Recent SEC Enforcement Actions Involving Accounting Gatekeepers

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In January 2016, the SEC warned that it would continue its bullseye focus on holding "gatekeepers, including audit committee members and external auditors" accountable for accounting fraud and related misconduct.[1] Indeed, SEC Chair White explained that in fiscal years 2015 and 2016, the SEC doubled its enforcement activity against individual actors as compared to fiscal years 2012 and 2013.[2]

The SEC's focus is understandable given its philosophy. In a November 2016 speech, SEC Chair Mary Jo White hailed the increase in individual cases as "an example of [the SEC's] continuing focus on gatekeepers, who are uniquely in a position to prevent or detect wrongdoing."[3] Three recent enforcement actions: Logitech International S.A., Ener1, Inc. and Orthofix International N.V. provide significant insight into the types of misconduct that warrant individual liability. These actions also make clear that the SEC continues to focus on whether companies have implemented appropriate internal accounting controls to avoid financial reporting misconduct. The recent settlement with General Motors Company regarding its defective controls processes is particularly informative given that the only charge against the company was for violating Section 13(b)(2)(B) of the Exchange Act—a recordkeeping and internal controls provision.

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[1] Andrew Ceresney, Director, Div. of Enf't, SEC, 2016 Keynote Address at Directors Forum at San Diego (Jan. 25, 2016).

[2] Mary Jo White, Chair, SEC, Speech at New York University School of Law: A New Model for SEC Enforcement: Producing Bold and Unrelenting Results (Nov. 18, 2016), https://www.sec.gov/news/speech/chair-white-speech-new-york-university-111816.html.

[3] *Id*.

A. Audit firms and other external players

Logitech International S.A.[4]

Improper revenue recognition remains one of the SEC's mainstays. On April 19, 2016, Logitech International, S.A. ("Logitech") agreed to pay a penalty of $7.5 million for the improper inflation of its fiscal year 2011 earnings based on inappropriate accounting for inventory reserves.[5] The same day, the SEC also settled actions against two Logitech executives, Michael Doktorczyk (former Vice President of Finance and Corporate Controller), and Sherralyn Boles (former Director of Accounting and Financial Reporting), alleging that Doktorczyk and Bolles were responsible for reporting errors in Logitech's 2012 and 2013 financial statements.[6] The SEC also filed a securities fraud complaint against Logitech's former CFO, Erik Bardman, and former Acting Controller Jennifer Wolf, alleging that they minimized the write-down of excess inventory causing the improper inflation of fiscal year 2011 revenues.[7]

In its press release announcing the order, the SEC stated: "We are intensely focused on whether companies and their officers evaluate judgmental accounting issues in good faith and based on GAAP."[8] The Chief Accountant in the SEC's Enforcement Division, Michael Maloney, also had a few choice words for the company's auditors, noting that they "play a critical role regarding the accuracy of financial statements relied upon by investors, and they

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[4] *In re Logitech Int'l*, Sec. Exch. Release No. 77644 (Apr. 19, 2016).

[5] *Id.* ¶ 16; Press Release, SEC, Announces Financial Fraud Cases (Apr. 19, 2016), https://www.sec.gov/news/pressrelease/2016-74.html.

[6] Press Release, SEC, Announces Financial Fraud Cases, *supra* note 13.

[7] *Id.*; *see* Complaint, *SEC* v. *Bardman*, No. 3:16-cv-02023 (N.D. Cal. Apr. 18, 2016).

[8] Press Release, SEC, Announces Financial Fraud Cases, *supra* note 13.

must be held accountable when they fail to do everything required under professional auditing standards."[9]

Inventory Manipulation

In October 2010, Logitech launched "Revue," a television set-top device to be used in tandem with Google TV that allowed users to access the internet and stream videos.[10] Logitech contracted with a third-party manufacturer to produce the units in anticipation of a high demand during the year-end holidays.[11] Unfortunately, actual demand was not in line with what the company had hoped.

By late November 2010, sales and finance personnel, including senior executives, discussed whether Revue's market price of $299 should be reduced.[12] The SEC alleged that, given those discussions, the company should have been prepared to evaluate whether its Revue inventory was impaired such that taking a "lower of cost or market" ("LCM") charge was appropriate: "[Logitech] was required to value its inventory at the lower of the inventory's cost or market value. Specifically, if the market value of a company's inventory (generally calculated for finished goods as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation) is less than its cost, then the company must write-down the inventory value in its financial statements."[13]

In December 2010, after sales continued to slide, Logitech directed the third-party manufacturer to stop producing Revue units and to hold shipment on the 26,000 units that were

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[9] *Id.*

[10] *In re Logitech Int'l*, *supra* note 4.

[11] *Id.*

[12] *Id.* ¶ 2.

[13] *Id.* ¶ 3.

completed.[14] By that time, the manufacturer had already purchased more than $11 million in component parts to build additional Revue units, the cost for which Logitech was on the hook.[15] By the end of December, the company had conducted an LCM analysis of the inventory while sales of Revue were only 40% of forecasts.[16] Nevertheless, Logitech did not take any write-down on its finished goods inventory.[17]

In January 2011, Logitech management decided to lower Revue's retail price from $249 to $199 in future quarters.[18] No member of management informed the independent auditor of this plan.[19] Instead, Logitech's January 2011 earnings release increased the company's guidance for annual revenue through the quarter of 2011 and confirmed its prior guidance for annual operating income.[20]

By the fourth quarter of 2011, Revue sales continued to lag, and Logitech had more than 200,000 finished and near-finished units on hand, totaling $19.4 million.[21] At that time, a finance employee cautioned the company to take a reserve.[22] On March 31, 2011, Logitech announced that it would miss its operating income guidance by $30 million.[23] As part

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[14] *Id.* ¶ 4.

[15] *Id.*

[16] *Id.* ¶ 5.

[17] *Id.*

[18] *Id.* ¶ 7.

[19] *Id.*

[20] *Id.* ¶ 8.

[21] *Id.* ¶ 12.

[22] *Id.*

[23] *Id.* ¶ 13.

of the year-end closing process, Logitech also performed an LCM analysis and determined to take no LCM adjustment on the Revue inventory.[24] The independent auditor questioned this analysis, and Logitech revised its analysis to record a $2.2 million adjustment for Revue finished goods inventory.[25] The independent auditor once again questioned the analysis given that Logitech was already on the hook for $11 million in excess components.[26] The Vice President of Global Sourcing, who was responsible for "managing the component inventory liability," informed Wolf that he did not believe the company would use the components.[27] As a result, he suggested $.25 recovery on the dollar.[28] Wolf discussed the issue with Bardman, and suggested that the excess components nevertheless could be used and that the write-down for the inventory could be further reduced to $1.1 million.[29] The SEC alleged that Wolf had no basis for her assumption given that Logitech had no timetable for re-starting production of the units and none for completing the units that had been in process.[30] Making matters worse, Logitech had been attempting to sell the on-hand excess components at substantial discounts.[31] The independent auditor continued to raise questions about the assumptions Logitech used in its LCM analysis, including the company's failure to consider future decreases to the unit price.[32] Notwithstanding

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[24] *Id.* ¶ 14.

[25] *Id.*

[26] *Id.* ¶ 16.

[27] *Id.* ¶ 17.

[28] *Id.*

[29] *Id.* ¶ 20.

[30] *Id.* ¶ 23.

[31] *Id.*

[32] *Id.* ¶ 25.

these questions, Wolf and Bardman allowed Logitech to file an annual report that misstated the company's operating revenue by more than 25 percent in order to stay in line with the March 31, 2011 operating income guidance.[33]

Warranty Accrual Accounting

The company also engaged in other accounting improprieties in 2009, 2012 and 2013. As part of its business, Logitech offered warranties on its products sold throughout the world, ranging from one to five years.[34] Logitech used a warranty accrual model for the AMR region (Americas) based on the assumption that if a product were to fail, it would fail quickly and be returned within one quarter.[35] The SEC alleged that Logitech had no basis for this assumption, nor did it have sufficient data to evaluate such an assumption.[36]

In 2011 and 2013, two different company accountants reviewed the model and concluded that the model had serious deficiencies, and did not comply with GAAP.[37] By the end of 2013, one of those accountants had developed a robust "waterfall" model that estimated that Logitech was under-reserved by more than $25 million dollars in 2012 and $17 million in 2013 based on the faulty return timing assumption and the failure to anticipate that returns might be made later within the warranty period.[38] She shared her findings with Doktorczyk and Bolles

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[33] *Id.* ¶ 27.

[34] *Id.* ¶ 28.

[35] *Id.* ¶ 29.

[36] *Id.*

[37] *Id.* ¶¶ 31-38.

[38] *Id.* ¶ 33.

who failed to correct the model's deficiencies and failed to make the independent auditor aware of those deficiencies.[39]

The SEC alleged that Logitech violated Sections 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, 13a-11 and 13a-13; Doktorczyk violated Section 13(b)(5) of the Exchange Act, and Rules 13a-1.4, 13b2-1 and 13b2-2, and also caused Logitech's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder; and Bolles violated Exchange Act Rule 13b2-1, and caused Logitech's violations of Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder.[40] Doktorczyk was ordered to pay a monetary penalty of $50,000; and Bolles was order to pay a penalty of $25,000.[41] In addition, although not charged with any misconduct, former CEO, Gerald Quindlen, returned $194,487 in compensation and profits from company stock sales.[42]

Ener1, Inc.[43]

Also on April 19, 2016, the SEC announced its settlement with Ener1, Inc. ("Ener1") and three of its executives, Charles Gassenheimer, (former CEO), Jeffrey Seidel (former CFO), and Robert Kamischke (former Chief Accounting Officer/CAO).[44] The SEC alleged that Ener1 materially overstated its earnings and assets in its 2010 Form 10-K and 2011

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[39] *Id.* ¶¶ 33, 35.

[40] *Id.* ¶¶ 74-76.

[41] *Id.* at pp. 15-16.

[42] Press Release, SEC, Announces Financial Fraud Cases, *supra* note 13.

[43]Sec. Exch. Release No. 77645 (Apr. 19, 2016).

[44] Press Release, SEC, Announces Financial Fraud Cases, *supra* note 13.

Form 10-Q. The SEC also charged Robert Hesselgesser, Ener1's engagement partner from PricewaterhouseCoopers LLP, with improper professional conduct.[45]

Prior to its bankruptcy, Ener1 was a publicly traded company that manufactured lithium ion batteries for various purposes, including for electric cars.[46] Think Global ("Think"), a Norwegian manufacturer of electric cars, which went bankrupt in 2011 (the third time it had filed for bankruptcy) was one of Ener1's largest customers.[47] In Ener1's Form 10-K filed on March 10, 2011 ("2010 Form 10-K"), Ener1 reported an equity investment in Think of $58.6 million, which represented 15% of Ener1's $396.5 million in total assets; accounts receivable from Think of $13.6 million, which represented 3% of Ener1's assets; and loans receivable from Think totaling $14.0 million, which represented 3.5% of Ener1's assets.[48] In addition to being the CEO of Ener1, Gassenheimer was also Chairman of Think. The SEC alleged that Ener1's 2010 Form 10-K reporting did not conform to GAAP because the company failed to take into account appropriate impairment factors on its various Think investments in light of the information the company knew about Think's deteriorating financial condition.[49]

Under GAAP, a company is required to routinely evaluate when "an event or change in circumstances has occurred in that period that may have had an adverse effect on the

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[45] *In re Robert D. Hesselgesser*, Sec. Exch. Release No. 77646 (Apr. 19, 2016); Press Release, SEC, Announces Financial Fraud Cases, *supra* note 13.

[46] *In re Ener1*, *supra* note 43, ¶¶ 1, 6.

[47] *Id.* ¶ 6.

[48] *Id.*

[49] *Id.*

fair value of the investment."[50] To do so, it should evaluate the following non-exhaustive list of impairment factors:

> 1) a significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee; 2) a significant adverse change in the regulatory, economic, or technological environment of the investee; 3) a significant adverse change in the general market condition of either the geographic area or the industry in which the investee operates; 4) a bona fide offer to purchase (whether solicited or unsolicited), an offer by the investee to sell, or a completed auction process for the same or similar security for an amount less than the cost of the investment; and/or 5) factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.[51]

In addition to being the CEO of Ener1, Gassenheimer was also Chairman of Think. The SEC alleged that, by late 2010, Gassenheimer knew about Think's precarious financial condition given his dual role as Think's Chairman.[52] In particular, the SEC alleged that Gassenheimer knew that Think's sales had been declining; it was seeking to raise funds by pitching to investors; it had stopped producing cars; it lacked the cash necessary to pay creditors and maintain operations; and it had failed to pay back Ener1 loans when due.[53] In spite of all this, Think's accounting department prepared an impairment memorandum, which concluded that the Think investment was not impaired because no impairment factors were present.[54] The memorandum was reviewed by Seidel and Kamischke and provided to Ener1's external

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[50] *Id.*

[51] *Id.* ¶ 16.

[52] *Id.*

[53] *Id.*

[54] *Id.* ¶ 20.

auditors.[55] Quite contrary to the memorandum, however, on January 12, 2011, Ener1 management emailed Think management a memorandum requiring that Think present a plan to address Think's immediate operations and cash management.[56] Gassenheimer, Seidel and Kamischke were copied on this email.[57] On January 14, 2011, Think presented a plan that requested a $10 million bridge loan from Ener1.[58] Ener1 could not provide Think with the $10 million in additional funding.[59]

Moreover, on January 20, 2011, Gassenheimer, Seidel and Kamischke received a report from Think's auditor that outlined the various risks to the going concern of Think's operations.[60] On January 21, 2011, Think's auditor sent a letter to Think's Board, which included Gassenheimer, that warned the directors that if the company could not make timely payments and equity fell to less than half of capital, the directors had an obligation under Norwegian law to dissolve the company.[61] The SEC thus alleged that Gassenheimer, Seidel and Kamischke "were aware of information that should have indicated that a change of circumstances had occurred that had an adverse effect on the fair value of Ener1's investment in Think from the time of purchase such that the equity investment should have been impaired," and that they failed to provide this information to Ener1's auditors.[62]

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[55] *Id.* ¶ 21.

[56] *Id.*¶ 11.

[57] *Id.*

[58] *Id.*

[59] *Id.* ¶ 15.

[60] *Id.* ¶ 12.

[61] *Id.*

[62] *Id.* ¶ 21.

When Think filed for bankruptcy in June 2011, Ener1 announced that it would amend its 2010 Form 10-K and Form 10-Q 2012 filing to reflect the impairments of its investments in Think, and its account receivables and loans receivable from Think.[63] Ener1 never filed the restatements as it filed for bankruptcy protection in January 2012.[64]

As a result of the misconduct, Ener1 overstated its $58.6 million equity investment in Think, its $13 million Think accounts receivable, and its $14 million Think loans receivable.[65] The SEC found that Ener1 violated Securities Act Sections 17(a)(2) and (3) and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B), and Exchange Act Rules 12b-20, 13a-1 and 13a-13 thereunder; Gassenheimer, Seidel and Kamischke violated Sections 17(a)(2) and (3) of the Securities Act and Exchange Act and Rule 13a-14 thereunder; and Gassenheimer, Seidel and Kamischke caused Ener1's violations of Section 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act and Exchange Act Rules 12b-20, 13a-1 and 13a-13 thereunder.[66] The SEC imposed monetary penalties on Gassenheimer, Seidel and Kamischke of $100,000, $50,000, and $30,000, respectively.[67]

The SEC also made various findings with respect to the deficient accounting controls at Ener1.[68] The SEC found that Ener1's accounting staff did not have sufficient command of GAAP, nor did they receive the proper information to determine whether Think

[63] *Id.* ¶ 34.

[64] *Id.* ¶¶ 32-33.

[65] *Id.* ¶¶ 45-46.

[66] *Id.* at pp. 12-13.

[67] *Id.*

[68] *Id.* ¶ 36.

revenue and investments were recorded in conformity with GAAP.[69] The SEC also found that the company did not maintain appropriate policies and procedures to ensure Ener1's financial statements would accord with GAAP.[70]

PWC Audit Partner in Charge of Ener1's Audit

In connection with Ener1's financial reporting errors, the SEC alleged that Robert Hesselgesser's (PWC) audit of Ener1's 2010 financial statements violated Public Company Accounting Oversight Board ("PCAOB") Standards by failing to (i) appropriately plan for the audit; (ii) perform audit procedures sufficient to support his audit conclusions regarding Ener1's Think-related accounting; and (iii) exercise due professional care by accepting management's conclusions concerning Ener1's Think investments and receivables without sufficient evidence. Under PCAOB Standard AU § 326.01, Hesselgesser had a professional obligation to corroborate Ener1's statements and information used in Ener1's impairment analysis, particularly because Think was a related party.[71] The SEC noted that "[r]epresentations from management are part of the evidential matter . . . not a substitute for the application of auditing procedures necessary to afford a reasonable basis for an audit opinion."[72] Especially troubling for the SEC was the fact that Hesselgesser knew that Think had stopped paying its accounts receivable obligations to Ener1 in the third quarter of 2010 and sought additional loans from Ener1, and in the fourth quarter of 2010, sought multiple extensions on its loan repayment obligations to Ener1.[73] A key

[69] *Id.* ¶ 38.

[70] *Id.* ¶ 36.

[71] *In re Robert D. Hesselgesser, supra* note 45, ¶¶ 8-9.

[72] *Id.* ¶ 8.

[73] *Id.* ¶ 7.

red flag for the SEC was the fact that Ener1 did not have a written revenue recognition policy, nor had its staff conducted a collectability analysis on amounts outstanding from Think.[74] As the SEC stated: "Due professional care requires the auditor to exercise professional skepticism which is an attitude that includes a questioning mind and a critical assessment of the audit evidence."[75]

The SEC also alleged that Hesselgesser failed to properly document his oral communications with Ener1 management that purportedly substantiated the company's accounting treatment of the Think investments and receivables, and failed to properly supervise his audit team.[76] Indeed, the SEC alleged that, if Hesselgesser had read the relevant Ener1 board minutes or meeting summaries, he would have seen red flags as to Think's dire financial situation.[77]

Based on the SEC's findings that Hesselgesser engaged in improper professional conduct under Section 4C of the Exchange Act[78] and Rule 102(e)(1)(iv)(B)(1)&(2) of the SEC's

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[74] *Id.*

[75] *Id.* ¶ *6.*; *see also* PCAOB Standard AU § 230.07.

[76] *Id.* ¶¶ 13-15.

[77] *Id.* ¶ 15.

[78] Under this section, "[t]he Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found by the Commission, after notice and opportunity for hearing in the matter—(1) not to possess the requisite qualifications to represent others; (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder." 15 U.S.C. § 78d-3(a). "Improper professional conduct" is defined as "(1) intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; and (2) negligent conduct in the form of—(A) a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which the registered public accounting firm or associated person knows, or should know, that heightened scrutiny is warranted; or (B) repeated instances of unreasonable conduct, each resulting in a violation of applicable

Rules of Practice,[79] Hesselgesser was barred from practicing before the Commission, but allowed to request reinstatement after two years.[80]

Orthofix International N.V.[81]

Springing forward to 2017, the SEC continued to show its commitment to holding individuals liable for a company's accounting misconduct. On January 18, 2017, the SEC settled charges with Orthofix International N.V. ("Orthofix") and four of its then-executives for improper revenue recognition, among other violations.[82] The SEC alleged that, from at least 2011 to mid-2013, Orthofix materially misstated distributor revenue and operating income in its annual and quarterly filings in violation of Sections 17(a)(2) and 17(a)(3) of the Securities Act and Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-1, 13a-11 and 13a-13 thereunder, for which it paid a monetary penalty of $8.25 million.[83] Brian McCollum (former CFO), Bryan McMillan (former President of Orthofix's Spine Segment), Kenneth Mack (former Vice President of Global Sales and Development), and Jeffrey Hammel (former CFO of Orthofix's Spine Segment), settled charges that they caused the material

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professional standards, that indicate a lack of competence to practice before the Commission." *Id.* § 78d-3(b).

[79] These rules are identical to Section 4C's definition of improper professional conduct.

[80] *Id.* at pp. 7-8.

[81] Sec. Exch. Release No. 79815 (Jan. 18, 2017).

[82] Press Release, SEC, Medical Device Company Charged With Accounting Failures and FCPA Violations (Jan. 18, 2017), https://www.sec.gov/news/pressrelease/2017-18.html.

[83] *In re Orthofix*, *supra* note 80, at p. 17.

misstatements in Orthofix's financial statements in violation of Section 13(a) of the Exchange Act.[84]

Orthofix's Transactions with Brazilian Distributor

Orthofix is a medical device company specializing in products related to orthopedic conditions.[85] The SEC alleged that Orthofix improperly recognized revenue on several transactions with its largest international distributor in Brazil, and its second largest customer for 2011 through the first quarter or 2013.[86] Accounting Standards Codification ("ASC") 605 provides guidance with respect to transaction-specific revenue recognition, including product sales.[87] In its financial statements, Orthofix stated that it recognized revenue in a reporting period when "(i) persuasive evidence of an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the seller's price to the buyer is fixed and determinable; and (iv) collectability is reasonably assured."[88] As with Logitech, the SEC found that the company did not properly estimate how product returns affected its revenue recognition where sale contracts provided that right. This was particularly troubling given that Orthofix's practice was to recognize revenue when products were shipped to distributors, without accounting for product returns, or refusals to pay.

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[84] *See In re Kenneth Mack*, Sec. Exch. Release No. 79820, ¶ 42; *In re Jeffrey Hammel*, Sec. Exch. Release No. 10282, ¶ 59 (Jan. 18, 2017); *In re Brian McCollum*, Sec. Exch. Release No. 79819. ¶ 40 (Jan. 18, 2017).

[85] *In re Orthofix*, *supra* note 80, at p. 2.

[86] *Id.*

[87] *Id.* ¶ 9.

[88] *Id.* ¶ 10.

In the second and third quarters of 2011, Orthofix shipped approximately $5 million worth of implants to the Brazilian distributor.[89] The SEC alleged that Orthofix's recognition of this shipment as revenue was improper because the Brazilian distributor's payment was contingent upon Orthofix supplying new instrument sets with the implants, as required by new regulations imposed by Brazil's health regulatory agency ("ANVISA").[90] By 2012, Orthofix shipped less than half of the new instruments, and the Brazilian distributor refused to pay for the devices shipped in 2011.[91]

By April 2012, the Brazilian distributor still had not received all of the new instruments.[92] After discussions with McMillan and Mack, the distributor agreed to a reduced repayment schedule with payments due in December 2012 and February 2013.[93] McMillan and Mack did not inform Hammel of this arrangement, who was the only person authorized within the company to make such modifications, nor did McMillan and Mach ensure that personnel in the company's finance and accounting departments were aware of the revised payment plan.[94]

Notwithstanding these payment issues, in May 2012, McCollum made yet another arrangement with the Brazilian distributor—this time, for shipment of a new product the company was launching, called Firebird. McCollum and the distributor agreed that the distributor would pay nearly $2.5 million for the new devices contingent on three conditions: (i)

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[89] *Id.* ¶¶ 21-26.

[90] *Id.* ¶¶ 33-38.

[91] *Id.* ¶¶ 31-32.

[92] *Id.* ¶ 31.

[93] *Id.* ¶¶ 29-31.

[94] *Id.* ¶ 32.

it had one year to pay for the implants subject to approval by ANVISA; (ii) it had 210 days to pay on all future orders; and (iii) all corresponding instrument sets had to be available after ANVISA approval.[95]

After the Firebird products were shipped and the revenue was recognized by the company, Hammel found out about the terms of the deal.[96] He questioned McMillian and Mack about the delayed payment terms, and even received a PowerPoint presentation outlining the chronology of events from the Brazilian distributor's President. He nevertheless allowed the revenue to remain recognized in the second quarter of 2012, without correction, because the company needed the revenue.[97] Orthofix's recognition of this revenue was plainly improper given that the distributor had no obligation to pay for the devices unless the products received ANVISA's approval, thus violating the fixed and determinable criteria under ASC 605.[98]

Notwithstanding all of these issues, and to keep the gravy train going, in September 2012, Mack further negotiated with the Brazilian distributor to purchase another $1.5 million worth of implants that had not been approved by ANVISA.[99] Once again, the distributor negotiated payment contingencies: (i) a right to negotiate the payment terms if ANVISA did not approve the products within three months; and (ii) one year to pay (which one would think was

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[95] *Id.* ¶¶ 33-34.

[96] *Id.* ¶¶ 40-41.

[97] *Id.* ¶¶ 58-60.

[98] *Id.* ¶¶ 52-53.

[99] *Id.* ¶ 51.

covered by the prior agreement). Once again, Orthofix recognized the revenue on the sale when the products were shipped.[100]

As is often the case, once a wrongdoer begins manipulating revenue recognition, it becomes caught in a cycle of continual wrongdoing in order to keep up with sales targets. In addition to these accounting shenanigans with the Brazilian distributor, the company also improperly recognized revenue on product shipments with distributors in Italy, Spain, Mexico and U.S. distributors as well.[101] In addition, in 2012, in the face of stiff competition, the company also started offering products to wholesalers at deep discounts without a corresponding adjustment to the purchase price as required by ASC 605, and for which it also paid the wholesalers referral fees—fees the company accounted for as commissions rather than as expense reductions to revenue.[102]

On the same day, Orthofix also entered into a separate settlement with the SEC to resolve violations of Sections 13(b)(2)(A) and 13(b)(2)(B) of the Exchange Act in connection with a Brazilian subsidiary's violations of the Foreign Corrupt Practices Act of 1977 ("FCPA") with respect to books and records and internal controls failures based on that subsidiary's payment of kickbacks to doctors at government hospitals to get them to use Orthofix products as a way to increase sales.[103] The company improperly booked the kickbacks as legitimate expenses and the corresponding revenue from product sales as legitimate profits.[104] The SEC

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[100] *Id.* ¶ 52.

[101] *Id.* ¶ 63.

[102] *Id.* ¶ 77.

[103] *In re Orthofix*, *supra* note 80; Press Release, SEC, Medical Device Company Charged With Accounting Failures and FCPA Violations, *supra* note 92.

[104] *In re Orthofix*, *supra n*ote 80, ¶ 10-13.

also noted that the controls failures were particularly egregious given that, in 2012, Orthofix had entered into a $7.4 million settlement and deferred prosecution agreement with the SEC and DOJ to resolve charges that a Mexican subsidiary had violated the FCPA by paying bribes to Mexican government officials.[105] The company had to pay more than $6 million to resolve the additional charges.[106]

B. Internal controls over financial reporting

In addition to the SEC's focus on gatekeepers, the SEC continues to highlight the importance of implementing sufficient internal control procedures and proper management oversight to ensure that a company's financial statements are accurate. In *Ener1* and *Orthofix*, the SEC focused on the companies' failure to implement and maintain the internal accounting controls necessary to provide "reasonable assurances"[107] of the reliability of the company's record-keeping and financial reporting. We also see the SEC's commitment to reviewing corporate internal controls processes in the *General Motors Company* settlement, where the SEC imposed a $1 million fine to settle charges that the company's deficient accounting controls were responsible for the company's improper assessment of the potential financial impact of defective ignition switches in certain vehicles.[108]

Ener1. The SEC alleged that Ener1 had "numerous deficiencies throughout its systems of internal accounting controls that were attributable, in part, to its failure to understand

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[105] *Id.* ¶¶ 1-2, 17-18.

[106] *Id.* at p. 7.

[107] "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).

[108] *Infra* note 135.

and assess the risks in its control."[109] First, the SEC noted that Ener1 lacked appropriate procedures to ensure that its accounting staff received the necessary information to consider the proper accounting treatment of the Think-related investments and revenue.[110] Second, the SEC noted that Ener1 did not maintain a "sufficient complement of personnel with the requisite level of accounting knowledge, experience, and training in the application of GAAP."[111] Seidel and Kamischke were Ener1's CFO and CAO, respectively, yet they had never been CPAs.[112] Accordingly, the SEC found that Seidel and Kamischke lacked sufficient accounting expertise to determine Ener1's true accounting exposure with Think.[113] Third, the SEC alleged that Ener1 did not have specific documented accounting procedures to buttress its impairment analysis.[114] In the impairment memorandum, the accounting staff provided a skimpy explanation as to why no impairment was necessary.[115] Making matters worse, the staff failed to cite to any specific GAAP standards in the memorandum, which the SEC found a sure-fire example that they did not have the requisite level of accounting knowledge, experience, and training in the application of GAAP.[116]

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[109] *In re Ener1*, *supra* note 43, ¶ 36.

[110] *Id.*

[111] *Id.*

[112] *Id.* ¶ 38.

[113] *Id.*

[114] *Id.* ¶ 36.

[115] *Id.* ¶ 22.

[116] *Id.*

Finally, the SEC alleged that Ener1 lacked any specific procedures regarding distribution of financial information to the accounting staff.[117] Although Gassenheimer, Seidel and Kamischke were aware of Think's precarious financial condition, this information was not shared with the accounting department.[118] And, as noted above, the SEC found fault with Ener1's failure to publish a written revenue recognition policy.[119]

Orthofix. The SEC found that Orthofix's improper revenue recognition was telling of a broader problem within the company. The SEC alleged that specifically with the first transaction—the shipment of the implants without the new instrument sets in the second quarter of 2011—Orthofix had "inadequate internal accounting controls to evaluate the impact of these facts on the revenue that was previously recognized . . . ."[120] For example, the SEC stated that McCollum, Orthofix's CFO, did not take appropriate steps to investigate the circumstances of the transaction to confirm whether it conformed to the company's revenue recognition policy.[121] Unlike the Ener1 action, where the company lacked a written revenue recognition policy, Orthofix had an appropriate policy, but failed to comply with it.[122] Also telling was Orthofix's "culture of aggressively setting internal sales targets and imposing pressure upon its sales personnel to meet those targets."[123] It is commonplace for the SEC to comment on corporate sales culture in its settlement orders, particularly with respect to revenue recognition

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[117] *Id.* ¶ 37.

[118] *Id.*

[119] *Id.* ¶ 24.

[120] *In re Orthofix*, *supra n*ote 80, ¶ 48.

[121] *Id.* ¶ 47.

[122] *Id.* at p. 2.

[123] *Id.* ¶ 16.

improprieties. Indeed, the settlement contained quotations from two internal emails as an example of the undue pressure affecting the sales force:

> On August 28, 2012 – and reflecting the pressure imposed to meet revenue targets – the Spine Sales VP sent the following email to his sales team with the subject line 'September Gut:'
>
> > I need your gut feeling on the revenue we can generate in September. We need $2 million in addition to what is on the portal . . . based on the feedback I have received I have gotten so far, we are off about $1.5 million. I know what people say they need, but as you know this is important. We need to ask everyone to purchase just a bit more . . . if I have to walk into [the Spine President's] office and tell him we are short again, that is going to be a major problem.
>
> After receiving the above email, one of the sales persons who reported to the Spine Sales VP emailed a colleague separately and wrote:
>
> > I was just speaking with [the Spine Sales VP] and had finance listened to us last year we wouldn't be in this mess. We all predicted our markets could not sustain this growth but they got greedy. Found this budget brutal because here we are for another year just estimating the dollars.[124]

General Motors Company. On January 18, 2017, the SEC settled with General Motors Company ("GM") for violating Section 13(b)(2)(B) of the Exchange Act.[125] The SEC alleged that GM's internal accounting controls systems were insufficient in that they failed to allow personnel to timely identify and evaluate loss contingencies for car recalls as required

[124] *Id.* ¶¶ 16-20.

[125] *In re General Motors Co.*, Sec. Exch. Release No. 79825, ¶ 20 (Jan. 18, 2017); Press Release, SEC, General Motors Charged with Accounting Control Failures (Jan. 18, 2017), https://www.sec.gov/news/pressrelease/2017-19.html.

under ASC 450.[126] GM accrued estimated losses on vehicle recalls using actuarial assumptions if the recall was valued at less than $5 million, and took a per-vehicle accrual on each vehicle, for the life of the vehicle, at the time of sale.[127] If the campaign was over $5 million, GM recorded a specific accrual when the recall was probable and estimable.[128]

On February 7, 2014, GM alerted the National Highway Traffic Safety Administration that it was recalling 619,122 vehicles, a number of which involved vehicles with defective ignition switches.[129] GM discovered that, in those models, the ignition switch would move out of the "run" position causing the power steering and power brakes features to disable.[130] In situations where there was a collision and the switch was in the "Accessory" or "Off" position, the vehicle's airbags did not always deploy.[131]

GM's Warranty Group was responsible for estimating possible losses related to recalls of vehicles that were already out in the market; but the Warranty Group was disconnected from other areas of the company such that its personnel were not aware when significant enough engineering issues had been raised that may make a recall likely or whether GM would be liable for such a recall.[132] Under ASC 450, companies are required to "assess the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability is remote, reasonably possible or probable. 'Probable' means the future event or events

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[126] *In re General Motors, supra* note 124, ¶¶ 13-20.

[127] *Id.* ¶ 6.

[128] *Id.*

[129] *Id.* ¶ 11.

[130] *Id.*

[131] *Id.*

[132] *Id.* ¶¶ 9-10.

are likely to occur. A loss is considered 'reasonably possible' when the chance of the future event or events occurring is more than remote but less than likely. A loss is considered 'remote' when the chance of the future event or events occurring is slight."[133]

GM engineers began reviewing claims related to faulty airbags in 2012, and in April 2012, an engineer identified the defective switch as a "probable root cause."[134] The SEC faulted GM's internal controls procedures, which did not make it necessary to inform the Warranty Group about potential issues that may lead to future recalls, but rather, provided information relating to recalls only when they were probable and the associated costs estimable. But ASC 450 requires more than that:

> If a loss is probable but a reasonable estimate of the amount of the loss cannot be made, the issuer is required to disclose the nature of the contingency and provide an estimate of the loss or range of loss or a statement that such an estimate cannot be made. Disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. ASC 450 also requires consideration of whether a loss contingency is reasonably possible and estimable, and whether disclosure is necessary. Neither accrual nor disclosure is required under ASC 450 if the loss contingency is remote.[135]

In instances where GM engineers identified potential problems with vehicles, these issues were included on an Emerging Issues List.[136] The Emerging Issues List was then given to the Warranty Group for their calculation and assessment.[137] However, before a potential

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[133] *Id.* ¶ 4.

[134] *Id.* ¶ 12.

[135] *Id.* ¶ 5.

[136] *Id.* ¶ 9.

[137] *Id.* ¶ 12.

issue could be included on the list, the matter would undergo a formal, multi-tiered review process, during which potential issues could be stricken from the list.

The SEC alleged that on four occasions GM personnel were informed of the defective ignition switch with certain vehicles, yet the Warranty Group was not timely informed to assess possible losses. The first time was in the spring of 2012, as mentioned above. In that instance, the engineer reported the issue to his supervisor.[138] The supervisor reported the issue to his manager and a GM attorney.[139] The SEC alleged that, at this point, although certain GM personnel understood the defective switch to be a problem, the issue was not added to the Emerging Issues List for the Warranty Group's review.[140]

On April 29, 2013, GM personnel were also alerted to the defective switch issue a second time during a deposition involving a collision case.[141] During the deposition, the plaintiff's attorney provided evidence that a component of the defective switch in the plaintiff's vehicle differed from the same component in an earlier model car that did not have the defect.[142] The SEC alleged that GM was on notice for a third time in July 2013, when the company retained an expert who confirmed that later models of the vehicles had a different ignition switch component than those in earlier model years.[143] The SEC stated, "[T]he Warranty Group

[138] *Id.*

[139] *Id.*

[140] *Id.*

[141] *Id.* ¶ 14.

[142] *Id.*

[143] *Id.* ¶ 15.

remained uninformed of this information and thus was unable to assess the possible losses related to the potential recall of vehicles with the Defective Switch at this time."[144]

The SEC alleged that a fourth time, in October 2013, GM received written confirmation from the device supplier that the ignition switch had been changed.[145] It was not until December 2013, that the defective switch was finally placed on the Emerging Issues List.[146] At that point, the Warranty Group properly recorded a $41 million accrual for recalling the affected vehicles.[147]

The SEC noted in its order that GM made "fundamental changes" to its internal processes such that the Warranty Group is made aware of potential recall issues much earlier than its receipt of the Emerging Issues List.[148]

* * *

Corporate individuals who are responsible for verifying a company's financial statements must give careful consideration to whether they are operating within the confines of GAAP given this current environment where the SEC has made clear that it has a laser beam focus corporate personnel involved with financial reporting. Corporate personnel must also be careful not to bow down to client pressure or pressure to increase revenue. Most importantly, auditors should exercise a healthy amount of skepticism about the information they are receiving. Moreover, it is not enough to simply piece together an internal controls program—a company must ensure that relevant personnel are sufficiently trained in GAAP, that they document their

[144] *Id.*

[145] *Id.* ¶ 16.

[146] *Id.* ¶ 17.

[147] *Id.*

[148] *Id.* ¶ 19.

findings, and are aware of how their work flows up to the company's financial statements. With these steps, the gatekeepers can effectively spot gaps in policies and procedures so they can be remediated promptly, before a restatement is necessary.

Appendix: Key Federal Securities Laws[1]

The Securities Act of 1933

Since the past financial crisis, the SEC has increased its reliance on Section 17(a) of the '33 Act in enforcement actions. The Act regulates initial securities offerings, and seeks to ensure that companies present investors with information material to their decisions to purchase a security.

Sections 17(a)(1), (2) and (3) make it unlawful for any person:

> (a) in the offer or sale of any securities (including security-based swaps) or any security-based swap agreement by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[2]

The Securities Exchange Act of 1934

The '34 Act established the SEC. Its provisions also regulate securities transactions in the secondary market and require reporting companies to, among other things, make routine disclosers to investors so they can make informed decisions about their investments. Section 10(b) and Rule 10b-5 are antifraud provisions of the '34 Act, and are quite similar to Section

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1 The following is a list of the key statutes we see the SEC relying on in enforcement actions concerning accounting fraud.

2 15 U.S.C. § 77q.

17(a) of the '33 Act. A key difference is that liability under Section 10(b) and Rule 10b-5 cannot be based on negligent conduct.

Section 10(b) makes it unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[3]

Pursuant to this section, the SEC promulgated Rule 10b-5, which makes it unlawful for any person

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[4]

Section 13(a) of the '34 Act regulates the periodic reporting requirements of public companies.

> (a) Every issuer of a security registered pursuant to section 78l of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as

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[3] 15 U.S.C. § 78j.

[4] 17 C.F.R. 240.10b-5(b).

> necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—
>
> > (1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 78l of this title . . .
> >
> > (2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.[5]

Rules 13a-1, 13a-11, and 13a-13 promulgated thereunder require companies to file annual, current and quarterly reports, respectively. In addition, Rule 12b-20 requires companies to add "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."[6]

Section 13(b) of the Act gives the SEC the authority to prescribe the manner in which the reports must be made, the details to include within those reports, the manner in which companies should keep their books and records, and mandates implementation of accounting controls.

> (b)(2) Every issuer which has a class of securities registered pursuant to section 78l of this title and every issuer which is required to file reports pursuant to section 78o(d) of this title shall—
>
> > (A) 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;
> >
> > (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—
> >
> > > (i) transactions are executed in accordance with management's general or specific authorization;

5 15 U.S.C. § 78m.

6 17 C.F.R. 240.12b-20.

> (ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) 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.[7]

Section 13(b)(5) prohibits any person from knowingly circumventing or knowingly failing "to implement a system of internal accounting controls" or knowingly falsifying "any book, record, or account described in paragraph (2)."[8]

Sarbanes-Oxley Act of 2002

SOX, which is also known as the "Public Company Accounting Reform and Investor Protection Act" or the "Corporate and Auditing Accountability and Responsibility Act," applies to all public companies (certain provisions apply to the private subsidiaries of public companies), and was passed in the wake of the *Enron* and *WorldCom* accounting scandals. Sections 201 through 209 address external auditor independence. Sections 301 through 308 address management responsibility for financial reporting and internal controls. Sections 401 through 409 address enhanced corporate financial disclosures, including amendments to Section 13 of the '34 Act to add additional reporting requirements. Section 801 through 807 and 1101 through 1107 address corporate and criminal fraud and accountability.

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7 15 U.S.C. § 78m.

8 *Id*.