAAP requires valuation from a market participant perspective. Presumably the SEC believed a market participant would not factor cash flows related to this project into its valuation of the portfolio company.
- **Impairment Analysis Questions** – The SEC also found the value of another fund was overstated because the value of a loan it held was not written down for more than three years, even though the borrower never made payments. Enviso Capital eventually deemed the loan to be worthless as of the December 31, 2014 reporting date and wrote its value down to zero. However, the SEC's findings suggest that Enviso Capital should have taken impairment charges earlier as conditions worsened over time.

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- **Advisers Act Violations** – The SEC's settlement order largely found violations of the Investment Advisers Act. It is important to remember that accounting and financial reporting cases are not limited to GAAP and internal controls violations at public companies. In addition to myriad other compliance issues they must consider, registered investment advisers should confirm that their accounting processes remain in compliance with GAAP. Indeed, at least some of the issues related to Enviso Capital's fair value assumptions appear to have been raised in the context of a routine investment adviser exam undertaken by the SEC Office of Compliance Inspections & Examinations.

The settlement order with Enviso Capital and two of its executives can be found here: https://www.sec.gov/litigation/admin/2017/34-81173.pdf.

PCAOB Reaches $1 Million Settlement with PwC over Allegedly Insufficient Internal Controls Testing

The PCAOB reiterated its role as a key player in in regulatory oversight of Big 4 audit firms—particularly with respect to internal controls testing—when it announced a $1 million settlement with PricewaterhouseCoopers LLP ("PwC") on August 2. Although the underlying subject matter of the PCAOB's allegations focused on testing of compliance with a broker-dealer custody rule and did not necessarily directly implicate the core, public company-focused accounting and financial reporting issues that are traditionally the subjects of the Round-Up, the key takeaways with respect to the PCAOB's focus on internal controls examinations conducted by a preeminent audit firm are broadly applicable.

As alleged by the PCAOB, PwC did not obtain sufficient evidence to support its opinion regarding the compliance of Merrill Lynch, Pierce, Fenner & Smith, Incorporated ("Merrill Lynch") with the SEC's broker-dealer customer protection rule in fiscal year 2014. PwC settled without admitting or denying the PCAOB's findings.

- **Focus on Internal Controls** – The PCAOB's order focused on allegedly inadequate internal controls testing by PwC at a granular level of detail, both with respect to the design and operating effectiveness of the controls in place. As alleged, PwC's controls walkthrough procedures did not adequately consider a specific provision of the customer protection rule regarding liens on client assets in Merrill Lynch custody. Furthermore, PwC's testing was allegedly insufficient to identify potential controls concerns related to compliance with the provision. Cases like this one with detailed findings about account or internal controls testing can be fertile ground for PCAOB enforcement actions.
- **Prior Settlement by Audit Client with the SEC** – Merrill Lynch settled a case with the SEC regarding the alleged underlying violations of the customer protection rule in June 2016. Subsequent action by the PCAOB against PwC more than one year later suggests an appetite for focused enforcement inquiries against audit firms whose testing allegedly should have caught the underlying violations earlier. In addition, it is interesting in this case that the SEC deferred to the PCAOB and did not investigate the audit conduct as well. The division of labor between the PCAOB and SEC is sometimes unclear, but typically the SEC will investigate auditor conduct as part of its investigation of the issuer.

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PCAOB Reaches $1 Million Settlement with PwC over Allegedly Insufficient Internal Controls Testing

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> Here, however, the SEC deferred to the PCAOB, presumably because of the non-traditional nature of this financial reporting action, and because the underlying action against the issuer originated in a specialized unit, the Complex Financial Instruments Unit, that is less likely to focus on auditor conduct.

The settlement order with PwC can be found here: https://pcaobus.org/Enforcement/Decisions/Documents/105-2017-032-PwC-Merrill.pdf.

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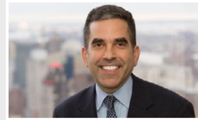

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