Internal Corporate Accounting Controls: Spotlight on CFOs

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During 2012 and the first quarter of 2013, the U.S. Securities and Exchange Commission (the "SEC") has put the spotlight on Chief Financial Officers to identify and remedy accounting improprieties. This recent activity highlights the importance of sufficient internal control procedures and management oversight to ensure that a company's financial statements are credible and accurate.

The Internal Controls Regime

The landscape of regulations and guidance addressing internal controls is well beyond the scope of this article; for context, however, some of the most important statutory or regulatory provisions follow.[1] Section 13(b)(2)(B) of the Securities and Exchange Act of 1934, as amended requires that every publicly traded company: "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances[2] that—

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[1] Neither the Exchange Act nor the SEC has specified an internal control procedure that a U.S issuer must implement. The only SEC-recognized framework is a discretionary one established in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). *See* Section II.B.3.a of SEC Release No. 33-8238 ("The COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation and disclosure requirements. However, the final rules do not mandate use of a particular framework[.]"); *see also* Donald C. Langevoort, Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems", 31 J. Corp. L. 949, 953 (2006) (discussing creation of the Treadway Commission and noting that "[i]ts report, *Internal Controls: An Integrated Framework*, was released in 1992, and now plays a significant role under Sarbanes-Oxley"). In November 2010, COSO announced that it intended to update the 1992 framework. The comment period for the proposal closed in March 2012. The December 2011 draft framework defines internal controls as a process "designed to provide reasonable assurance regarding the achievement of objections in . . . effectiveness and efficiency of operations[;] reliability of reporting[; and] compliance with applicable laws and regulations." Draft Framework, December 2011, *available at* http://www.coso.org/documents/coso_framework_body_v6.pdf.

[2] "Reasonable assurance" is defined as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." 15 U.S.C. § 78m(b)(7).

> (i) transactions are executed in accordance with management's general or specific authorization;
> (ii) transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for assets;
> (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
> (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences[.]"[3]

Additionally, Section 13(b)(5) prohibits any person from "knowingly circumvent[ing] or knowingly fail[ing] to implement a system of internal accounting controls or knowingly falsify[ing] any book, record, or account described in paragraph (2)."[4] Neither provision requires scienter, or proof of wrongful intent by the alleged wrongdoer, in order to impose civil sanctions.[5]

In June 2007, the SEC provided its Final Rule on *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act*

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[3] 15 U.S.C. § 78m(b)(2) (B). Section 13(b)(2)(A), violations of which are frequently alleged in connection with Section 13(b)(2)(B), provides that every issuer shall "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." 15 U.S.C. § 78m(b)(2)(A); *see also* Letter to Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, and Douglas Roeder, Senior Deputy Comptroller, Large Bank Supervision, Re: Guidance on the Potential Liability of Financial Institutions for Securities Law Violations Arising from Deceptive Structured Finance Products and Transactions (December 3, 2003) ("[R]ecordkeeping and internal controls violations often arise as a result of financial fraud. An issuer that engaged in a deceptive structured finance transaction may take steps to conceal the fraud, including manipulating books and records and bypassing internal controls."), *available at* http://www.federalreserve.gov/boarddocs/srletters/2004/sr0401a1.pdf.

[4] 15 U.S.C. § 78m(b)(5). *See also* SEC Spotlight on FCPA, *available at* http://www.sec.gov/spotlight/fcpa/fcpa-recordkeeping.pdf.

[5] *See SEC* v. *World-Wide Coin Investments, Ltd.*, 567 F. Supp. 724, 749 (N.D. Ga. 1983).

Periodic Reports,[6] requiring every issuer to "maintain disclosure controls and procedures . . . and interim control over financial reporting."[7] The SEC defines "internal control over financial reporting" as "a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles."[8] That process must:

> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.[9]

[6] The Final Rule was promulgated in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which requires issuers to present information in their annual reports addressing the scope, sufficiency and effectiveness of their internal controls and procedures for financial reporting. *See also* Internal Controls at 954, *supra* note 1 (noting that Section 302 of Sarbanes-Oxley also imposes internal controls obligations, namely requiring that chief executive officers and CFOs certify the issuer's 10-Ks and 10-Qs, including by stating that they are responsible for internal controls, have designed such controls to ensure that material information is brought to their attention, have evaluated the control's effectiveness in the last 90 days, and have discussed in the report any changes to internal controls during the period under review).

[7] 17 C.F.R. 240.13a-15(a).

[8] 17 C.F.R. 240.13a-15(f).

[9] *Id.*

Finally, Item 308 of Regulation S-K requires management to provide an annual report that:

> (1) states management's responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant;
> (2) identifies the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting;
> (3) provides management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective; and
> (4) states that the registrant's outside auditors have issued an attestation report on the registrant's internal control over financial reporting. This report must be included in the Form 10-K.[10]

Management's assessment of the effectiveness of its internal controls must disclose "any material weakness in the registrant's internal control over financial reporting identified by management."[11]

<u>Facilitating Improper Revenue Recognition</u>

While neither its most newsworthy nor financially sizable prosecution, the SEC's December 18, 2012 complaints against TheStreet, Inc. ("TheStreet") and its Chief Financial Officer ("CFO"), Eric Ashman, are instructive. In those complaints, the SEC charged TheStreet, a financial media company co-founded in 1999 by CNBC personality Jim Cramer, and Ashman with engaging in widespread accounting fraud resulting in the dissemination of financial statements violating U.S. Generally Accepted Accounting Principles ("GAAP").[12] The SEC's

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[10] 17 C.F.R. 229.308.

[11] *Id.* (further stating that "[m]anagement is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting[.]")

[12] *See* SEC Litigation Release No. 22575, SEC Charges TheStreet, Inc. and Former Executives In Connection With Accounting Fraud (Dec. 18, 2012), *available at* http://www.sec.gov/litigation/litreleases/2012/lr22575.htm. *See also* Fortune, TheStreet.com Charged With Accounting Fraud (Dec. 18, 2012), *available at*

allegations stemmed from TheStreet's acquisition of a subsidiary specializing in online promotions (the "Subsidiary") in August 2007.[13] As described in the SEC's complaint against Ashman, both TheStreet and Ashman expressed confidence in the Subsidiary's long-term prospects during analyst calls in December 2007 and the first quarter of 2008.[14] That optimism was short-lived. Although Ashman predicted that the Subsidiary would generate approximately $3 million in revenue per quarter for 2008, the Subsidiary instead generated $2.2 million in revenue for the first quarter 2008; "its actual second quarter revenue was less than $2.1 million, third quarter revenue was less than $750,000, and fourth quarter revenue was less than $1.1 million."[15] According to the SEC, "[r]ather than acknowledge this, Ashman substantially assisted TheStreet in artificially inflating [the Subsidiary's] revenue, which in turn improperly inflated TheStreet's reported results."[16]

Because the Subsidiary's financial results were consolidated with those of TheStreet for reporting purposes, the Subsidiary's improper revenue resulted in material misstatements to TheStreet's operating income by approximately 31% for the first quarter of 2008 ($305 thousand), 118% for the second quarter ($930 thousand), 31% for the third quarter

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http://www.finance.fortune.cnn.com/2012/12/18/thestreet-com-fraud/. Two co-presidents of TheStreet's subsidiary were also charged with accounting fraud.

[13] *See* Complaint at 2, *SEC* v. *Ashman*, No. 12-CV-9189 (JGK) (S.D.N.Y. December 18, 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp22575-2.pdf. TheStreet acquired the Subsidiary for $20.7 million in August 2007 and sold it for $3.1 million in December 2008. *See* Bloomberg News, TheStreet and Former Executives Settle SEC Probe Into Accounting Fraud (Dec. 19, 2012).

[14] Complaint at 5, *SEC* v. *Ashman*, *supra* note 13.

[15] *Id.* at 6.

[16] *See* Complaint at 2, *SEC* v. *TheStreet, Inc.*, No. 12-CV-9187 (JGK) (S.D.N.Y. December 18, 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp22575-1.pdf.

(\$289 thousand), and 10.5% for the fourth quarter (\$210 thousand).[17] The combined impact of these quarterly misstatements was TheStreet's misstatement of its operating income by 152% (\$1.7 million) on its 2008 Form 10-K.[18] On February 8, 2010, TheStreet restated its 2008 Form 10-K and disclosed improprieties related to revenue recognition[19] at the Subsidiary. The SEC alleged that TheStreet's alleged misconduct violated Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-3 promulgated thereunder.[20] Ashman was charged separately with violating Section 13(b)(5) of the Exchange Act and Section 304(a) of Sarbanes-Oxley, as well as aiding and abetting violations by TheStreet of Sections 10(b), 13(a) and 13(b)(2)(B) of the Exchange Act and Rules 10b-5(b), 12b-20, 13a-1 and 13a-13 promulgated thereunder.[21]

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[17] Complaint at 6, *SEC* v. *Ashman*, *supra* note 13.

[18] Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13, known as the reporting requirements of the federal securities laws, require all issuers to file periodic reports with the SEC, including quarterly reports known as Form 10-Qs and annual reports known as Form 10-Ks, that are accurate and do not omit information that would otherwise make the information in the reports misleading. *See* 15 U.S.C. § 78m(2); *see also SEC* v. *Savoy Industries*, 587 F.2d 1149, 1167 (D.C. Cir. 1978) ("[T]he requirement that an issuer file reports under Section 13(a) embodies the requirement that such reports be true and correct."). Financial statements incorporated in any of these reports must comply with Regulation S-X, which in turn requires conformity with GAAP. *See supra* note 10.

[19] Although the SEC has decreased the number of its enforcement actions related to revenue recognition in the past two years, *see* SEC, Select SEC and Market Data 2012, at 3, *available at* http://www.sec.gov/about/secstats2012.pdf, these cases remain an active part of its caseload. For a discussion of SEC enforcement actions in years 2010 and 2011, please review Ms. High's 2011 PLI article. Under SEC Staff Accounting Bulletin No. 104 ("SAB 104"), revenue is properly recorded when: (i) persuasive evidence of an arrangement exists; (ii) delivery of a product or service has occurred; (iii) the fee or price received or determinable, and (iv) the likelihood of collection and returns is reasonably assured. *See* SAB 104, 17 C.F.R. Part 211 (2003), *available at* http://www.sec.gov/interps/account/sab104rev.pdf.

[20] *See* Complaint at 3, *SEC* v. *TheStreet*, *supra* note 16.

[21] *See* Complaint at 3, *SEC* v. *Ashman, supra* note 13.

In bringing the action, the SEC repeatedly cited the Subsidiary's lack of appropriate internal controls. While the Subsidiary, as a privately held company, did not have—and was not required to maintain—a system of internal controls, the SEC alleged that, post-acquisition, it was "incumbent upon [TheStreet] to implement controls at [the Subsidiary] to assure that, among other things, its financial records were complete and accurate, and its financial statements were prepared in compliance with applicable accounting standards."[22] The SEC highlighted Ashman's failure as CFO "to devise and/or maintain a system of internal controls to reasonably assure the accuracy and integrity of the Company's financial statements."[23]

The Subsidiary's deficient internal controls led to a panoply of accounting improprieties. "The first, and most egregious, involved sham transactions with friendly counterparties that had little to no economic substance."[24] Those transactions included: (1) fabricating revenue-producing contracts where the actual transaction constituted a loan repayment; (2) obtaining a fraudulent audit confirmation that the Subsidiary had performed services under the sham contracts; (3) altering documents used to support revenue recognition to add terms to which the counterparties had not agreed; (4) papering transactions to improperly

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[22] *See* Complaint at 4, *SEC* v. *The Street*, *supra* note 16. The SEC has made clear that although the internal controls provisions are directed at issuers, "an issuer's books and records include those of its consolidated subsidiaries and affiliates. An issuer's responsibility thus extends to ensuring that subsidiaries or affiliates under its control . . . comply with the accounting provisions." The Criminal Division of the U.S. Department of Justice and the Enforcement Division of the U.S. Securities and Exchange Commission, A Resource Guide to the U.S. Foreign Corrupt Practices Act at 43, *available at* http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf.

[23] Complaint at 6, *SEC* v. *Ashman*, *supra* note 13. The director of the SEC's New York regional office concluded that, "Ashman ignored basic accounting rules, and TheStreet failed to put controls in place to spot the wrongdoing." Bloomberg News, *supra* note 13.

[24] *See* Complaint at 5-6, *SEC* v. *The Street*, *supra* note 16.

recognize revenue where no revenue had been, or would be, earned; (5) misrepresenting to TheStreet's finance department that the Subsidiary needed fixed assets purchased in a round-trip transaction where there was no legitimate business need for the fixed asset; and (6) backdating contracts that formed the basis for revenue recognition.[25]

While "most egregious," the aforementioned conduct was not the sole basis for the SEC's complaint. The SEC claimed that the Subsidiary also failed to implement appropriate methods to recognize revenue such that "revenue was routinely based on the unsubstantiated 'say so' of executives at [the Subsidiary] and TheStreet."[26] Thus, not only was revenue improperly documented, "more fundamentally, [the Subsidiary] has not performed the required work or reached the related milestones in several instances, and the revenue was not actually earned."[27] And, again, due to the lack of internal controls, TheStreet itself prematurely recognized approximately $235 thousand in revenue for services yet to occur.[28] The SEC concluded that "[i]n sum, ineffective and inefficient internal controls over revenue recognition at [the Subsidiary] failed to prevent, and effectively set the stage for, the creation of false financial statements and records."[29]

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[25] *See id.* at 6.

[26] *Id.*

[27] *Id.*

[28] *See id.* at 6-7. The SEC also claimed that Ashman facilitated premature revenue recognition for four transactions in 2008 totaling almost $1.8 million. The SEC also alleged that, rather than notify TheStreet's outside auditors about these transactions, Ashman "instructed his staff to make entries in [the Subsidiary's] financial and accounting books and records to 'burn off' the previously-recognized $580,000 in revenue over time." Complaint at 10, *SEC* v. *Ashman*, *supra* note 13.

[29] *See* Complaint at 7, *SEC* v. *The Street*, *supra* note 16. Without admitting or denying the allegations, Ashman entered into a settlement with the SEC shortly after being charged. He is permanently enjoined from violating the antifraud and internal controls provisions of the federal

On January 10, 2013, the SEC charged Jack Egan, former Senior Vice President, CFO and Principal Financial Officer of Volt Information Sciences, Inc. ("Volt") with providing "substantial assistance to" Volt's improper and fraudulent recognition of $7.55 million in revenue, resulting in materially overstated consolidated, pre-tax net income of approximately $5.45 million for Volt's fourth quarter of 2007 (constituting an approximate 16% overstatement) and fiscal year 2007 (an approximate 10% overstatement).[30] Volt, which provides services relating to staffing, telecommunications, and computer systems through corresponding business units, and Egan allegedly participated in a scheme to overstate Volt's income through improper revenue recognition.[31]

At the core of the alleged conspiracy was Volt's computer-segment subsidiary ("VDR")[32] which, with the assistance of Egan and Volt, relied upon fabricated paperwork to sell certain software services to a customer. According to the SEC, Egan knew that the sale was "impossible" because Volt intended to lease the same software to the same customer the following year.[33] Specifically, VDR recognized revenue based on its purported completion and

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securities laws and agreed to pay a $125 thousand civil penalty and reimburse TheStreet $34,240.40. Litigation Release No. 22575, *supra* note 12. TheStreet settled the matter on the same day as Ashman and agreed to cease and desist from committing or causing any future violation of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder. *Id.*

[30] Complaint at 1, *SEC* v. *Egan*, 13-CV-236 (WHP) (S.D.N.Y. Jan. 10, 2013), *available at* http://www.sec.gov/litigation/complaints/2013/comp22589-egan.pdf.

[31] Complaint at 4, *SEC* v. *Volt Information Sciences, Inc.*, 13-CV-237 (AKH) (S.D.N.Y. Jan. 10, 2013), *available at* http://www.sec.gov/litigation/complaints/2013/comp22589-volt.pdf.

[32] VDR's profit margin was among the highest of Volt's business segments. Complaint at 7, *SEC* v. *Egan*, *supra* note 30.

[33] *See* SEC Litigation Release No. 22589, *SEC Charges Volt Information Sciences, Inc. and Two Former Officers with Securities Fraud* (Jan. 10, 2013), *available at*

sale of certain software for $7.55 million:[34] "The alleged arrangement between VDR and the [customer] was evidenced by a purported 'contract of sale' and required VDR to complete and sell all four software modules ("Four Modules") to [the customer] for a total 'price' of $10 million . . . The Purported Contract of Sale, constructed from a phony purchase order embedded in an actual general purchase agreement, never existed."[35] Nor could that agreement have existed because, on the same date that the sale contract was fabricated, VDR and the customer were in the process of negotiating a four-year lease arrangement for the same Four Modules for a price exceeding $70 million.[36] On January 22, 2007, the customer transferred $10 million to Volt and VDR, believing that the $10 million would be refundable until the leasing contract began on January 1, 2008. In late October 2008, in connection with the fraudulent sale contract, Volt and Egan "made a corresponding journal entry showing $7.55 million in revenue for Volt's fourth quarter."[37]

The SEC further alleged that Volt failed to apply appropriate revenue recognition principles under GAAP to VDR's transaction with the customer. More importantly, "Egan, as a certified public accountant, CFO, and PFO, knew of Volt's representations in its filings that its revenue recognition policy was to comply with GAAP," while simultaneously knowing—but ignoring—that fulfilling the purported sale contract was incompatible with the pending lease

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http://www.sec.gov/litigation/litreleases/2013/lr22589.htm. The SEC also filed a complaint against VDR's former CFO.

[34] While the total purchase price was $10 million, the purchase price for certain of the services was $7.55 million. Complaint at 6, *SEC* v. *Volt*, *supra* note 31.

[35] Complaint at 2, *SEC* v. *Egan, supra* note 30.

[36] *Id.*

[37] Complaint at 6, *SEC* v. *Volt*, *supra* note 31.

arrangement and that recognition of revenue springing from that contract did not comply with GAAP.[38] Egan signed the financial statements incorporating the overstated revenue,[39]as well as misleading Volt's external auditors and executing a false certification under Section 302 of Sarbanes-Oxley.[40] In so doing, the SEC theorized that Egan intentionally circumvented internal controls and knowingly falsified books and records in furtherance of the purported scheme.

As a result of this misconduct, Volt allegedly violated Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Rules 10b-5(a), 12b-20, 13a-1, and 13a-11 promulgated thereunder.[41] Egan allegedly violated Sections 10(b) and Section 13(b)(5) of the Exchange Act and Rules 10b-5, 13a-14, 13b2-1, and 13b2-2 promulgated thereunder, Section 17(a) of the Securities Act, and aided and abetted Volt's violations of Section 10(b), 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1 and 13a-11 promulgated thereunder. Without admitting or denying the allegations of the complaint, Volt

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[38] *Id.* at 3.

[39] These financial statements included its (1) earnings release on Form 8-K, provided to the SEC on December 20, 2007; and (2) 2007 Form 10-K filed on January 11, 2008, as amended by Form 10-K/A filed on February 25, 2008. That overstated income was also incorporated by reference in its Form S-8 filed on July 31, 2008 and its 2008 Form 10-K filed on February 2, 2009. *Id.* at 6; Complaint at 2, *SEC* v. *Volt*, *supra* note 31.

[40] *See* SEC Litigation Release No. 22589, *supra* note 33.

[41] Complaint at 2, *SEC* v. *Volt*, *supra* note 31; complaint at 4-5, *SEC* v. *Egan*, *supra* note 30.

settled with the SEC, agreeing to an injunction from violating applicable securities laws.[42] Egan's case is pending in the Southern District of New York.[43]

Ignoring the "Red Flags"

The SEC has not only brought enforcement actions against those complicit in actually facilitating accounting fraud, as arguably Ashman and Egan were, but also against CFOs who purportedly failed to pay attention to "red flags" putting them on notice of accounting irregularities. On February 28, 2013, the SEC filed a complaint in the district court of the District of Columbia against a CFO who "encountered red flags that should have indicated that the company was not" providing proper statements to its auditors.[44] The SEC alleged that the CFO's conduct was particularly "problematic" because the company had "limited understanding and experience with U.S. accounting requirements"[45]—suggesting that a company's specific vulnerabilities may be relevant to the decision-making about when to bring an enforcement action.

The SEC charged Keyuan Petrochemicals ("Keyuan") with violations of the antifraud, reporting, books and records, and internal control provisions of the federal securities

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[42] *See* SEC Litigation Release No. 22589, *supra* note 33. The Court will later determine issues relating to civil money penalties and other remedies. Volt cooperated with the SEC's investigation and since that investigation, has "undertaken significant remediation efforts." *Id.*

[43] *See* Accounting Today, SEC Charges Tech Consultancy Volt with Fraud (Jan. 11, 2003), *available at* http://www.accountingtoday.com/news/SEC-Charges-Tech-Consultancy-Volt-Fraud-65333-1.html.

[44] *See* SEC Litigation Release No. 22627, *Securities and Exchange Commission* v. *Keyuan Petrochemicals, Inc. and Aichun Li*, Civil Action No. 13-cv-00263 (D.D.C. Feb. 28, 2013), *available at* http://www.sec.gov/litigation/litreleases/2013/lr22627.htm; *see also* Wall Street Journal, SEC: Keyuan Petrochemicals, Former CFO Agree to Pay $1 Million to Settle Alleged Disclosure Violations (Feb. 28, 2013).

[45] Complaint at 12, *SEC* v. *Keyuan Petrochemicals, Inc., et al.*, 13-CV-00263 (RC) (D.D.C. Feb. 28, 2012), *available at* http://www.sec.gov/litigation/complaints/2013/comp-pr2013-30.pdf.

laws, namely Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 (the "Securities Act"), Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20 and 13a-13 promulgated thereunder. Aichun Li, Keyuan's CFO, was also charged with aiding and abetting Keyuan's reporting and books and records violations and failing to implement appropriate internal accounting controls.[46]

Keyuan, a China-based company, conducts business through its wholly owned subsidiary Ningbo Keyuan Plastics.[47] In April 2010, Ningbo Keyuan Plastics completed a reverse merger with a Nevada shell corporation, becoming the wholly owned subsidiary of the shell entity, which was renamed Keyuan Petrochemicals.[48] Simultaneous with the reverse merger, Keyuan closed an approximately $23 million private placement in April 2010. On May 21, 2010, Keyuan filed a registration statement on Form S-1 to resell up to 10 million shares of common stock.[49] Less than six months later, on November 3, 2010, Keyuan filed a second registration statement on Form S-1 to resell 7.6 million shares of common stock. Keyuan filed its 10-K for 2010 on October 20, 2011 and filed restated 10-Qs for the second and third quarters of 2010 on November 1, 2011. On February 21, 2012, Keyuan filed post-effective amendments to its Form S-1 registration. In each of these filings, the SEC alleged that "Keyuan disclosed numerous material related party transactions as well as [an] off-balance sheet cash account."[50]

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[46] *See id.*

[47] Complaint at 4, *SEC* v. *Keyuan Petrochemicals, Inc.*, *et al.*, *supra* note 45.

[48] *Id.*

[49] *Id.*

[50] *Id.* at 5-6

The SEC characterized Keyuan as, "[i]n its short operating history,"[51] engaging in a considerable number of dealings with related parties,[52] including its three founding and controlling shareholders, entities controlled by or affiliated with them, or entities controlled by Keyuan's management or their family members. The transactions took the form of sales of products totaling $107 million by the third quarter of 2010 (approximately 23% of Keyuan's total sales), purchases of raw materials totaling $98 million by the third quarter of 2010 (approximately 28% of total purchases), loan guarantees constituting approximately 87% of the total guarantees, and short-term transfers to and from related parties, ostensibly for financing purposes, totaling $26 million by the third quarter of 2010 (approximately 10% of the total debt financing).[53] Keyuan failed to disclose these related party transactions in any of its statements filed with the Commission between May 2010 and January 2011, violating, *inter alia*, Item 404(a) of Regulation S-K, Financial Accounting Standards Board Accounting Standards Codification Topic 850 ("ASC 850")[54] and Regulation S-X.[55]

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[51] *Id.* at 6.

[52] Item 404 of Regulation S-K requires disclosure of any transaction over $120 thousand that has either occurred since the prior fiscal year or currently proposed in "which any related person had or will have a direct or material interest." 17 C.F.R. § 229.404(a). A related person includes any director, executive officer, nominee, five percent shareholder or that person's immediate family. *Id.*

[53] Complaint at 6-8, *SEC* v. *Keyuan Petrochemicals, Inc., et al.*, *supra* note 45.

[54] ASC 850 governs how auditors should treat material related party transactions "that could affect the financial statements and of common ownership or management control relationships" requiring disclosure. *See* AU § 334.02, *available at* http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00334.pdf.

[55] Regulation S-X provides that all "[r]elated party transactions should be identified and the amounts stated on the face of the balance sheet, income statement, or statement of cash flows." Reg. § 210.4-08(k)(1).

According to the SEC, more troubling than Keyuan's concealment of the related party transactions was the failure by its CFO, Li,[56] upon receiving notification of the transactions, to take appropriate steps to ensure proper disclosure. The SEC alleged that during a conversation with the company's outside auditor in the second quarter of 2010, Li was informed that "the company was engaged in related party transactions and that those transactions should be separately identified and disclosed . . . Li was also advised that Keyuan's accounting department should going forward keep track of these transactions."[57] In addition to that conversation, Li was repeatedly told of Keyuan's dealings with related parties. In August 2010, the Vice President of Accounting and Keyuan's Deputy Accounting Manager notified Li that related parties had guaranteed a significant number of Keyuan's loans. Li was also copied on four e-mails that attached summary schedules identifying loan guarantors that were related parties.[58] Although "the issue of related party disclosures warranted heightened scrutiny," Li ignored a series of "red flags," including the receipt of information from senior management suggesting that Keyuan was not engaged in any related party transactions—which, according to the SEC, was plainly false.[59] Indeed, the SEC implied that Li was distinctly culpable as one of the few people at the company knowledgeable about U.S. accounting principles, noting her acknowledgment in a public filing

[56] Li was hired in May 2010 "to fill a gap in the company's accounting department, specifically, a lack of familiarity with U.S. accounting rules, SEC reporting requirements, and Commission rules and regulations." Complaint at 10, *SEC* v. *Keyuan Petrochemicals, Inc., et al.*, *supra* note 45.

[57] *Id.*

[58] *Id.* at 10-11.

[59] Li allegedly sought assistance from Keyuan's Deputy Accounting Manager in preparing a list of related party transactions and was told that Keyuan has not engaged in any related party transactions. Additionally, on "two occasions," Li was provided with questionnaires that asked for identification of related party transactions. None of the questionnaires that Li received disclosed any transactions. *Id.* at 11.

executed on May 21, 2010 that "Keyuan's internal controls were weak, in part, because of the company's limited understanding of the requirements applicable to U.S. public companies."[60]

Finally, the SEC charged Keyuan with maintaining an off-balance sheet cash account, resulting in the misstatement of the company's reported balances in its financial statements for cash, receivables, construction-in-progress, interest income, other income, and general and administrative expenses.[61] Between July 2008 and March 2011, amounts funded to and disbursed from the account totaled approximately $1 million, including monies disbursed to pay employee bonuses, travel and entertainment expenses and cash and non-cash gifts to Chinese government officials. Keyuan employees concealed the account from the company's auditors and downplayed the size of the account once it was discovered, providing only a partial accounting.[62]

Had Keyuan and Li implemented sufficient controls, including reasonable procedures to identify related parties, the SEC maintained that the Board of Directors or the Audit Committee would have learned of, and remedied, the aforementioned misconduct. Indeed, the SEC intimated that Li bore ultimate responsibility for the oversight as both the CFO and the person hired to ensure compliance with U.S. accounting regulations. Without admitting or denying the claims against them, Keyuan and Li settled the matter on the day that they were charged and consented to a final judgment permanently enjoining them from violations of the statutes and rules specified above. Keyuan agreed to pay a civil money penalty in the amount of $1 million and Li agreed to pay a penalty of $25 thousand. Additionally, Li was suspended from

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[60] *Id.* at 12.

[61] *See id.*

[62] *See id.* at 13.

appearing or practicing as an accountant before the Commission with the right to reapply for reinstatement pursuant to Rule 102(e)(3) of the Commission's Rules of Practice.[63]

"Lack of Management Integrity"

In late 2012, the SEC pursued a CFO for what can only be described as malfeasance and pure self-dealing. On September 28, the SEC filed a partially settled civil injunction against Subramanian Krishnan.[64] Krishnan, the former CFO of Digi International ("Digi"), a company manufacturing device networking products for businesses, was charged with not only causing Digi to file inaccurate reports, failing to enforce Digi's internal controls and wrongly certifying that he evaluated the effectiveness of Digi's internal controls, but also with demonstrating "a lack of management integrity."[65] The SEC alleged that Krishnan's purported lack of integrity was manifested by his failure to "properly devise, maintain and abide by a system of internal controls[,]" resulting in the approval of expense reports that violated company policies and the use of corporate funds as reimbursement for unauthorized personal employee expenses for over five years.[66]

Among his infractions, Krishnan not only authorized corporate travel and entertainment expenses "which appeared to have marginal, if any, business purposes," he reviewed and approved his very own unauthorized expenses—"a material weakness in Digi's

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[63] *See* Litigation Release No. 22627, *supra* note 44.

[64] *See* SEC Litigation Release No. 22500, SEC Charges Former CFO with Evading Internal Controls to Pay for Unauthorized Travel and Entertainment Expenses (Sept. 28, 2012), *available at* http://www.sec.gov/litigation/litreleases/2012/lr22500.htm.

[65] Complaint at 2, *SEC* v. *Krishnan*, 12-CV-02495 (PAM-JJG) (D. Minn. Sept. 28, 2012), *available at* http://www.sec.gov/litigation/complaints/2012/comp-pr2012-203.pdf.

[66] *Id.* at 3.

internal controls over financial reporting."[67] Krishnan approved numerous payments unsupported by documentation, allegedly knowing full well that they were improper.[68] The SEC also alleged that Krishnan made several false, material representations in both Digi's SEC filings and to its auditor, that the company's internal controls were effective although they were not.[69] Finally, he was charged with signing inaccurate Forms 10-K and Forms 10-Q on behalf of Digi.

On the same day that the SEC's complaint was filed, without admitting or denying the allegations, Krishnan consented to a final judgment permanently enjoining him from future violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder. Krishnan was also enjoined from future violations of Sections 13(a) and 13(b)(5) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13, 13a-14, 13b2-1 and 13b2-2 promulgated thereunder, and from aiding and abetting violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act. The SEC barred Krishnan from serving as an officer or director of *any issuer* during the bar's duration. The amount of disgorgement, prejudgment interest, and a civil penalty will be determined at a later date.[70]

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[67] *Id. at 5.*

[68] The SEC contended that "Krishnan knew or should have known that such unsupported, personal expenses violated Digi's travel and entertainment policy *because Krishnan personally drafted, authorized and approved Digi's policy*." *Id.* at 5 (emphasis added).

[69] *See id.* at 6 ("Krishnan's representations were untrue as Krishnan knew or should have known of the inaccurate expense reports that he approved and that Digi's internal control over financial reporting was not effective.")

[70] *See* SEC Litigation Release No. 22500, *supra* note 64.

Post-Settlement Misconduct

Yet, even having sufficient internal controls in place may not be enough to avoid liability if those controls post-date reporting improprieties. If a company conducts an internal review and then self-reports, it may be subject to additional sanction by the SEC, particularly if the SEC previously charged or otherwise highlighted the proscribed conduct. On May 1, 2006, Tyco International Ltd. ("Tyco") settled an accounting fraud, disclosure and FCPA injunctive action with the SEC wherein Tyco agreed to cease and desist all violations of the antifraud, periodic reporting, books and records, internal controls and anti-bribery provisions of the federal securities law and to pay a $50 million civil penalty. Nearly six years later, on September 24, 2012, the SEC filed a settled civil action against Tyco in the district court for the District of Columbia citing misconduct occurring after the 2006 injunction.[71]

The complaint was based entirely on self-reported conduct between 2006 and 2009 emerging as the result of an internal investigation of Tyco's FCPA compliance and transactions by its foreign subsidiaries at or after the time of the settlement. According to the SEC, "[t]he FCPA misconduct reported by Tyco showed that Tyco's books and records were misstated as a result of at least twelve different, post-injunction illicit payment schemes occurring at Tyco subsidiaries across the globe," including illegal payments to foreign officials and employees of state-owned or controlled enterprises that were recorded to conceal the nature of the payments in violation of Section 13(b)(2)(A).[72] In addition, the SEC charged Tyco with

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[71] *See* SEC Litigation Release No. 22491, *SEC Charges Tyco with Making Illicit Payments to Foreign Officials* (Sept. 24, 2012), *available at* http://www.sec.gov/litigation/litreleases/2012/lr22491.htm; *see also* Business Insider, Tyco is Paying $26 Million to Settle Claims that Bribery Was its "Typical" Way of Doing Business (Sep. 24, 2012), *available at* http://www.businessinsder.com/tyco-fcpa-settlement-2012-9.

[72] Complaint at 2, *SEC* v. *Tyco International Ltd.*, 12-CV-1583 (RJL) (D.D.C. Sept. 24, 2012). The illicit payment schemes purportedly "involved fake commissions and related payments, and

failing to implement and maintain sufficient internal controls over a significant period of time and after the 2006 injunction.[73]

Tyco self-reported that a number of its subsidiaries made illicit payments to various foreign officials to secure contracts. The SEC alleged that because Tyco either controlled the subsidiaries engaging in the fraudulent conduct such that the subsidiary was an agent or because the subsidiary's financial results were incorporated in Tyco's publicly filed statements, Tyco received ill-gotten funds, rendering its books and records inaccurate. For example, through Tyco Waterworks Deustchland GmBH ("TWW Germany"), an indirect, wholly owned subsidiary of Tyco in Germany, Tyco received a substantial improper benefit—the largest alleged in the complaint—of $4,684,966.00. The SEC claimed that "TWW Germany and/or its agents paid or promised to pay third parties to secure contracts or avoid penalties or fines in several countries: the People's Republic of China, Croatia, India, Libya, Saudi Arabia, Serbia, Syria, and the United Arab Emirates. Those payments were ostensibly booked as commissions and in a manner that did not reflect the ultimate recipients of the funds."[74] Additionally, because the various subsidiaries did not maintain "sufficient controls" over their improper payments, Tyco violated the internal controls provisions of Section 13(b).[75]

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several also included the use of third-party agents to funnel money improperly." SEC Litigation Release No. 22491, *supra* note 71.

[73] Complaint at 3, *SEC* v. *Tyco*, *supra* note 72.

[74] *Id.* at 8

[75] *Id.* at 14. (The SEC charged Tyco with failing to "devise and maintain such a system of internal controls" rendering it unable to detect the conduct by its subsidiaries: "numerous Tyco subsidiaries engaged in violative conduct, the conduct was carried out by several different methods, the conduct occurred over a lengthy period of time, and it continued even after the 2006 injunction").

Tyco agreed to pay over $13 million in disgorgement and prejudgment interest to settle the charges. In addition, it consented to the entry of a proposed final judgment permanently enjoining it from violating Sections 13(b)(2)(A), 13(b)(2)(B), and 30(a) of the Exchange Act.[76] Notably, the SEC praised Tyco's voluntary disclosure, particularly its remedial measures, which included firing the employees involved in the illicit activities, exiting certain lines of business, and making significant improvements to its FCPA compliance protocols.[77] The Tyco settlement reinforces two lessons from the cases cited above: (1) an issuer is liable for the misdeeds of both its subsidiaries and its employees, even if it has no knowledge of those misdeeds; and (2) careful oversight and monitoring, particularly of employees representing the company, is necessary to ensure compliance with the federal securities laws.

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The cases cited in this article are but a few of the many evincing the SEC's commitment to ensuring that CFOs and senior management are dedicated to implementing proper internal controls. While maintaining these controls may also be the responsibility of other directors, executives and employees of the company, the SEC's focus on CFOs illustrates its belief that as the persons expected to act for the financial benefit of the issuer, they bear the burden of ensuring that compliance is both prompt and fulsome.

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[76] On the same day that its settlement with the SEC was finalized, Tyco agreed to pay $13.68 million in criminal penalties to resolve related criminal proceedings and entered a non-prosecution agreement with the DOJ. DOJ Press Release, Subsidiary of Tyco International Ltd. Pleads Guilty, Is Sentenced for Conspiracy to Violate Foreign Corrupt Practices Act (Sept. 24, 2012), *available at* http://www.justice.gov/opa/pr/2012/September/12-crm-1149.html.

[77] *See* SEC Litigation Release No. 22491, *supra* note 71.