New Trends in SEC Enforcement Activity

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On February 20 and 21, 2015, the United States Securities and Exchange Commission (the "SEC") held its annual SEC Speaks conference, which highlighted its enforcement successes in 2014 and outlined its primary initiatives for 2015. SEC Chair Mary Jo White and other SEC officials announced that the SEC will renew its focus on financial reporting and accounting fraud.[1] They forecasted that 2015 will be characterized by increased enforcement activity by the Financial Reporting and Audit Task Force and greater efforts to hold auditors (seen as financial "gatekeepers") accountable for protecting the market against financial fraud.[2] In addition, enforcement trends indicate that the SEC's Enforcement Division ("Enforcement Division") can be expected to expand its enforcement of internal accounting controls cases, which have constituted a significant portion of its efforts in recent years. Recent activity in this area is particularly interesting given that it suggests the SEC will pursue internal control misconduct even in the absence of facts sufficient to bring fraud charges.

Financial Reporting and Audit Task Force

One of the SEC's most notable recent initiatives is the creation of the dedicated Financial Reporting and Audit Task Force ("Task Force"). The Task Force, which was created in 2013, is

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[1] *See* Mary Jo White, Chair, Sec. and Exch. Comm'n, Chair's Address at SEC Speaks 2015 (Feb. 20, 2015) (noting "a 40 percent jump in financial reporting cases last year"), *available at* http://www.sec.gov/news/speech/ 2015-spch022015mjw.html#.VRCInv7wtaQ. This 40 percent figure has been called into question on the ground that the SEC's approach to the data may overstate the number of financial reporting cases in proportion to total enforcement activity. *See e.g*., Mark J. Fagel, What the SEC Enforcement Stats Really Tell Us, Law360.com (Mar. 3, 2015) ("Without [one investigation involving a 20 mining company stop-order action], financial reporting would have constituted only 12 percent of the cases — a slight decline as a proportion of the docket.").

[2] *See* Mary Jo White, Chair, Sec. and Exch. Comm'n, Chairman's Address at SEC Speaks 2015 (Feb. 20, 2015), *available at* http://www.sec.gov/news/speech/2015-spch022015mjw.html#\.VQ7o2 _7wtaQ. *See also* Thomas P. Cimino, Jr. et al., *Highlights from SEC Speaks 2015: Enforcement and Litigation Trends*, Nat. L. Rev. (Feb. 27, 2015) (discussing SEC speaks' speeches and priorities), *available at* http://www.natlawreview.com/article/highlights-sec-speaks-2015-enforcement-and-litigation-trends.

responsible for "strengthening the agency's efforts to identify and prosecute securities law violations related to financial reporting and audit failures."[3] It is comprised of attorneys and accountants who work in collaboration with the Enforcement Division's Office of the Chief Accountant and others to identify securities-law violations relating to the "preparation of financial statements, issuer reporting and disclosure, and audit failures."[4]

This year, Chair White applauded the Task Force's recent successes, noting that its efforts are beginning to "bear fruit"[5] and suggesting that the SEC will continue to rely on the Task Force as a primary means of identifying new cases. She and other SEC officials indicated that key areas of Task Force enforcement will include: revenue recognition, auditor independence, expense recognition, faulty valuations used to support accounting estimates, faulty and untimely impairment decisions, and missing and insufficient related-party disclosures.[6] This broad list of directives is reflected in recent actions undertaken by the Task Force and the SEC more broadly.

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[3] U.S. Sec. and Exch. Comm'n, *Financial Reporting and Audit Task Force* (Jan. 8, 2014), *available at* https://www.sec.gov/spotlight/ finreporting-audittaskforce.shtml.

[4] SEC Press Release, U.S. Sec. and Exch. Comm'n, *SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis* (July 2, 2013) ("[The Task Force] will include Enforcement attorneys and accountants across the country, working in close consultation with the [Enforcement] Division's Office of the Chief Accountant, the SEC's Office of the Chief Accountant, the Division of Corporation Finance, and the Division of Economic and Risk Analysis."), *available at* http://www.sec.gov/News/PressRelease/Detail/ PressRelease/1365171624975#.VQ7QX_7wtaQ.

[5] Mary Jo White, Chair, Sec. and Exch. Comm'n, Chair's Address at SEC Speaks 2015 (Feb. 20, 2015) ("Our renewed focus on financial reporting is starting to bear fruit."), *available at* http://www.sec.gov/ news/speech/2015spch022015mjw.html#.VRCInv7wtaQ.

[6] *See e.g.*, David R. Woodcock, Sec. and Exch. Comm'n, Address at SEC Speaks 2015, Workshop C: Enforcement (Feb. 20, 2015), *available at* https://www.pli.edu/Content/Seminar/The_SEC_Speaks_in_2015/_/ N4kZ1z129yu?ID=225334.

In addition, the Task Force has created and implemented its own review process, which is known as its Issuer Monitoring and Review Initiative.[7] Drawing on internal and external data and tools, as well as other recently enhanced technology available to the SEC, the Task Force is actively monitoring issuers so that it can spot areas of potential investigative interest as early as possible.[8] Over the course of the last several months, the Task Force has identified more than 200 issuers of potential interest, which it plans to further investigate for possible misconduct with respect to accounting and financial reporting practices.[9]

The Task Force is the primary means by which a great deal of the implementation of future SEC initiatives is anticipated to occur. Furthermore, the SEC's efforts with respect to auditor accountability as well as internal accounting controls will likely be taken up as primary focuses of Task Force enforcement.

Gatekeeper Accountability: Spotlight on Auditors and Audit Committees

In addition to projected increases in Task Force-led enforcement, the SEC has enhanced its efforts to hold perceived "gatekeepers" accountable with respect to preventing financial fraud. While this category of so-called gatekeepers has been defined in various ways over time and has been thought to include auditors, attorneys, and Chief Financial Officers, the SEC has recently focused its enforcement efforts on auditors and audit committees.

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[7] Margaret S. McGuire, Sec. and Exch. Comm'n, Address at SEC Speaks 2015, Workshop C: Enforcement (Feb. 20, 2015), *available at* https://www.pli.edu/Content/Seminar/The_SEC_Speaks_in_2015/_/N4kZ1z129yu?ID=225334.

[8] *Id*. ("[The Issue Monitoring and Review Initiative] was an initiative that [the SEC] undertook to really identify those potential problematic issuers earlier in the process, earlier in the life cycle of a potential fraud.")

[9] *Id*. ("Using our methodology, [the SEC] ha[s] already identified over 200 issuers that are of interest to our work and our review of those issuers has resulted in a number of new investigative matters that have been undertaken across the Division.")

Chair White clarified the rationale for the focus on auditor accountability in an October 2013 speech at the Securities Enforcement Forum. Highlighting the importance of auditors, White noted that they "serve as critical gatekeepers – experts charged with making sure that the processes that companies use to prepare and report financial information are ones that are built on strength and integrity."[10] She also noted that investors rely heavily upon auditor work product in order to analyze their investments.[11]

As a means of furthering its increased emphasis on holding auditors accountable, the SEC launched Operation Broken Gate, an initiative designed, in part, to "identify auditors who neglect their duties and the required auditing standards."[12] According to White, the initiative was created to "prob[e] the quality of audits and determine[] whether the auditors missed or ignored red flags; whether they have proper documentation; and, whether they followed their professional standards."[13]

Operation Broken Gate (also known as the "Broken Window" Policy initiative) draws its name from the Broken Windows Theory – a metaphor first articulated by George L. Kelling and James Q. Wilson – which holds that allowing those who break a window to go unpunished signals that small crimes are tolerated and, as a result, leads to more and larger crimes. In order to encourage appropriate, socially-desirable behaviors, Broken Gate enforcement suggests that authorities should hold accountable individuals guilty of misconduct, regardless of the severity of their offenses. As applied to the

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[10] Mary Jo White, Chair, Sec. and Exch. Comm'n, Remarks at the Securities Enforcement Forum (Oct. 9, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539872100#.VQ7YYv7wtaQ.

[11] *Id*.

[12] *Id*.

[13] *Id*.

investigation of financial fraud, Operation Broken Gate has led the SEC to pursue enforcement even in instances of minor, frequently unenforced or overlooked violations.[14]

More recently, Chair White reaffirmed the SEC's commitment to holding auditor-gatekeepers accountable at a June 2014 speech at the Stanford Directors' College. She noted that "audit committees, in particular, have an extraordinarily important role in creating a culture of compliance through their oversight of financial reporting."[15] Chair White specifically referenced auditor accountability yet again during this year's SEC Speaks Conference.[16] She emphasized that the SEC's ongoing commitment to holding auditors accountable, even in the instance of small infractions, was an important extension of Operation Broken Window's enforcement efforts and she reaffirmed that it remains "important to pursue even the smallest infractions."[17]

Since the implementation of Operation Broken Gate, the Enforcement Division has made good on that promise, performing numerous targeted enforcement "sweeps" and holding individuals and companies liable for violations of non-fraud securities law provisions that have been underutilized historically.

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[14] CCH, Inc., *Securities Enforcement*, Insights: The Corp. & Sec. Law Advisor 1, Vol. 29, No. 2, Feb. 2015 ("[T]he [SEC Enforcement] Division has been executing the Chair's 'broken windows' policy, filing suit to enforce even minor, rarely-enforced provisions of the federal securities laws, often in broad sweeps targeting dozens of companies and individuals (a phenomenon which helps explain the record number of cases brought last year).")

[15] Mary Jo White, Chair, Sec. and Exch. Comm'n, Remarks at the Stanford University Rock Center for Corporate Governance: A Few Things Directors Should Know About the SEC, Twentieth Annual Stanford Directors' College (June 23, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542148863#.VQ7Y_v7wtaR.

[16] Mary Jo White, Chair, Sec. and Exch. Comm'n, Chair's Address at SEC Speaks 2015 (Feb. 20, 2015) ("We also remain closely focused on gatekeepers, having recently brought two cases dealing with Section 5 obligations of broker-dealers, as well as a number of cases against auditors, transfer agents and attorneys."), *available at* http://www.sec.gov/news/speech/2015-spch022015mjw.html#.

[17] Mary Jo White, Chair, Sec. and Exch. Comm'n, Remarks at the Stanford University Rock Center for Corporate Governance: A Few Things Directors Should Know About the SEC, Twentieth Annual Stanford Directors' College (June 23, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542148863#.VQ7Y_v7wtaR.

Recent Auditor Enforcement Actions

Though auditor accountability has been emphasized by the SEC on an ongoing basis, actual enforcement activity has been fairly limited and largely focused on small accounting firms. That said, the number of individuals implicated is on the rise as a review of recent cases bearing on auditor liability have implicated 80 defendants in the last few months alone.[18]

Violations of Professional Standards

An October 24, 2014 SEC complaint against Berman & Company, P.A. ("Berman & Co.") and Elliot Berman ("Elliot"), Berman & Co.'s principal and lead auditor, highlights recent SEC enforcement activity with respect to auditors' professional standards. This action focused on regulations requiring lead audit partners to periodically rotate off their audit engagements in order to preserve the integrity of the financial reporting process. According to the complaint, Elliot's failure to comply with the rotational requirements amounted to engaging in "improper professional conduct and willfully violat[ing] and aid[ing] and abett[ing] violations of the Federal securities laws and the rules and regulations thereunder" by both the company and Elliot as an individual.[19]

In spite of rotational requirements, Elliot opted to continue to serve as the lead auditor with respect to one of the company's issuer-clients. Specifically, he served as the primary point of contact with the issuer's management, board of directors and the board's audit committee. Additionally, he made audit-related presentations to the issuer's audit committee and communicated with the issuer's management on substantive issues. Finally, he commented on the issuer's 10-K, reviewed audit

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[18] CCH, Inc., *Securities Enforcement*, Insights: The Corp. & Sec. Law Advisor 3, Vol. 29, No. 2, Feb. 2015 ("All told, 5 [enforcement] sweeps in the last few months entangled 80 defendants.")

[19] *In the Matter of Berman & Co., P.A. and Elliot Berman CPA*, Admin. Proceeding File No. 3-16212 (Oct. 24, 2014), *available at* http://www.sec.gov/litigation/admin/2014/34-73427.pdf.

paperwork and directed staffing and work related to the issuer's audit.[20] According to the SEC, in an effort to cover-up his conduct, Elliot "installed" as lead auditor an employee who was not a certified public accountant, and then continued to perform those duties himself.

The SEC ultimately found that Elliot's misconduct amounted to violations of Section 4C(a)(2) of the Securities Exchange Act of 1934 (the "Exchange Act") as well as Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[21] In addition, the SEC's order found that Elliot and Berman & Co. violated Section 10A(j) of the Exchange Act and caused their client's violations of Section 13(a) of the Exchange Act and Rule 13a-1.[22] Finally, Berman & Co. violated and Elliot willfully aided and abetted Rule 2-02 of Regulation S-X.[23] In order to settle the charges, Elliot was required to pay a $15,000 penalty and was suspended for a minimum of one year from practicing as an accountant on behalf of any publicly traded company or other entity regulated by the SEC.[24]

Auditor Independence

In addition to its enforcement activity with respect to professional accounting standards, the SEC's recent activity has also involved auditor independence rules. In December 2014, the SEC initiated a Task Force-driven enforcement sweep against eight accounting firms for preparing financial statements of brokerage firms that they also audited in violation of the rules requiring auditor

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[20] *Id*.

[21] *Id*.

[22] *Id*.

[23] *Id*.

[24] SEC Press Release, *SEC Sanctions Florida-Based Auditor for Circumventing Rule* (Oct. 23, 2014), *available at* http://www.sec.gov/ News/PressRelease/Detail/PressRelease/1370543281121#.VQ8Y8v7wtaQ.

independence.[25] According to the SEC, the firms "participated in the preparation of their respective clients' financial statements, improperly playing the role of both preparer and auditor."[26]

Pursuant to auditor independence rules, firms are prohibited from "jeopardiz[ing] their objectivity and impartiality in the auditing process by providing…non-audit services to audit clients."[27] By undertaking to complete the financial statements, the firms effectively put themselves in the position of auditing their own work, inappropriately misaligning their interest with their clients' and undermining their abilities to function as objective auditors. Stephen L. Cohen, Associate Director of the SEC's Division of Enforcement, castigated the firms' actions and reiterated that "[a]uditors must vigilantly safeguard their independence."[28]

The SEC orders found that the firms: (1) violated Rule 17a-5(i) of the Exchange Act; (2) caused their broker-dealer audit clients to violate Section 17(a) of the Exchange Act and Rule 17a-5; and (3) engaged in improper professional conduct pursuant to Exchange Act Section 4C(a)(2) and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[29] As a result of these violations, the SEC assessed penalties totaling $140,000 upon the eight firms, which all agreed to settle the cases.

Relatedly, in its September 25, 2014 complaint against Mayer Hoffman McCann, P.C. ("MHM"), the SEC initiated proceedings against a small public accounting firm for independence

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[25] SEC Press Release, *SEC Sanctions Eight Audit Firms for Violating Auditor Independence Rules* (Dec. 8, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543608588#.VQ9I0v7wta.

[26] CCH, Inc., *Securities Enforcement*, Insights: The Corp. & Sec. Law Advisor 3, Vol. 29, No. 2, Feb. 2015.

[27] SEC Press Release, U.S. Sec. and Exch. Comm'n, *SEC Sanctions Eight Audit Firms for Violating Auditor Independence Rules* (Dec. 8, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543608588#.VRCepP7wtaQ.

[28] *Id*.

[29] *Id*.

violations based on its audit of a broker-dealer, which regularly traded the securities of a public company closely associated with the auditor.[30] The SEC alleged that MHM violated its duty as an independent auditor by performing audits on a client that invested in the stock of a company that MHM was tied to via an alternative practice structure, in violation of Sections 4C and 21C of the Exchange Act and Rule 102(e) of the Commission's Rules of Practice. The SEC found that the investment of one of MHM's audit clients in a company to which MHM was tied effectively undermined MHM's ability to appropriately and ethically function as the client's auditor.[31]

In addition to finding that MHM violated its independence obligations, the SEC contended that MHM's procedures were deficient in preventing independence violations for other broker-dealers and investment fund audit clients.[32] After undertaking an intensive investigation of MHM's conduct, the SEC found that MHM's deficient internal mechanisms resulted in multiple failures to comply with auditor independence rules or meet adequate professional standards.[33]

Examples like the cases outlined above highlight the SEC's increased focus on the role of auditors as well as the obligations associated with auditor independence and professional conduct. SEC officials' discussions of the SEC's ongoing commitment to enforcement in relation to auditor accountability likely serves as a foreshadowing of what is on the horizon. If the last several months are any indication, auditors and audit committees should anticipate continued intensive and ongoing scrutiny by the Enforcement Division.

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[30] CCH, Inc., *Securities Enforcement*, Insights: The Corp. & Sec. Law Advisor 3, Vol. 29, No. 2, Feb. 2015.

[31] Michael Cohn, *SEC Institutes Proceedings against Mayer Hoffman McCann*, Accounting Now (Sept. 30, 2014), *available at* http://www.accountingtoday.com/news/auditing/sec-institutes proceedings-against-mayer-hoffman-mccann-72150-1.html.

[32] *Id*.

[33] *In the Matter of Mayer Hoffman McCann, P.C.*, Admin. Proceeding File No. 3-16171 (Sept. 25, 2014), at 2, *available at* www.sec.gov /litigation/admin/2014/34-73224.pdf.

Continued Internal Controls Enforcement

The SEC has also demonstrated a renewed commitment to enforcement of internal accounting controls standards. Though activity in this area is old hat, recent enforcement actions suggest a willingness on the part of the SEC to pursue wrongdoing based on internal controls failures, even in the absence of other fraud charges. This approach represents a departure from the SEC's prior approach of generally requiring concurrent fraud violations in order to pursue claims based on faulty or insufficient internal controls. Before discussing recent cases demonstrating the SEC's shift, we briefly outline existing regulations governing internal controls and audit standards.

The Internal Controls Regime

Section 13(b)(2)(B) of the Exchange Act requires that every publicly traded company: "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances[34] that—

> (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[.]"[35]

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[34] "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).

[35] 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 from Annette Nazareth, Director, U.S. Securities and Exchange Commission, to Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and Douglas Roeder, Senior Deputy Comptroller, Large Bank Supervision, Office of the Comptroller of the Currency, Re: Guidance on the Potential Liability of Financial Institutions for Securities Law

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)."[36] Neither provision requires scienter, or proof of wrongful intent by the alleged wrongdoer, in order to impose civil sanctions.[37]

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").[38] 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 Periodic Reports*,[39] requiring every issuer to

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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.

[36] 15 U.S.C. § 78m(b)(5). *See also* SEC Spotlight on FCPA, *available at* http://www.sec.gov/spotlight/fcpa/fcpa-recordkeeping.pdf.

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

[38] *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.

[39] 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 5 (noting that Section 302 of Sarbanes-Oxley also imposes internal control obligations, namely requiring

"maintain disclosure controls and procedures . . . and interim control over financial reporting."[40] 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."[41] 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.[42]

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;

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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 controls' effectiveness in the last 90 days, and have discussed in the report any changes to internal controls during the period under review).

[40] 17 C.F.R. 240.13a-15(a).

[41] 17 C.F.R. 240.13a-15(f).

[42] *Id.*

> (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.[43]

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."[44]

<u>Governing Audit Provisions</u>

Though a more thorough exposition of auditing provisions and principles is beyond the scope of this article, it bears mentioning that companies attempting to ensure compliance with relevant audit standards and requirements familiarize themselves with Public Company Accounting Board's ("PCAOB") Auditing Standard 16 ("AS 16"), which outlines various standards with respect to the execution of audits and details issues that auditors are required to discuss with the audit committee. Effective in 2013 for calendar-year registrants, AS 16 provides broader guidance with respect to the professional standards for auditors, outlining their objectives as follows:

> a. Communicate[45] to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;
> b. Obtain information from the audit committee relevant to the audit;
> c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and
> d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.[46]

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[43] 17 C.F.R. 229.308.

[44] *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[.]")

[45] "Communicate to," as used in this standard, is meant to encourage effective two-way communication between the auditor and the audit committee throughout the audit to assist in understanding matters relevant to the audit.

AS 16 also holds auditors responsible for establishing an understanding of the terms of the audit, noting that:

> The auditor should establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the following:
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> a. The objective of the audit;
> b. The responsibilities of the auditor; and
> c. The responsibilities of management.[47]

Beyond requiring auditors to establish an understanding with respect to audit terms, AS 16 requires auditors to record the agreed-upon understanding so that a clear record can later be consulted should issues arise:

> The auditor should record the understanding of the terms of the audit engagement in an engagement letter and provide the engagement letter to the audit committee annually. The auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company. If the appropriate party or parties are other than the audit committee, or its chair on behalf of the audit committee, the auditor should determine that the audit committee has acknowledged and agreed to the terms of the engagement.[48]

In addition, AS 16 contains specific instructions with respect to the overall audit strategy, timing of the audit and significant risks. It also addresses numerous issues likely to be implicated in the course of an audit and provides instructions on how auditors are expected to proceed.

Moreover, in light of the SEC's 2014 adoption of PCAOB Auditing Standard No. 18 ("AS 18"), auditors are also required to consider on three key areas within their audits: related party

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[46] Pub. Co. Accounting Oversight Bd., Release No. 2012-004, Auditing Standard No. 16, *Communication with the Audit Committee* (Aug. 15, 2012), *available at* http://pcaobus.org/Rules/Rulemaking/Docket030/ Release_2012-004.pdf.

[47] *Id*. at ¶5.

[48] *Id*. at ¶6.

transactions; significant unusual transactions; and financial relationship and transactions with executive officers, including executive compensation arrangements.[49] Additionally, auditors are encouraged to "connect the dots" between different aspects of the audit, and specifically, to scrutinize the "business purpose (or the lack thereof) of companies' significant unusual transactions required by Auditing Standard No. 16."[50]

Though it remains to be seen how the SEC will use AS 18 in its enforcement arsenal, auditors would do well to take note that with the SEC's renewed vigilance in financial reporting matters, a working knowledge of relevant audit principles is necessary in order to avoid liability for potential SEC fraud violations based on the actions of their auditors.

Faulty Internal Controls

The SEC's recent enforcement action with respect to an Arizona software company serves as a good example of the recent shift with respect to controls cases. In the case of JDA Software Group, Inc. ("JDA"), the SEC alleged 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.[51]

The SEC alleged that JDA "failed to properly recognize and report revenue from certain software license agreements it sold to customers." According to the SEC, this reporting error occurred "because [JDA's] internal accounting controls failed to consider information needed for determining a critical component of revenue recognition for software companies." Proper recognition of this "critical"

[49] PCAOB Release No. 2014-002 at 6, Auditing Standard 18, Related Parties (June 10, 2014), *available at* http://pcaobus.org/Rules/ Rulemaking/Docket038/Release_2014_002_Related_Parties.pdf.

[50] *Id*.

[51] SEC Press Release, U.S. Sec. and Exch. Comm'n, *SEC Charges Arizona-Based Software Company for Inadequate Accounting Controls Over Its Financial Reporting* (Sept. 25, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/ 1370543042731#.VRCslf7wtaQ.

accounting component, known as vendor specific objective evidence of fair value ("VSOE") is necessary in order for software companies to properly recognize the revenue from their agreements.

Based on its investigation of JDA, the SEC found that JDA's violations amounted to inadequate internal controls surrounding revenue recognition, which ultimately resulted in the company misstating revenues in public filings. The SEC also found that the issues with respect to JDA's internal controls constituted a sufficient basis for liability, as the company's financial statements in 2008, 2009, 2010, and 2011 were materially misstated as a result.[52]

Ultimately, and in spite of the absence of concurrent fraud or individual charges, the SEC forced JDA to pay a $750,000 penalty, finding that its conduct violated the reporting, books and records, and internal controls provisions of the federal securities laws.[53]

Relatedly, the SEC's willingness to pursue standalone internal controls cases apart from fraud claims, was also highlighted by its imposition of $150,000 in fines on Great Lakes Dredge & Dock Corporation ("Great Lakes") in October 2014. The SEC's action against Great Lakes was based on allegations that it recorded revenue without sufficient proof of customer acceptance of shipped inventory.

By way of its organizational structure, Great Lakes has two operating divisions, a dredging segment responsible for most of the firm's revenue and a demolition segment. The SEC's complaint alleges that Great Lakes overstated revenue in the company's demolition segment in the second and third quarters of 2012. Specifically, the SEC found that the company's "demolition segment recorded revenue for pending change orders even though it did not have sufficient proof of customer

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[52] SEC Press Release, U.S. Sec. and Exch. Comm'n, *SEC Charges Arizona-Based Software Company for Inadequate Accounting Controls Over Its Financial Reporting* (Sept. 25, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/ 1370543042731#.VRCslf7wtaQ.

[53] *Id*.

acceptance of the pending change orders."[54] As a result, revenue was overstated during the year-end audit. The company discovered the issue during one of its routine audits and announced a restatement.

According to the SEC, the company's overstatement resulted from a material weakness in its internal controls. With respect to its internal controls, the SEC found that Great Lakes "failed to capture and analyze timely and consistently pending change orders in its demolition segment."[55] Based on its investigation, the SEC found that the alleged failure was "largely as a result of inadequate accounting policies and procedures, inadequate training of segment personnel, and insufficient monitoring by corporate accounting staff."[56]

In order to resolve the proceeding, Great Lakes consented to the entry of a cease and desist order under Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B). In assessing its fine, the SEC gave consideration to Great Lakes' remedial acts as well as the company's substantial cooperation.

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Through its emphasis on intensifying Task Force enforcement, increasing auditor accountability, and pursuing internal controls violations in the absence of concurrent fraud charges, the SEC appears poised to increase its financial reporting enforcement activity even beyond the 40% uptick that it experienced in 2014. From the progress it has made in the first quarter of 2015, the SEC seems well on track to surpass last year.

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[54] *In the Matter of Great Lakes Dredge & Dock Corporation*, Admin. Proceeding File No. 3-16215 (Oct. 27, 2014).

[55] *Id*.

[56] *Id*.