Out of Control:
Recent SEC Enforcement Actions Concerning Internal Audit Programs

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During 2015 and the first quarter of 2016, the U.S. Securities and Exchange Commission ("SEC") continued its focus on the adequacy of corporate internal control programs. As SEC Chair Mary Jo White stated in a recent speech, the SEC has "been closely scrutinizing the gatekeepers of financial reporting, continuing to hold accountants, auditors, and audit committees accountable in appropriate circumstances."[1] Recent enforcement actions run the gamut from penalizing firms for implementing inadequate controls—including the failure to even implement controls—to censuring firms and individuals for failure to comply with the requirements of existing controls. The SEC has gained significant mileage by using information it has learned during its investigations of companies and corporate officers to later pursue external audit firms.

Chair White has emphasized that the SEC "still observe[s] too many instances where companies and their auditors have not discharged their responsibilities adequately under the securities laws and professional standards."[2] Chair White pointed in particular to enforcement actions brought within the last year "against national accounting firms and their partners for missing or ignoring red flags," calling the failures "totally unacceptable."[3]

[1] *See* Mary Jo White, Chair, Sec. & Exch. Comm'n, Keynote Address at the 2015 AICPA National Conference: "Maintaining High-Quality, Reliable Financial Reporting: A Shared and Weighty Responsibility" (Dec. 9, 2015), *available at* https://www.sec.gov/news/speech/keynote-2015-aicpa-white.html#_ftnref17.

[2] *Id.*

[3] *Id.* As discussed in detail *infra*, one action was brought against Grant Thornton, LLP. The other was brought against BDO. *See* Press Release No. 2015, SEC Charges BDO and Five Partners in Connection With False and Misleading Audit Opinions (Sept. 9 2015), *available at* http://www.sec.gov/news/pressrelease/2015-184.html.

The SEC's focus on audit controls is evident from its initiation of three types of recent enforcement actions. First, there have been actions focused on companies completely lacking internal controls. (Yes, there are still some reporting companies that simply choose to stick their proverbial heads in the sand.) Second, other actions have focused on the failure of individuals to comply with existing controls. Finally, "quality" controls at accounting firms have continued to catch the SEC's eye—and not in a good way.

Non-Existent Internal Controls and Conflicts of Interest

In two separate actions involving related-party transactions, the SEC entered a cease and desist order against Home Loan Servicing Solutions, Ltd. ("HLSS"), an entity that acquired mortgage servicing assets,[4] and Ocwen Financial Corp. ("Ocwen"), a mortgage servicer.[5] In the HLSS matter, the SEC found that HLSS made several inaccurate disclosures about its internal policies and procedures pertaining to conflicts of interest and misstated its financial results for the years 2012, 2013, and the first quarter of 2014 as a result of "an internal accounting controls failure."[6] In the Ocwen matter, as with HLSS, the SEC found that Ocwen made inaccurate disclosures about its policies concerning conflicts of interest.[7] The SEC also found that Ocwen suffered from internal accounting controls failures that resulted in Ocwen materially misstating its financial results for the second through fourth quarters of 2013 and the first quarter of 2014.[8]

[4] *In the Matter of Home Loan Servicing Solutions, Ltd.* (*HLSS*), Exch. Act Release No. 76074 (Oct. 5, 2015).

[5] *In the Matter of Ocwen Financial Corp.* (*Ocwen*), Exch. Act Release No. 76938 (January 20, 2016).

[6] *HLSS*, at 2 ¶ 1.

[7] *Ocwen*, at 2 ¶ 1.

[8] *Id.*

HLSS was founded in 2010 by William C. Erbey[9]—who was then also serving as the Executive Chairman of Ocwen and as the Chairman of Altisource, an entity that Ocwen created through a spin-off in 2009. According to the SEC, HLSS was created "to make Ocwen 'capital-light'" by "making it responsible for funding Ocwen's servicer advances."[10] Thus, in 2010, HLSS and Ocwen sought to negotiate an arrangement whereby HLSS would (1) purchase Ocwen's mortgage servicing rights ("MSRs") and (2) retain Ocwen as the subservicer for the underlying mortgages.[11] Ultimately, in 2012, HLSS instead purchased the rights to the MSRs and retained Ocwen as the subservicer, while Ocwen retained title to the MSRs.

Although Erbey recused himself from the MSR negotiations, the SEC observed that HLSS had "no written policies or procedures governing when an officer or director with a conflict of interest was required to recuse himself from negotiating or approving a related party transaction."[12] Moreover, "the responsibility for determining whether recusal was appropriate was left largely to the person with the conflict" and "[t]here was no meaningful oversight of that person's determination."[13]

Ocwen suffered from similar internal control deficiencies. The SEC noted that "[w]hile Ocwen's in-house counsel occasionally provided advice on whether the Executive

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[9] *HLSS*, at 3 ¶ 5; *see also*, *e.g.*, Home Loan Servicing Solutions, Ltd., Form 10-Q, at 18 (May 5, 2012) (listing William C. Erbey as HLSS's Chairman and founder).

[10] *HLSS*, at 4 ¶ 8.

[11] *Id.*; *Ocwen*, at 4 ¶ 11.

[12] *HLSS*, at 4 ¶ 10.

[13] *Id.* at 4 ¶ 11.

Chairman could participate in a related party transaction, there was no meaningful oversight of the Executive Chairman's determination."[14]

Moreover, personnel at both Ocwen and HLSS lacked a firm grasp of which types of transactions might require recusal because "there was no guidance or common understanding for making such a determination."[15] As a consequence of the nonexistence of related party transaction controls, Erbey inappropriately approved multiple transactions between Ocwen, HLSS, and/or Altisource. For example, Ocwen and HLSS entered into five "flow transactions" in 2012 totaling close to $70 billion.[16] On Ocwen's side, two of these transactions were approved by Erbey in his capacity as a member of the Ocwen Executive Committee.[17] In addition, he also concurrently approved those same transactions on behalf of HLSS in his capacity as a member of the HLSS Credit Committee.[18] He also approved several additional transactions in a similar fashion in 2013 and 2014. Both HLSS and Ocwen failed to document the approval of many of these transactions.[19]

Apart from their related party transaction control failures, HLSS and Ocwen suffered from further deficiencies in their internal accounting controls. Specifically, HLSS implemented a problematic valuation methodology whereby it tied the carrying value of its rights to MSRs to the unpaid balance on the principal of the underlying mortgages without considering

[14] *Ocwen*, at 4 ¶ 14.

[15] *Ocwen*, at 4-5 ¶ 15; *see also HLSS*, at 4 ¶ 12.

[16] *HLSS*, at 5 ¶ 18.

[17] *Ocwen*, at 6 ¶ 21

[18] *Id.*

[19] *Ocwen*, at 6 ¶¶ 24-25; *HLSS*, at 6 ¶¶ 22-23.

other factors that might have affected the valuation.[20] HLSS then used these faulty valuations as its presumptive fair value measurement of the MSR rights.[21] Although HLSS also obtained third-party fair value estimates, HLSS adjusted these estimates only if the third party valuation differed from the HLSS valuation by at least 5 percent.[22]

The SEC found that "[n]either HLSS's management nor its Audit Committee adequately reviewed or considered HLSS's valuation methodology for the Rights to MSRs."[23] In an ironic twist given his failure to perceive the problems inherent in approving related party transactions from both sides, it was Erbey who expressed concerns about HLSS's valuation methodology to one member of senior management. Erbey, however, failed to inform other members of management or the Audit Committee, or to otherwise follow up on his concerns.[24] Additionally, the "Audit Committee did not review the valuation methodology with HLSS's external auditors, had no discussions of substance concerning the development of the valuation methodology with HLSS management, [and] were not provided any documentation explaining the valuation methodology"—all in violation of the Committee's charter.[25]

As for Ocwen, it "relied upon HLSS's valuation methodology and used HLSS's calculation to account for its [own] financing liability associated with the Rights to MSRs," failing to conduct its own independent review.[26]

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[20] *HLSS*, at 7 ¶ 27.

[21] *Id.* at 7 ¶ 28.

[22] *Id.* at 7 ¶¶ 26, 28.

[23] *Id.* at 8 ¶ 31

[24] *Id.* at 8 ¶¶ 32-33.

[25] *Id.* at 8-9 ¶¶ 34-35.

[26] *Ocwen*, at 9 ¶ 35.

HLSS's valuation methodology caused HLSS to misstate key financial information in its 2012 quarterly and annual reports, and caused both Ocwen and HLSS to misstate their financials in 2013 and in the first quarter of 2014. Accordingly, each was required to restate those periods. These adjustments were not insignificant. Ocwen made adjustments decreasing in some periods its net income by 20%, and increasing it in some periods by 20%.[27] In one case, HLSS made adjustments decreasing its net income by 420%.[28]

As a result of these deficiencies, the SEC found that HLSS violated 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 ordered the company to pay a civil money penalty of $1.5 million. The SEC found that Ocwen violated the same Sections and Rules, and ordered the company to pay a civil money penalty of $2 million.

Failure to Comply with Existing Internal Controls

On the other side of the coin are violations of existing controls. On October 1, 2015, the SEC censured and imposed civil liability penalties on Grant Thornton Audit Pty Limited ("GT Audit"), an Australian affiliate of Grant Thornton International ("GTI"), after finding the audit firm violated auditor independence rules and standards.[29] In particular, GT Audit performed an audit for its client, named by the SEC as "Client A." Unbeknownst to GT Audit, two partners from GT Mauritius, another affiliate of GTI, sat on the board of Client A's Mauritius subsidiary.[30] Moreover, both partners sat on the board of Anex, the company that had

[27] *Id.* at 10 ¶ 43

[28] *HLSS*, at 9-10 ¶ 38.

[29] *In the Matter of Grant Thornton Audit Pty Limited* (*GT Audit*), Sec. Exch. Release No. 76066 (Oct. 1, 2015).

[30] *Id.* at 3 ¶¶ 7-8.

incorporated Client A's Mauritius subsidiary.[31] Given GT Mauritius's connections to Client A, the SEC found that it was improper for GT Audit to audit Client A's financial statements.

GT Audit's violations could have been avoided if the firm had trained its employees to comply with policies and procedures implemented by its parent firm, GTI. Among those policies and procedures was a requirement that auditors conduct and submit to GTI an International Relationship Check form ("IRC").[32] The IRC facilitated the identification of existing relationships between GT entities worldwide and their customers.[33] Under the relationship definitions set forth in the IRC, "Anex fell within the definition of a network firm of GT Mauritius, as it was under common control through the two GT Mauritius partners."[34]

GTI also "required its member firms to obtain annual independence confirmation letters in connection with auditing work," a task which included obtaining letters from GT member firms in every country in which the potential audit client maintained operations.[35] While GT Audit responded to audit confirmation requests from other GTI members, it failed to follow the requirements and solicit similar information when conducting its own audits of Client A from 2008 through 2011.[36]

The SEC entered a related order against Grant Thornton India LLP ("GT India"), also on October 1, 2015.[37] GT India audited Client A's financial statements in 2013.[38] Like GT

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[31] *Id.* at 3 ¶¶ 7-8

[32] *Id.* at 4 ¶ 11.

[33] *Id.*

[34] *Id.*

[35] *Id.* at 5 ¶ 12.

[36] *Id*. at 5 ¶ 13.

[37] *In the Matter of Grant Thornton India LLP*, Sec. Exch. Release No. 76065 (Oct. 1, 2015).

Audit, GT India was subject to GTI's compliance control procedures, including the requirement that it send an IRC to GTI (which was then sent on to relevant GTI firms), as well as obtain an independence confirmation letter from GT Mauritius.[39] In this case, although GT India submitted an IRC to GTI, GT Mauritius erroneously responded that it had no relationship with Client A.[40] GT India accepted this representation despite having listed the two GT Mauritius partners on the IRC as directors of Client A's subsidiary.[41] Moreover, GT India failed to request an annual independence confirmation letter from GT Mauritius.[42] Following this breakdown in protocol, GT India audited Client A's financial statements.

The SEC found that GT Audit had violated Rule 2-02(b)(1) of Regulation S-X, Section 13(a) of the Exchange Act, and Rule 13a-1 thereunder, and ordered the firm to pay $177,203 in disgorgement of audit fees, interest, and civil money penalties. The SEC found that GT India violated the same provisions, and the firm was ordered to pay $187,882 in disgorgement of audit fees, interest, and civil money penalties. In each case, the SEC took the firms' remedial efforts into account, including their undertakings to train employees in GTI's compliance control procedures.[43]

Quality Control Failures at Accounting and Auditing Firms

Another recent focus of the SEC has been the quality controls implemented by accounting and auditing firms. Speaking at a December 2015 conference of the American

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[38] *Id.* at 4 ¶ 11.

[39] *Id.* at 4 ¶¶ 12-13.

[40] *Id.* at 4-5 ¶¶ 14-15.

[41] *Id.*

[42] *Id.* at 5 ¶ 15.

[43] *Id.* at 8-9 ¶ 26; *GT Audit*, at 8-9 ¶ 24.

Institute of Certified Public Accountants, James V. Schnurr, Chief Accountant of the SEC, noted that "the independence of accountants who audit the financial statements included in filings with the Commission is essential to the credibility of financial reporting."[44] One way in which quality control failures have cropped up is in accounting and audit firms' failure to seek substantiation of client representations.

Such quality control failures at the Wisconsin offices of Grant Thornton, LLP ("Grant Thornton") resulted in the imposition of significant remedial measures, including the hiring of an independent consultant, disgorgement, civil money penalties and interest in excess of $4.5 million,[45] and an officer and director bar against one individual.[46] The SEC's enforcement action stemmed from Grant Thornton's failure to detect fraud at one of its audit clients, as well as its contribution to another audit client's omission of a multi-million dollar impairment from its financial statements. Both failures were the result of Grant Thornton's decision to ignore troubling or inconsistent information, or to rely on unsubstantiated information from company management.

Grant Thornton provided auditing services to the first client, Assisted Living Concepts, Inc. ("ALC"), in 2009, 2010, and 2011.[47] In 2008, ALC purchased the operations of eight assisted living facilities from Ventas, Inc. ("Ventas"), and through a leaseback, ALC agreed to operate the facilities for Ventas ("Ventas lease").[48] Certain covenants in the Ventas

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[44] James v. Schnurr, SEC Chief Accountant, Remarks Before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 9, 2015), *available at* https://www.sec.gov/news/speech/schnurr-remarks-aicpa-2015-conference-sec-pcaob-developments.html.

[45] *See In the Matter of Grant Thornton, LLP* (*Grant Thornton*), Sec. Exch. Release No. 76563 (Dec. 2, 2015).

[46] *See In the Matter of Laurie Bebo and John Buono, CPA*, Sec. Exch. Release No. 74177 (Jan. 29, 2015).

[47] *Grant Thornton*, at 7-18.

[48] *Id.* at 4 ¶ 10.

lease required ALC to maintain set coverage ratios and occupancy levels in each facility, or pay substantial financial penalties.[49]

ALC did not maintain those coverage ratios early on in the Ventas lease period because occupancy rates fell precipitously.[50] Nevertheless, ALC reported in its 2009, 2010, and 2011 financials that it was in compliance with the covenants.[51]

ALC managed to hide its non-compliance with the Ventas lease covenants through the elaborate measures of ALC's CEO, Laurie Bebo, and John Buono, ALC's CFO. The SEC alleged that Bebo and Buono doctored paperwork to make it appear that the Ventas properties were maintaining the requisite occupancy levels.[52] To carry out the scheme, at Bebo and Buono's direction, ALC included the names of current and former ALC employees, family members, and friends in its occupancy and financial covenant calculations.[53] While some ALC employees did periodically stay at the Ventas facilities, they were counted for purposes of the occupancy requirements for periods of time much longer than they actually stayed.[54] The number of non-residents needed to comply with the covenants was reverse engineered by Bebo, Buono, and others at ALC at the end of each quarter.[55]

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[49] *Id.* at 4 ¶¶ 11-12. "The lease defined 'coverage ratio' as cash flow divided by rent payments." *Id.* at 4 ¶ 11.

[50] *Id.* at 5 ¶ 13.

[51] *Id.*

[52] *See In the Matter of Laurie Bebo and John Buono, CPA*, at 5-7 ¶¶ 22-27.

[53] *Id.*

[54] *Id.*

[55] The SEC charged Buono with violations of Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13a-14, 13b2-1, and 13b2-2 thereunder. As part of his settlement, he agreed to pay $100,000 in civil money penalties and an officer and director bar. *Id*.

Bebo did not settle her action, and was charged with violating and causing violations of Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), and 13(b)(5) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13a-13, 13a-14, 13b2-

Although Grant Thornton was not aware of the fraud initially, its failed quality control procedures led it to ignore several red flags that might have uncovered the problems sooner than they were discovered. For example:

- the managing partner in charge of the ALC audit never asked the engagement team to verify the list of ALC employee occupants;[56]
- site visits to Ventas facilities included no procedures related to verifying the number of employees staying at the facilities;[57]
- the managing partner and the engagement manager repeatedly relied on verbal representations made by Buono instead of insisting on documentation;[58] and
- documentation provided by ALC consistently failed to mention the Ventas lease covenants or to demonstrate that ALC had communicated its occupancy calculations practices to Ventas.[59]

1, and 13b2-2 thereunder. She is appealing the Administrative Law Judge's: (1) findings that she violated each listed Section and Rule (except Rule 12b-20, which the judge held had not been violated); (2) imposition of a cease-and-desist order; (3) order that she pay a civil money penalty of $4.2 million; and (4) imposition of an officer and director bar. *See In the Matter of Laurie Bebo and John Buono, CPA*, Initial Decision Release No. 893 (Oct. 2, 2015).

Although the SEC actions against Bebo and Buono involved particularly egregious allegations, the SEC has also pursed actions against individuals in other cases for falsifying information on a much smaller scale. For example, on March 2, 2015, in an action where a company's internal controls were inadequate because they allowed for a one-man show, the SEC entered an order against Robert W. Elliot. *In the Matter of Robert W. Elliot* (*Elliot*), Exch. Act Release No. 74401 (Mar. 2, 2015). Elliot served first as the CFO of a private company Michael's Finer Meats, LLC ("MFM"), and later as a Vice President of Finance when MFM was acquired by a publicly traded company, The Chefs' Warehouse, Inc. ("Chefs'"). *Id.* at 2 ¶¶ 4-5. Elliot, who was tasked with creating an inventory spreadsheet for use in preparing MFM's financial statements, sometimes adjusted inventory information without "prepar[ing] any documentation supporting these adjustments," and other times "improperly increased the inventory amounts recorded in the spreadsheet to lower the cost of goods sold, and increase profit margins, to a range consistent with historical margins." *Id.* at 3 ¶ 7. Because MFM's financial statements were reported as part of Chefs' quarterly and financial statements, Elliot's improper adjustments resulted in inaccuracies in Chefs' 2012 and 2013 financial statements. *Id.* at 3 ¶ 9. Elliot's settlement included violations of Sections 13(b)(2)(A) and 13(b)(5) of the Exchange Act, and Rule 13b2-1 thereunder, and a $25,000 civil money penalty.

[56] *Grant Thornton*, at 9-10 ¶¶ 30, 34.

[57] *Id.* at 14 ¶ 59. Indeed, the Grant Thornton employee tasked with visiting the Ventas facilities in 2010 was not even aware of the occupancy adjustments at issue. *Id.*

[58] *See, e.g.*, *id.* at 15 ¶ 64; *id* at 18 ¶¶ 82-83.

[59] *See, e.g.*, *id.* at 8 ¶ 25; *id.* at 10 ¶ 34; *id.* at 12 ¶¶ 47-53; *id.* at 15 ¶ 64.

As for the second client, Grant Thornton similarly ignored red flags and inconsistencies in its auditing work for Broadwind Energy, Inc. ("Broadwind"). Broadwind acquired Brad Foote Gear Works, Inc. ("Brad Foote") in October 2007, and in so doing recorded intangible assets of $76 million.[60] That valuation largely came from two key Brad Foote customer relationships.[61] In 2008, both customers forecasted that they would drastically reduce their orders throughout the year, causing substantial declines in the projected revenue from those customers.[62] Broadwind attempted to offset those declines by employee downsizing and returning equipment to suppliers, among other measures.[63] Broadwind eventually hired a third-party appraisal firm to evaluate the relationships, and after first finding a $15 million impairment with respect to one of the customers, the appraisal firm reversed course and modified its calculations to find no impairment. After consulting with Grant Thornton, Broadwind did not record an impairment. This was despite the fact that "management offered no specific evidence to support its view that orders would return to the volumes forecasted in 2007."[64]

In 2009, these two customer relationships began to decline further, such that by the third quarter of 2009, both assets were impaired. Rather than require an adjustment, Grant Thornton relied on Broadwind management's representations that no triggering events had occurred that required the disclosure of the asset impairment.[65] Moreover, and perhaps most damning for the SEC, when Grant Thornton authored a memorandum in connection with its

[60] *Id.* at 20 ¶ 93.

[61] *Id.*

[62] *Id.* at 20 ¶ 95.

[63] *Id.* at 25 ¶¶ 123-24.

[64] *Id.* at 25 ¶ 123.

[65] *Id.*

year-end audit in 2009, the team “sought only evidence to corroborate management’s conclusion while disregarding evidence from their own prior work that contradicted management’s conclusion.”[66]

The SEC found that Grant Thornton violated Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder. The firm was censured and ordered to undertake several remediation projects, including extensively reviewing its controls, producing a written report, and hiring an independent consultant. Finally, the firm was ordered to pay disgorgement of audit fees, interest, and civil money penalties in excess of $4 million.

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In this environment, it is important for internal and external counsel to companies, corporate officers, an external auditors to give special attention to answering two questions. *First*, what is the quality of the controls companies have put in place to eradicate financial irregularities and do key personnel understand them? *Second*, what is the quality of the interaction between companies, corporate officers, and external auditors?

As recent SEC enforcement actions continue to show, companies and corporate officers must be forthcoming with auditors, and auditors must exercise a healthier amount of skepticism about information received from their audit clients. Moreover, it is not enough to simply piece together an internal control program without making sure that the appropriate personnel are aware of how the system operates and how to spot gaps in policies and procedures so they can be remediated quickly and effectively. Otherwise, it may be a short matter of time before the SEC takes action.

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[66] *Id.* at 28 ¶ 132.