2017 Enforcement Trends in Accounting Fraud

Tracy Richelle High, Partner and Tabitha F. Flood, Associate, Sullivan & Cromwell LLP

Notwithstanding that President Trump ushered in new leadership at the U.S. Securities and Exchange Commission ("SEC" or "Commission") after his election, the SEC's annual report for fiscal year ("FY") 2017 shows that the SEC's priorities with respect to enforcement actions concerning accounting misconduct remain largely unchanged. Thus, our advice from previous years to reporting companies and auditors remains the same—companies must maintain sufficient internal accounting controls to ensure the accuracy of their financial statements and individual actors (auditors and corporate management) must exercise professional skepticism to avoid becoming an accomplice to fraud.

In keeping with our task of highlighting the past year's significant developments in this area, we will discuss (1) the adoption of a new standard by the Public Company Accounting Oversight Board ("PCAOB"), *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which replaces portions of Auditing Standard No. 3101; and (2) four noteworthy accounting enforcement actions.

New PCAOB[1] Auditor Reporting Standard

On October 23, 2017, the Commission approved the new PCAOB standard[2] (and related amendments to other standards), which is designed to enhance readers' access to relevant information by requiring auditors to report all critical audit matters or ("CAMs") that arose

1 On December 12, 2017, the SEC appointed five new members to the five-member PCAOB board. Press Release, SEC, SEC Appoints New Chairman and Board Members to PCAOB (Dec. 12, 2017), https://www.sec.gov/news/press-release/2017-230.

2 *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, SEC Release No. 34-81916, File No. PCAOB-2017-01 (Oct. 23, 2017), https://www.sec.gov/rules/pcaob/2017/34-81916.pdf.

during the audit or affirmatively state that there were none.[3] The standard defines CAMs as "any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgment."[4] The auditor's report must describe (i) the CAM; (ii) the principal reasons why the auditor determined the matter to be a CAM; (iii) how the CAM was addressed during the audit; and (iv) the relevant financial statement accounts or disclosures.[5] The standard retains the pass/fail opinion of the report.[6]

The new standard also includes a number of changes to the format of the report in an effort "to clarify the auditor's role and responsibilities related to the audit" and "[to] make the auditor's report easier to read."[7] These changes include requiring:

- a statement disclosing the auditor's tenure;
- a statement regarding the auditors independence;
- that the report be addressed to, at a minimum, the company's shareholders and board of directors or its equivalents;
- certain amendments to standardized language in the report, including adding the phrase "'whether due to error or fraud,' when describing the

---

3 The new standard will not apply for audits of emerging growth companies; broker dealers reporting under Exchange Act Rule 17a-5 (except issuers); investment companies other than business development companies; and employee stock purchase and similar plans. *Id.* at 6-7.

4 *Id.* at 3.

5 *Id.* at 4.

6 *Id.* at 2.

7 *Id.* at 4-5.

auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material statements"; and

- that the opinion appears in the first section of the report with section titles to ease the reader's review.

Related amendments included revisions to (i) standards addressing engagement with the audit committee; (ii) the communication of CAMs; (iii) terminology; (iv) the report's format; and (v) the responsibilities of the engagement quality reviewer.[8]

The new standard is effective for audits of fiscal years ending on or after December 15, 2017 except with respect to the paragraphs concerning CAMs, which will be effective for audits of large accelerated filers for fiscal years ending on or after June 30, 2019, and for all other covered companies for audits covering fiscal years ending on or after December 15, 2020.[9]

Most commenters responding to the proposed changes were supportive of the PCAOB's objectives.[10]

Specific Enforcement Actions

***In re* Michael Hayford**[11]

On June 9, 2017, the SEC settled charges against an executive of UniTek Global Services, Inc. ("UniTek") and two executives[12] of UniTek's wholly owned subsidiary, Pinnacle

---

8 *Id.* at 5-6.

9 *Id.* at 7.

10 *Id.* at 7-8.

11 Sec. Exch. Release No. 10369 (June 9, 2017).

Wireless, Inc. ("Pinnacle"), for violating Section 17(a)(3) of the Securities Act of 1933 ("the Securities Act"), Sections 13(a),(b)(2) and (5) of the Securities Exchange Act of 1934 ("the Exchange Act") and Exchange Rules 12b-20, 13a-1, 13a-13 and 13b2-1 thereunder based on allegations that UniTek materially overstated its earnings in 2011 and 2012 due to the premature recognition of revenue generated by Pinnacle.[13] UniTek,[14] an infrastructure services company specializing in the telecommunications market, acquired Pinnacle in April 2011 and, for reporting purposes, consolidated Pinnacle's financial information with a segment of UniTek. In addition to finding that UniTek prematurely recognized Pinnacle revenue, the SEC also found that UniTek lacked sufficient internal accounting controls to detect and prevent Respondents' fraudulent actions.[15]

Improper Revenue Recognition Based on Invoices

In April 2011, UniTek purchased Pinnacle in exchange for $20.7 million in cash and up to $30 million in UniTek securities, and the contingent agreement to make "earn-out payments" of up to $30 million to the prior owners of Pinnacle, including Hayford.[16] The earn-

---

12 Kevin McClelland, Chief Accounting Officer and Corporate Controller of UniTek; Michael Hayford, President of Pinnacle; and Daniel Rothbaum, Pinnacle's Controller and Accounting Manager (collectively, "Respondents"), all of whom were terminated from the companies as a result of the misconduct. The SEC also alleged that each of them caused UniTek to violate Sections 13(a) and (b) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder. The SEC further alleged that McClelland and Rothbaum violated Section 4C of the Exchange Act and Rule 102(3) of the Commission's Rules of Practice.

13 *Id.* ¶¶ 57-61.

14 UniTek was a publicly traded company until August 2014 when its shares were delisted from NASDAQ. In November 2014, UniTek filed for bankruptcy protection. The company is currently privately owned. *Id.* ¶ 14.

15 *Id.* ¶¶ 44-53.

16 *Id.* ¶ 22.

out payments were contingent on the prior owners' ability to meet certain performance milestones from April 3, 2011 through March 31, 2013.[17]

At the time of the acquisition, Pinnacle's largest revenue source was its contract with the Port Authority of New York and New Jersey in which Pinnacle provided equipment and services for the rebuild of the World Trade Center.[18] Pinnacle fulfilled its obligations by entering into long-term contracts with subcontractors who provided the equipment and services for the rebuild.[19]

In 2011, it became apparent to Hayford and Rothbaum that the rebuild would take longer than projected and Pinnacle would not meet all of its internal financial forecasts for the year.[20] UniTek used the percentage of completion ("POC") methodology as its revenue recognition model.[21] The company measured a project's completion by the cost-to-cost method, wherein costs that the company incurred to date under a contract were "divided by the total amount of costs expected to be incurred upon completion of the contract."[22] That amount was then "multiplied by the total project revenue to compute the amount of revenue that can recognized as of that date."[23] Under the POC methodology, UniTek should only recognize the

---

17 *Id.*

18 *Id.* ¶ 1.

19 *Id.*

20 *Id.* ¶ 23.

21 *Id.* ¶ 5.

22 *Id.*

23 *Id.*

revenue under its subcontractor contracts when the goods and services were actually delivered.[24] Instead, to forestall a revenue shortfall, Hayford went to Rothbaum and McClelland to discuss whether the company could recognize the costs and associated revenue from invoices it received from its subcontractors for work not yet completed.[25] Notwithstanding that McClelland was a CPA, he incorrectly told Rothbaum that the company could recognize the revenue "so long as the invoice 'matched' the purchase order . . . [and] the goods were not cancellable and the materials were 100% custom for the World Trade Center project."[26] Rothbaum, also a CPA, then relayed this advice to Hayford, explaining that Hayford would have to make sure that the invoices stated "'that the materials are custom built equipment for the World Trade Center project.'"[27]

The SEC explained that there were several obvious problems with using the invoices to recognize revenue. *First*, the SEC noted that Rothbaum and McClelland lacked the necessary experience with the POC methodology as demonstrated by their advice to Hayford, which also violated company policy.[28] According to UniTek's internal accounting policy, "'revenue from infrastructure equipment construction and installation contracts is recorded under the percentage of completion method based on the percentage that total direct costs incurred to date bear to estimated total costs at completion.'"[29] UniTek's policy for revenue recognition stated that "'revenue is recognized on a percentage of completion basis based on costs incurred

---

24 *Id.* ¶ 6.

25 *Id.* ¶ 24.

26 *Id.* ¶ 25.

27 *Id.*

28 *Id.* ¶ 24.

29 *Id.* ¶ 20.

and invoiced upon completion of the job.'"[30] The SEC found that, despite their inexperience, Rothbaum and McClelland did not conduct any independent research to support their advice, nor did they consult with outside experts.[31] Making matters worse, they also failed to review UniTek's internal policies regarding revenue recognition.[32] *Second*, the SEC explained that Hayford knew that (i) the invoices inaccurately reflected the goods actually shipped and services actually performed; and (ii) the invoices contained material terms that were inconsistent with the purchase orders.[33] And, most egregiously, because Hayford's compensation was, in part, incentivized by the company's performance, Hayford and McClelland, sometimes, solicited invoices from subcontractors knowing that not all the costs had been incurred by UniTek.[34]

The invoices at issue ranged from $20,000 to $1.7 million.[35] The SEC provided the following examples of when invoices did not reflect the costs or services ultimately completed:

- In December 2011, Hayford requested that a subcontractor issue an invoice for "as much as possible." At the time of the invoice, none of the equipment had been shipped. Upon receipt of this invoice, UniTek improperly recognized revenue of approximately $860,000.[36]

---

[30] *Id.*

[31] *Id.* ¶ 24.

[32] *Id.*

[33] *Id.* ¶ 31.

[34] *Id.* ¶ 28.

[35] *Id.*

[36] *Id.* ¶ 29.

- On March 27, 2012, Hayford solicited the same subcontractor issuing the December 2011 invoice to issue another invoice for $310,000. The subcontractor only shipped $166,000 worth of the equipment. However, upon receipt of the invoice, UniTek improperly recognized $225,000 in revenue.[37]
- In the first quarter of 2012, Hayford directed a Pinnacle employee to ask a subcontractor to issue an invoice for the full price of a shipment. The corresponding purchase order did not require that the subcontractor make any prior delivery of the equipment. However, Pinnacle recognized as revenue the full $345,690 of the invoice. The subcontractor ultimately made a partial delivery for less than the full amount on the invoice.[38]
- In the second and third quarters of 2012, Hayford and Rothbaum instructed a Pinnacle employee to have a subcontractor issue invoices every month for "as much as possible." The subcontractor provided engineering services on a bi-monthly basis. Hayford and Rothbaum were told by Pinnacle staff that the subcontractor had not completed its services reflected on the invoices. But Hayford recorded these invoices as revenue anyway. As a result, UniTek overstated revenue of more than $150,000 in the second quarter and $350,000 in the third quarter of 2012.[39]

---

[37] *Id.* ¶ 30.

[38] *Id.* ¶¶ 33-34.

[39] *Id.* ¶¶ 37-38.

In sum, the SEC concluded that Pinnacle's improper revenue recognition practices caused UniTek's quarterly and annual reports to contain material misrepresentations as to the financial performance of its Engineering and Construction Segment, which included Pinnacle's results.

UniTek's Lack of Sufficient Internal Accounting Controls

The SEC also concluded that UniTek had "material weaknesses in its internal control over financial reporting that compromised the company's ability to prevent or detect material misstatements of revenue and earnings."[40] UniTek failed to establish a process by which its personnel could determine the accuracy of the cost inputs in the company's POC methodology.[41] Additionally, the SEC found that UniTek lacked a clear process to ensure purchase orders were clear as to their terms or to track modifications to purchase orders.[42] UniTek's database storing the purchase orders and invoices was also defective because the database held multiple versions of the same purchase order and did not differentiate when changes were made to the orders or which version of a purchase order was operative.[43] The SEC also found that Respondents were the cause of UniTek's failure to create and maintain a sufficient system of internal accounting controls.[44] The SEC stated that McClelland, as UniTek's Chief Accounting Officer and Corporate Controller, was responsible for ensuring that

---

[40] *Id.* ¶ 44.

[41] *Id.* ¶ 45.

[42] *Id.* ¶ 46.

[43] *Id.* ¶¶ 46-47.

[44] *Id.* ¶¶ 48-53.

he and his staff had proper training in the POC method and revenue recognition.[45] McClelland was also responsible for the accuracy of UniTek's financial statements.[46] As Corporate Controller, Rothbaum was responsible for tracking cost inputs that could impact revenue.[47] The SEC further stated that Rothbaum knew that the purchase orders were inaccurate and incomplete, and oftentimes did not match with corresponding invoices. Rothbaum also failed to maintain a system that would allow UniTek to recognize revenue on final and accurate purchase orders.[48] As for Hayford, the SEC found that he was responsible for the negotiation and approval of purchase orders, and knew that Pinnacle's purchase orders were vague and that UniTek's tracking database was deficient.[49]

As a result of their misconduct, Respondents were placed under cease-and-desist orders from committing, or causing others to commit, violations of Sections 17(a)(3) of the Securities Act and Sections 13(b)(2)(A) and (B) of the Exchange Act, as well as Rules 12b-20, 13a-1, 13a-13, and 13b2-1 thereunder. In addition, Hayford was ordered to cease and desist from committing, or causing others to commit, violations of Section 13(b)(5) of the Exchange Act, and ordered to pay disgorgement of $35,000 and prejudgment interest of $3,500, as well as a civil penalty of $125,000. McClelland was ordered to pay a civil penalty of $75,000. Rothbaum was ordered to cease and desist from committing, or causing others to commit, violations of Section 13(b)(5) of the Exchange Act, and ordered to pay a civil penalty of

---

45 *Id.* ¶ 48.

46 *Id.* ¶ 49.

47 *Id.* ¶ 50.

48 *Id.* ¶ 51.

49 *Id.* ¶ 52.

$25,000. McClelland and Rothbaum were also barred from appearing before the Commission as accountants, but allowed to request reinstatement after three years.

SEC v. Penn West Petroleum

On June 28, 2017, the SEC filed a civil action in the Southern District of New York against a Canadian gas and oil producer, Penn West Petroleum Ltd. ("Penn West"), currently doing business as Obsidian Energy Ltd.[50] The complaint also named as defendants three former senior accounting and finance managers at Penn West: Todd Takeyasu, Chief Financial Officer; Jeferry Curran, Vice President of Accounting and Reporting; and Waldemar Grab, Operations Controller for Revenue, Expenses, and Capital.[51] The SEC alleged that Takeyasu, Curran and Grab orchestrated a "multi-year account fraud scheme" through which they caused Penn West to materially understate its operating expenses to make the company appear to be operating "more efficiently than it actually was," thus appearing more attractive to investors.[52] The SEC contended that Penn West, Takeyasu, Curran and Grab violated numerous provisions of the Securities Act and the Exchange Act, including various anti-fraud provisions. The enumerated violations span 12 sub-paragraphs.[53]

Penn West (prior to its name change) was a publicly traded oil and gas company whose shares were traded on the Toronto Stock Exchange and the New York Stock Exchange during the period covered by the SEC's complaint.[54] According to the complaint, the company

---

50 *See* Complaint, *SEC* v. *Penn West Petroleum Ltd.*, No. 17 Civ. 4866 (S.D.N.Y. June 28, 2017), ECF No. 2.

51 *Id.* ¶ 1.

52 *Id.* ¶ 2.

53 *Id.* ¶ 10.

54 Complaint ¶ 17, *SEC* v. *Penn West Petroleum Ltd.*

"was considered one of the highest-cost producers in the oil and gas industry and had been for many years."[55] As the SEC further explained, "[b]ecause the prices of oil and gas are set by the market, one of the few ways that an oil and gas producer can earn profits and distinguish itself from its peers is by reducing the cost of extracting and processing a barrel of oil or gas for sale."[56] Although Penn West struggled to keep its operating expenses down for many years, it could not make itself as attractive to investors as other Canadian oil and gas producers in the market.[57] Beginning in 2012 and continuing through the first quarter of 2014, Takeyasu, Curran and Grab colluded to artificially lower Penn West's operating costs by improperly (i) "reclassifying" operating expenses as capital expenditures and royalty payments; and (ii) reducing accruals in subsequent periods for operating expenses that were accrued but not expended during prior periods that should have been written off.[58] As a result, Penn West's operating expenses were understated by 16% for 2012, 20% for 2013, and 16% for the first quarter of 2014.[59] In 2014, after Takeyasu and Curran were terminated, a member of Penn West's accounting staff raised concerns about the improper accounting practices.[60] Her alarms set off an internal investigation, ultimately leading the company to restate its financial statements for those periods.[61]

---

[55] *Id.* ¶ 23.

[56] *Id.* ¶ 21.

[57] *Id.* ¶¶ 21-24.

[58] *Id.* ¶¶ 7, 41-107.

[59] *Id.* ¶ 175.

[60] *Id.* ¶¶ 113-125.

[61] *Id.* ¶¶ 94-95.

On November 20, 2017, the district court ordered Penn West to pay a civil money penalty of $8.5 million and enjoined Penn West from committing future violations of certain provisions of the Securities Act and the Exchange Act.[62] Penn West also agreed to continue cooperating with the SEC in its ongoing proceeding against Takeyasu, Curran and Grab. That case is still pending in the Southern District of New York.

***In re* KPMG LLP and John Riordan**[63]

On August 15, 2017, the SEC settled its enforcement action against KPMG LLP and John Riordan, a partner of KPMG, for professional misconduct in violation of Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice, and causing violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated thereunder.[64] The misconduct related to KPMG's review and audit of Miller Energy Resources, Inc. ("Miller Energy")'s 2011 financial statements. Before KPMG was hired in 2011, the company, an oil and gas drilling contractor, had overstated its gas and oil interests in Alaska. Although Miller Energy purchased the interests for $2.25 million and the assumption of $2.2 million in liabilities, Miller Energy valued the acquisition at $480 million—$386 million for the oil and gas properties and $110 million for fixed assets—and also recognized $277 million in after-tax bargain purchase gain. The SEC stated that, despite evidence that contradicted Miller Energy's value of the assets, KPMG completed an auditor report that did not question Miller

---

62 Final Judgment Imposing Permanent Injunction and Civil Money Penalty As to Defendant Penn West Petroleum Ltd., *SEC* v. *Penn West Petroleum Ltd.*, No. 17 Civ. 4866 (S.D.N.Y. Nov. 20, 2017), ECF No. 68.

63 Sec. Exch. Release No. 81396 (Aug. 15, 2017).

64 *Id.* ¶¶ 74-75, 97-98.

Energy's inflation of the assets, violating a number of professional audit standards in the process.[65]

History of the Assets

In 2010, Miller Energy went from being a penny-stock traded company with a history of reporting losses to a company with substantial assets as a result of the acquisition. Specifically, the assets included (i) leases covering 602,000 acres, (ii) five operative oil and gas wells, (iii) two major facilities, and (iv) an offshore platform (the "Alaska Assets").[66] The land had a unique purchase history. The former owner tried to sell it previously, but had no interested buyers.[67] The former owner then filed for bankruptcy in order to abandon the land and be relieved from all of its financial obligations.[68] There was one bidder for the property in the auction process for $8 million, but the bidder never closed the deal.[69] Miller Energy ultimately was able to close the acquisition at a fire-sale price.

Under the PCAOB Auditing Standard Section ("ASC") 820-10-35-9A, Miller Energy was required to record the fair value of the assets and record any gain from the bargain purchase on its income statement.[70] In recording the value of the Alaska Assets at $480 million, Miller Energy relied on (i) a reserve report that was prepared by a third party under guidelines of "supplemental oil and gas disclosures, but not for fair value purposes" and (ii) a pre-existing

---

65 *Id.* ¶¶ 6-17.

66 *Id.* ¶ 7.

67 *Id.* ¶ 8.

68 *Id.* ¶ 9.

69 *Id.* ¶ 8.

70 *Id.* ¶¶ 29-30.

insurance report that showed replacement costs of the assets, which, through their inclusion in the valuation, caused the double counting of nearly all of the fixed assets.[71]

When KPMG came on board to audit and review Miller Energy's financial statements for FY 2011, Riordan, the engagement partner, accepted without question the valuation of the Alaska Assets from the company's prior auditor.[72]

Failure to properly assess the risks associated with accepting Miller Energy as a client. PCAOB quality control standards require that an audit firm "establish policies and procedures to provide reasonable assurance that each firm appropriately considers the risks associated with providing professional services in the particular circumstances."[73] Before KPMG could come on board, the firm had to evaluate the risks associated with taking Miller Energy as a client.[74] The SEC found that KPMG's initial evaluation of Miller Energy was deficient because that evaluation did not consider Miller Energy's "bargain purchase" of the Alaska Assets, its history as a penny-stock company, its lack of experienced executives and accounting staff, or its history of reporting losses.[75] KPMG's initial evaluation designated Miller Energy as a "low" risk client, which KPMG later changed to "high" after it issued its unqualified opinion.[76]

---

71 *Id.* ¶¶ 13-15.

72 *Id.* ¶ 26.

73 *Id.* ¶ 21.

74 *Id.* ¶¶ 21-22.

75 *Id.* ¶ 22.

76 *Id.*

Failure to properly staff the audit. The SEC also found that KPMG did not properly staff the audit with partners and other staff with oil and gas industry experience.[77] Riordan did not have any prior experience in the industry, notwithstanding that he was the engagement partner for the audit.[78] Although Riordan staffed a senior manager to the audit with some experience in the industry, the SEC found that his experience did not mitigate the partner-in-charge's lack of oil and gas experience.[79] The SEC stated: "Many of the departures from PCAOB auditing standards listed below occurred in part because Riordan lacked the industry-specific knowledge to spot potential problems and meaningfully review the work of his assistants."[80]

Failure to properly consider evidence that indicated possible overvaluation of assets. Auditors are required to obtain "sufficient competent evidential matter to afford a reasonable basis for expressing an opinion on the financial statements . . . including evaluating the consistency of the application of accounting principles."[81] In the 2011 annual audit and the third quarter 2011 review, KPMG personnel acknowledged that the previous auditor did not document sufficient evidence to support the impact of the Alaska Assets on the current financial statements, but KPMG failed to identify these deficiencies in its work papers.[82] KPMG failed to implement additional audit procedures to obtain "sufficient competent evidence regarding the

---

77 *Id.* ¶ 23.

78 *Id.* ¶¶ 23-24.

79 *Id.* ¶ 24.

80 *Id.*

81 *Id.* ¶ 25.

82 *Id.* ¶¶ 48-49.

impact of the opening balances on the current period's financial statements."[83] The additional procedures KPMG did implement failed to include (i) a proper assessment of whether Miller Energy's fair value estimate conformed with GAAP; and (ii) reviewing the replacement costs Miller Energy used for the valuation of certain of the fixed assets.[84]

Failure to exercise the requisite degree of due professional care and skepticism. Under ASC 230.07, "[d]ue professional care requires an auditor to exercise professional skepticism – *i.e.*, an attitude that includes a questioning mind and critical assessment of audit evidence."[85] "Due professional care also requires the auditor to consider the competency and sufficiency of the evidence."[86] The SEC found that KPMG and Riordan failed to consider and appropriately question the reports Miller Energy relied on for its valuation of the Alaska Assets in its 2010 financials.[87] The SEC also found that KPMG and Riordan failed to properly investigate the allegations in an article on a financial blog that questioned Miller Energy's valuation of the Alaska Assets.[88] The audit team and Riordan were aware of the article the day it was published, yet Riordan failed to investigate the allegations in the article.[89] Indeed, the day after the article was published, Miller Energy's CEO caused the company to file its

---

83 *Id.* ¶ 26.

84 *Id.* ¶ 27; *see also id.* ¶¶ 37-54.

85 *Id.* ¶ 58.

86 *Id.*

87 *Id.* ¶ 64.

88 *Id.* ¶ 67.

89 *Id.* ¶¶ 67-69.

annual report, which included KPMG's unqualified opinion, even though KPMG had not finished its audit and had not obtained KPMG's consent to the filing.[90]

As a result of the settlement, KPMG was censured and required to (i) undertake various remedial reforms; (ii) engage an independent consultant to review KPMG's policies and procedures; and (iii) certify for 2018 and 2019 that its policies and procedures complied with Commission regulations and PCAOB standards.[91] KPMG was also required to pay disgorgement of the audit and audit-related fees in the amount of $4,675,680 as well as a civil penalty of $1 million.[92] Riordan was subject to a cease and desist order preventing him from committing, or causing others to commit, violations of Section 13(a) of the Exchange Act, and Rules 13a-1 and 13a-13 promulgated thereunder.[93] Riordan was also ordered to pay a $25,000 civil penalty and barred from appearing before the Commission as an accountant, but allowed to request reinstatement after two years.[94]

***In re* Anton & Chia, LLP**[95]

On December 4, 2017, the SEC issued a 43-page order concerning the conduct of Anton & Chia, LLP ("A&C"), a public accounting firm, and several members of its senior staff.[96] The SEC found that A&C engaged in serial violations of the federal securities laws and

90 *Id.*

91 *Id.* ¶¶ 100-114.

92 *Id.* ¶ 114(H) & (I).

93 *Id.* ¶ 114(A).

94 *Id.* ¶ 114(E) & (I).

95 Sec. Exch. Release No. 82206 (Dec. 4, 2017).

96 On the same day, the SEC also settled separate actions against A&C's engagement partners, Richard Koch and Rahuldev Gandhi. Admin. Proceeding Order, *In re Richard J. Koch,*

engaged in improper professional conduct during its audits and interim reviews of three companies: Accelera Innovations, Inc. ("Accelera"), Premier Holding Corporation ("Premier") and CannaVEST Corp. ("CannaVEST").[97] In harsh language, the SEC stated that, "in performing the audits and interim reviews of the Reporting Companies' financial statements, Respondents egregiously deviated from multiple standards of the PCAOB and ignored numerous red flags that indicated the Reporting Companies' financial statements and public filings contained material misstatements."[98]

Accelera

From 2013 to 2015, Accelera, a healthcare service company, incorporated into its financial statements the revenues, assets and liabilities of a separate company that it did not own or control. Accelera's consolidation resulted in its overstatement of revenue ranging between 69% and 90% during the reporting periods.[99] In 2013, Accelera entered into a Stock Purchase Agreement to buy 100% of the shares of Behavioral Health Care Associates, Ltd. ("BHCA").[100] Pursuant to the agreement, Accelera was to take 100% interest in BHCA for the purchase price of $4.55 million after making an initial payment of $1 million and later payments until

---

CPA, Sec. Exch. Release No. 82207 (Dec. 4, 2017); Admin. Proceeding Order, *In re Rahuldev Gandhi, CPA*, Sec. Exch. Release No. 82208 (Dec. 4, 2017); *see also* Press Release, SEC, Audit Firm Charged with Fraud Relating to Auditing of Penny Stock Companies (Dec. 4, 2017), https://www.sec.gov/news/press-release/2017-220.

[97] The SEC also filed civil actions against these companies: *SEC* v. *Accelera Innovations, Inc.*, No. 17-cv-7052 (N.D. Ill. filed Sept. 29, 2017); *SEC* v. *Wallin*, No. 17-cv-7057 (N.D. Ill. filed Sept. 29, 2017) (pending); *SEC* v. *Premier Holding Corp.*, 1:17-cv-09485 (S.D.N.Y. filed Dec. 4, 2017) (pending); *SEC* v. *CannaVEST Corp.*, 2:17-cv-01681 (D. Nev. filed June 15, 2017) (pending).

[98] *Id.* ¶ 1.

[99] *Id.* ¶ 2.

[100] *Id.* ¶ 40.

complete.[101] Several clauses in the Stock Purchase Agreement stated, unequivocally, that full ownership interest would not pass to Accelera unless BHCA received the entire purchase price for payment.[102] Accelera never made any payments to BHCA, and the transaction remained unconsummated.[103] Nevertheless, Accelera incorporated BHCA's revenue, assets, and liabilities in its financial statements from 2013 to 2015.[104] In reality, Accelera was a shell company that previously reported $0 in revenue and $50 in assets.[105]

During the 2013 audit of Accelera, A&C hired a new staff accountant with no audit experience to draft a memorandum analyzing the BHCA transaction.[106] The new accountant concluded that Accelera would have control over BHCA in the future, but never identified the acquisition date, whether Accelera had taken control of BHCA, when Accelera would pay BHCA, or whether Accelera would own BHCA before purchasing the shares.[107] Aside from preparing the memorandum and reviewing the transaction documents, A&C did not institute any other procedures to analyze whether Accelera could properly consolidate BHCA's financials with its own in 2013, and A&C failed to re-analyze that decision in 2014 when BHCA's owner told A&C staff that Accelera did not own or control BHCA.[108] Not only did A&C ignore this red flag, it also ignored three separate disclosures by Accelera's CFO in 2014

---

101 *Id.*

102 *Id.* ¶ 41.

103 *Id.* ¶ 43.

104 *Id.* ¶ 33.

105 *Id.* ¶ 36.

106 *Id.* ¶ 68.

107 *Id.* ¶¶ 70-71.

108 *Id.* ¶¶ 56, 69-74.

and 2015 that he believed consolidation was inappropriate.[109] The engagement quality reviewer ("EQR") for A&C's 2014 year-end audit and for the firm's interim reviews of the company in the third quarter 2014 and first and second quarters of 2015 testified that "he just assumed that [the 2013 engagement team] had made the right decisions."[110] He also testified that "he ignored all of the issues raised by the CFO, both because he did not respect the CFO and because he believed A&C was a good firm."[111] The SEC found that A&C violated a plethora of auditing standards by failing to:

- appropriately staff the engagement team with personnel with the requisite accounting experience and expertise;
- adequately supervise the staff who were assigned to the engagement;
- obtain "sufficient appropriate audit evidence";
- document the significant findings and issues raised by the consolidation of financials;
- maintain an appropriate system of quality control for its audits and interim reviews; and
- ensure its audit reports were not false.[112]

The SEC concluded that no reasonable auditor would have concluded that Accelera owned or controlled BHCA to make consolidation appropriate.[113] As a result of

---

109 *Id.* ¶¶ 59-60.

110 *Id.* ¶ 77.

111 *Id.*

112 *Id.* ¶¶ 80-111.

113 *Id.* ¶¶ 49-51.

A&C's improper conduct during the audits and interim reviews, the SEC found that A&C violated Exchange Act Section 10(b) and Rule 10b-5(b) thereunder.[114] The SEC also found that A&C, Wahl and Deutchman (who had been reprimanded by A&C for failure to adequately supervise staff on two occasions prior to the Accelera engagement, and who had also been censured by the Commission in 2008 and barred by the PCAOB in 2015 from associating with a public accounting firm) aided and abetted Accelera's violation of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.[115] The SEC further found that A&C violated Rule 2-02(b) of Regulation S-X, and Wahl and Deutchman aided and abetted A&C's violation of Regulation S-X.[116] In addition, the SEC found that A&C, Wahl and Deutchman violated or aided and abetted violations of Section 4C(a)(3) of the Exchange Act and Rule 102(e)(1)(iii) of the Commission's Rules of Practice, and engaged in improper professional conduct under Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[117]

Premier

Once again, A&C acted as an accomplice to its client's fraud rather than operating on the front lines of defense. The SEC found that Premier inflated the value of (i) a promissory note in its financial statements from 2013 to 2015, and (ii) an ownership interest in another company.[118] As with Accelera, A&C signed off on Premier's financial statements containing

[114] *Id.* ¶ 206.

[115] *Id.* ¶ 209; *see also id.* ¶ 12.

[116] *Id.* ¶¶ 211-13.

[117] *Id.* ¶¶ 214-15.

[118] *Id.* ¶ 3.

these inaccurate and inflated values.[119] The SEC concluded that A&C ignored numerous red flags that could have prevented Premier's fraudulent actions.[120]

In 2011, Premier transformed its business from selling low-priced caskets to providing clean energy products and services through a series of transactions wherein it created a wholly owned subsidiary, WePower Ecolutions ("WePower"), focused on green energy.[121] In 2013, after a "management shake-up" resulting in the replacement of WePower's president, Premier sold WePower to a newly created company, WePower Eco Corp. ("New Eco").[122] Through the sale, New Eco issued Premier an unsecured promissory note with a face value of $5 million and agreed to assume certain of Premier's liabilities.[123]

The terms of the note were very favorable to New Eco.[124] In addition to being unsecured, the note was secondary to all of New Eco's new debt, the interest was 2% (below market rate), and the note had a 20-year-repayment schedule that included no principal payments for the first five years or interest due for eleven months.[125] Under ASC 310-10-30-5, Premier was required to record the note at fair value.[126] Premier engaged a third-party valuation firm to assess the value of the note and provided the valuation firm with the materials for its

---

119 *Id.* ¶ 154.

120 *Id.* ¶¶ 147-54.

121 *Id.* ¶¶ 113-16.

122 *Id.* ¶¶ 115-16.

123 *Id.*

124 *Id.* ¶ 117.

125 *Id.*

126 *Id.* ¶ 118.

calculations.[127] The SEC stated that Premier's materials consisted of Excel spreadsheets, which contained outdated and unsupported revenue projections for New Eco.[128] Premier provided the firm with two figures for the fair value of New Eco and one for the fair value of the promissory note.[129] The highest of the three was $869,000, which was one of the estimates of New Eco's fair value.[130] Premier never provided the valuation firm with any of the updated revenue projections and other documentation it sought.[131] Although the firm finished its work without these materials, it ultimately valued the note at $0 and New Eco at under $10,000.[132] Nevertheless, in its first quarter 2013 financial statement, Premier recorded the fair value of the note at $869,000, among other improprieties.[133] New Eco missed its first interest payment on December 7, 2013, and the note went into default on December 22.[134] After the default, Premier exchanged the note for the return of 2.5 million shares of Premier common stock held by WePower LLC, a related party.[135] Premier never evaluated the promissory note for impairment as required by GAAP, and instead, continued to carry the note as an $869,000 asset as of December 31 without disclosing the default.[136]

---

127 *Id.* ¶ 119.

128 *Id.* ¶ 119 n.9.

129 *Id.*

130 *Id.*

131 *Id.*

132 *Id.* ¶ 119 n.10.

133 *Id.* ¶ 119.

134 *Id.* ¶ 122.

135 *Id.* ¶ 123.

136 *Id.* ¶¶ 121-24.

In February 2013, Premier also acquired an 80% interest in The Power Company USA, LLC ("TPC").[137] Premier gave TPC 30 million Premier shares in exchange for the 80% stake.[138] In all of its 2013 filings, Premier valued its interest in TPC at $4.5 million, the purported value of the 30 million Premier shares.[139] Premier allocated the $4.5 million value to goodwill.[140] Under ASC 805-30, Premier was required to value the customer contracts and receivables it acquired from TPC and assign some portion of the purchase price to those assets.[141] However, the company improperly recognized the entire purchase price as goodwill.[142] Premier also failed to recognize any impairment to the goodwill in 2013, when it was, in fact, impaired, which Premier did not determine until late 2014.[143] The SEC found that A&C contributed to Premier's wrongdoing by failing to conduct the 2013 yearly audit in accordance with professional standards.[144] The SEC also found that A&C ignored a number of red flags.[145]

In 2013, Wahl was the engagement partner for Premier's 2013 audit.[146] The A&C team asked the valuation firm for a copy of the valuation report for the note.[147] The firm told

---

137 *Id.* ¶ 125.

138 *Id.* ¶¶ 125-26.

139 *Id.* ¶ 126.

140 *Id.* ¶¶ 126-27.

141 *Id.* ¶ 127.

142 *Id.* ¶ 128.

143 *Id.* ¶¶ 129-134.

144 *Id.*

145 *Id.*

146 *Id.* ¶ 130.

147 *Id.* ¶ 136.

A&C that it had relied on spreadsheets provided by Premier and did not prepare a draft report.[148] When A&C turned to Premier for a valuation report of the note, Premier told A&C that an independent report was not necessary because the value of the promissory note was already addressed in a prior audit.[149] This was not correct, and the A&C team relied on the spreadsheets that Premier provided the valuation firm, which contained the outdated and unsupported revenue projections of New Eco.[150] In addition, despite Wahl identifying several significant risks concerning Premier's control environment, including the lack of an audit committee and inexperience of the board and CEO with financial reporting matters, the SEC stated that A&C lacked the necessary skepticism and level of professional care with respect to the valuation of the note and the TPC acquisition.[151] A&C ultimately concluded that $869,000 was a fair value of the note, but the SEC stated that A&C and Wahl should have insisted on getting a valuation report from the valuation firm or, if need be, consulting an independent expert on the matter.[152] A&C also did not adhere to certain PCAOB auditing standards because it failed to understand the assumptions within the spreadsheets.[153]

The SEC further found that A&C and Wahl failed to exercise the level of skepticism that is required by concluding that TPC's goodwill was not impaired as of December 31. The SEC stated that had Wahl exercised due professional care and skepticism,

---

148 *Id.*

149 *Id.*

150 *Id.* ¶ 137.

151 *Id.* ¶¶ 132-33.

152 *Id.* ¶ 137.

153 *Id.*; *see* PCAOB Standard AU § 336, *Using the Work of a Specialist*.

Wahl would have noticed that Premier's publicly stated in its filings that it was acquiring sales contracts and receivables as part of the TPC acquisition, not only the goodwill of the company.[154] In addition, regarding the promissory note, the SEC found that the note's generous terms and the missed interest payment, as well as Premier's failure to provide the valuation firm with the requested information, gave sufficient indications that the note was materially overstated.[155]

The SEC determined that A&C and Wahl violated Section 10(b) of the Exchange Act and Rule 10(b)5-(b) promulgated thereunder, and that Wahl aided and abetted A&C's violations of Section 10(b) of the Exchange Act and Rule 10(b)5-(b) promulgated thereunder.[156] The SEC also determined that A&C and Wahl aided and abetted Premier's violation of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder.[157] Additionally, A&C violated, or aided and abetted violations of, Section 4(C)(a)(3) of the Exchange Act, Rule 2-02(b) of Regulation S-X, and Rules 102(e)(1)(iii) and 102(3)(1)(ii) of the Commission's Rules of Practice.[158]

CannaVEST

In December 2012, CannaVEST purchased PhytoSphere Systems, LLC ("PhytoSphere") for $35 million in CannaVEST shares.[159] The purchase agreement for the

---

154 Sec. Exch. Release No. 82206 ¶ 139.

155

156 *Id.* ¶ 158.

157 *Id.*

158 *Id.*

159 *Id.* ¶ 159.

acquisition stated a value of $4.50 to $6 per share—a value provided by CannaVEST's CEO.[160] However, CannaVEST knew that its shares had little to no value because prior to the acquisition, CannaVEST was a shell company with no revenue and only $431 in assets.[161] CannaVEST nevertheless reported in its first quarter of 2013 that CannaVEST had $35 million in assets based on the PhytoSphere acquisition.[162] In CannaVEST's third quarter 2013 filing, it wrote down the value of the assets to $8 million after receiving a third-party valuation report, but CannaVEST failed to inform the valuation firm that CannaVEST had not paid $35 million for the assets, or that it had materially overstated its first and second quarter balance sheets.[163]

The SEC found that Wahl (engagement partner) and Shek (audit manager) failed to make adequate inquiries into the fair value of CannaVEST's shares, instead relying on the purchase agreement to support the asset valuation.[164] The CEO of CannaVEST valued the shares at $4.50 to $6 per share, but he had no reasonable basis for assigning this value.[165] The SEC that had Wahl and Shek inquired about the share price, they would have realized that the CEO had no reasonable basis for determining the value of the shares.[166] The SEC also found that Wahl and Shek failed to perform appropriate analytical procedures for the first and second quarter 2013

---

[160] *Id.* ¶ 172.

[161] *Id.* ¶¶ 159, 162.

[162] *Id.* ¶ 162.

[163] *Id.* ¶ 163.

[164] *Id.* ¶¶ 172-73.

[165] *Id.*

[166] *Id.*

interim reviews, and that after receiving the $8 million valuation report, they failed to consider whether CannaVEST should file a restatement.[167]

Georgia Chung, one of A&C's founders, was the EQR for CannaVEST's first quarter of 2013 interim review.[168] The SEC found that she failed to conduct an adequate EQR of the interim review because she did not identify that the engagement team did not make adequate inquiries of CannaVEST's acquisition.[169] As the engagement quality reviewer, Chung was responsible for calling out the engagement team's deficiencies, *i.e.*, the team's failure to make adequate inquiries of management regarding the acquisition, to properly plan the engagement, and to prepare adequate documentation for the engagement.[170] Chung provided a concurring approval of the interim review, but the SEC disagreed with Chung's approval given the engagement team's glaring deficiencies.[171]

The SEC determined that A&C, Wahl, Shek and Chung engaged in improper professional conduct under Section 4(C)(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[172]

As a result of the SEC's findings, the Commission ordered public administrative and cease-and-desist proceedings against A&C, Wahl and Deutchman, and public administrative proceedings against Chung and Shek to allow them to refute the allegations and to determine

---

167 *Id.* ¶ 180.

168 *Id.* ¶ 167.

169 *Id.* ¶¶ 196-202.

170 *Id.* ¶ 199.

171 *Id.*

172 *Id.* ¶ 205.

whether any combination of cease-and-desists orders, disgorgement, monetary penalties and bars on their ability to practice before the Commission should be imposed.[173]

[173] *Id.* at 42-43.