

CREDIBILITY
INTERNATIONAL



SEC and PCAOB Accounting and Auditing Enforcement Observations, Analysis & Insights

2020

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1 Introduction

Credibility International is pleased to present the second edition of our study of U.S. Securities and Exchange Commission (“SEC”) and Public Company Accounting Oversight Board (“PCAOB”) enforcement activity related to financial reporting, auditing, and professional responsibilities of accountants. The first edition of our study covered the six-month period from July 1, 2019 through December 31, 2019. This second edition has been expanded to include a full year of activity, covering enforcement cases filed and adjudications finalized from January 1, 2020 through December 31, 2020.

Our objective continues to be to provide our readers with informative and useful data analyses, trends and insights about SEC and PCAOB enforcement activity. In **Section 2**, we present summary data about the SEC and PCAOB’s overall enforcement activity in the relevant areas and communicate major themes we observed from the historical data. Additionally, we explore potential areas likely to be a focus for enforcement activity in coming periods based on these themes, recent policy initiatives, and prevailing market conditions.

We then further analyze the data and highlight relevant or interesting cases from 2020. We have segregated our detailed findings into two primary sections. First, in **Section 3** we analyze enforcement matters involving the financial reporting of public-company issuers, registered investment companies, investment advisors, brokers and dealers, and private funds. This includes actions brought by the SEC against these entities and their executive management and boards. In **Section 4**, our focus is on matters brought by both the SEC and the PCAOB against audit firms and individual auditors. In the appendices, we provide additional detail about specific cases.

The preparation of this study was led by Credibility International’s President, **Michael Maloney**, who served as Chief Accountant of the SEC’s Division of Enforcement from 2014 through 2018, and **Ryan Wolfe** of Credibility who served in the SEC’s Office of the Chief Accountant from 2011 through 2020. Mike and Ryan would like to recognize the significant contributions of our Credibility colleagues Matthew Lupo, Tyler Famiglietti, Jack Concannon, and Bryan Roach in preparing this study.

2 Enforcement Activity Level and Major Themes

2.1 Enforcement Activity Level – Calendar Year 2020

■ Overall (Financial Reporting and Auditing Cases Combined)

- The SEC and PCAOB combined brought matters against **137 respondents** (or defendants when brought in Federal District Court). Excluding 12 matters that involved 102(e) reinstatement or the termination of bars, the total is **125 respondents in new matters**
- Of these **125** new matters against respondents, **77 (62%)** were brought against individuals, and **48 (38%)** were brought against entities (e.g. corporations, audit firms, investment funds)
- Our methodology indicated that the **125** new matters against respondents represented **72** unique matters, or **1.7** respondents per matter.

■ Financial Reporting Cases (SEC)

- Of the overall totals above, the SEC brought financial reporting matters against **75** respondents in **48** unique matters
- Of the SEC's **75** new matters against respondents, **31 (41%)** were against entities and **44 (59%)** were against individuals

■ Auditing Cases (SEC and PCAOB)

- Of the overall totals above, The SEC and PCAOB combined brought auditing matters against **50** respondents in **23** unique matters.
- The SEC brought auditing actions against **19** respondents in **9** unique matters. Of the **19** respondents, **5 (26%)** were audit firms and **14 (74%)** were individual auditors. Two unique matters were brought solely against an audit firm.
- The PCAOB brought auditing actions against **31** respondents in **14** unique matters. Of the **31** respondents, **12 (39%)** were audit firms and **19 (61%)** were individual auditors. Four unique matters were brought solely against an audit firm (all related to Form 3 violations)

2.2 Major Themes

Revenue Recognition and Related Disclosures

In a year unlike any other due to the COVID-19 pandemic, revenue recognition cases persisted as the leading area of financial reporting enforcement activity. While this is consistent with past trends, this is an important time in the evolution of the SEC's enforcement program related to revenue recognition given multiple evolving factors.

First, issuers now have an additional year of reporting pursuant to the new revenue standard in ASC 606 (adopted by most public companies on January 1, 2018). Although there were no enforcement cases brought in calendar year 2020 related to the misapplication of ASC 606, those cases will likely emerge soon. While the new revenue accounting model has changed, it is likely that similar fact patterns that have historically given rise to enforcement investigations will continue to result in scrutiny. It is also important to note that ASC 606 requires significant additional disclosures related to revenue accounting policies that could attract scrutiny. As such, enforcement activity in this area should remain robust.

A second important observation arising from 2020 activity is the prevalence of revenue recognition cases alleging revenue disclosure violations with no related alleged GAAP violation. These cases related to: (1) disclosures about known trends and uncertainties in Management's Discussion and Analysis of Financial Position and Results of Operations ("MD&A"), and (2) reporting of sales-related key performance indicators ("KPIs") and the presentation of non-GAAP financial measures related to revenue recognition. Further, given the SEC's increased focus in recent years on non-GAAP financial measures and on disclosures contained outside the audited financial statements, we anticipate continued enforcement activity in this area, regardless of whether alleged revenue violations result in material misstatements of GAAP financial statements.

Internal Controls and Disclosure Controls and Procedures

Cases enforcing the internal accounting controls provisions of Section 13 of the Securities Exchange Act continue to be an area of emphasis for the SEC. In addition, while only one case included violations of Rule 13a-15 related to management's evaluation of Internal Control over Financial Reporting ("ICFR"), multiple cases made reference to ICFR, and continued scrutiny of both issuers' processes for evaluating ICFR and auditors' assessments of ICFR can be expected.

With respect to disclosures outside the financial statements, multiple cases in 2020 related to issuers' responsibility to maintain Disclosure Controls and Procedures ("DCP"). Disclosure cases covered a variety of areas, including the sufficiency of MD&A disclosures, the presentation of non-GAAP financial measures, disclosure of perquisites, and disclosures regarding board governance.

Gatekeepers

Given the pervasive roles and responsibilities placed on accountants by the federal securities laws to prepare and certify financial statements, a high-degree of scrutiny on accountants and auditors will likely continue. Consistent with past trends, multiple cases were brought by both the SEC and the PCAOB against auditors for violating professional standards. It is worth noting that no matters alleging violations of auditor independence standards under Rule 2-01 of SEC Regulation S-X were filed by the SEC or PCAOB in 2020, despite both regulators having a history of pursuing independence matters. Further, continued strong remedies were obtained against accountants charged in criminal matters, including six forthwith suspensions pursuant to Rule 102(e) related to criminal convictions (resulting in permanent suspensions).

Cooperation Credit and Remediation

Certain SEC officials have emphasized the importance of cooperation with investigations over the past several years.¹ This emphasis is reflected in cases brought in 2020, with multiple SEC Orders in the financial reporting area citing cooperation of respondents. Closely related to cooperation is the remediation of the factors giving rise to the relevant securities law violations. As discussed further in this study, remedial measures were also prevalent in the auditor context, with several cases noting audit firms' systems of quality control. In addition, certain SEC and PCAOB cases included notable undertakings including two instances where issuer undertakings required supplemental evaluation of the company's ICFR.

Audit Firm Quality Control Systems

Both the SEC and the PCAOB continued to scrutinize audit firms' systems of quality control, both for registered accounting firms performing audits of issuers and broker-dealers pursuant to PCAOB standards, and for accounting firms appearing and practicing before the SEC in other capacities (e.g. conducting audits of private funds pursuant to AICPA standards to satisfy the Custody Rule).² In the notable case summaries in Appendix B, we highlight specific aspects of firms' quality control systems evaluated by the SEC and the PCAOB and describe unique undertakings imposed on audit firms in this area.

Areas to Watch: Asset Impairment, Valuation, Earnings/EPS Management, Blank Check Companies, and COVID Accounting and Disclosures

Although there were only a limited number of cases brought in 2020 in the areas of asset impairment, valuation, earnings/eps management, and Blank Check Companies, the SEC has a track record of aggressive enforcement in these areas. Given the current economic climate and past precedent, it would not be surprising to see increased scrutiny of these areas going forward. As such, we specifically call out three unique matters in these areas in the notable case summaries in Appendix A.

1 See e.g. Speech by Steven Peikin, Co-Director of the Division of Enforcement at the PLI White Collar Crime 2018: Prosecutors and Regulators Speak Conference, *Remedies and Relief in SEC Enforcement Actions*, October 3, 2018.

2 See SEC Rule 2-06(4)-2 of the Investment Advisors Act of 1940.

Additionally, in early stages of the COVID-19 pandemic both the SEC³ and the PCAOB⁴ issued statements and guidance for issuers and their auditors regarding accounting, disclosure and auditing considerations unique to COVID-19. Even as the pandemic recedes, it would not be surprising to see the SEC and PCAOB scrutinize accounting, disclosure, and auditing decisions of issuers and their auditors, particularly related to the areas highlighted in their previous statements and guidance documents.

Auditing Issues Regarding Issuers with Operations in China

Given ongoing issues with access, regulators have focused on policy issues related to issuers and gatekeepers operating in the People's Republic of China. This focus ultimately resulted in legislation that amended the Sarbanes Oxley Act to establish a disclosure regime to identify issuers who rely on auditors where the PCAOB cannot access documents to conduct inspections.⁵

In this context, 2020 included enforcement activity related to gatekeepers in China, particularly related to multiple cases brought by the PCAOB related to failures to file Forms 3, wherein the PCAOB alleged that registered public accounting firms failed to report instances of the China Securities Regulatory Commission instituting disciplinary proceedings. In addition, the PCAOB charged a U.S. audit firm with violating its rules with respect to an audit of an issuer with substantially all of its operations in China, including requiring the firm to engage in a self-review of its system of quality control and imposing a bespoke undertaking preventing the firm from issuing an audit report for any SEC issuer with substantially all of its operations in China.

3 See e.g. Public Statement of Sagar Teotia, Statement on the Continued Importance of High-Quality Financial Reporting for Investors in Light of COVID-19, June 23, 2020, available at <https://www.sec.gov/news/public-statement/teotia-financial-reporting-covid-19-2020-06-23> and Division of Corporation Finance Disclosure Guidance: Topic 9, Coronavirus (COVID-19), March 25, 2020, available at <https://www.sec.gov/corpfin/coronavirus-covid-19>.

4 See e.g., PCAOB Spotlight, Staff Observations and Reminders during the COVID-19 Pandemic, December 2020, available at <https://pcaobus.org/about/response-to-covid-19>

5 See Holding Foreign Companies Accountable Act, December 18, 2020.

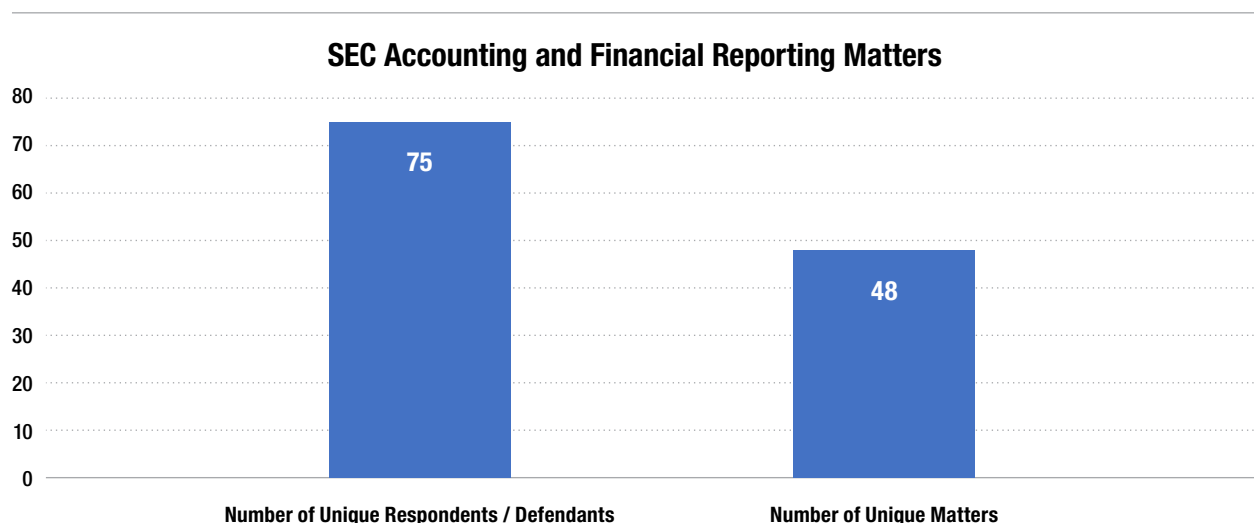
3 SEC Accounting and Financial Reporting Enforcement Matters - Data and Trends (Calendar Year 2020)

3.1 Introduction

This portion of the study presents and analyzes 2020 data and trends regarding SEC accounting and financial reporting cases as presented in SEC Accounting and Auditing Enforcement Releases (“AAERs”), as well as other related matters, such as accountants engaged in offering frauds, insider trading, and other violations of the federal securities laws that were designated as AAERs. SEC actions against auditors of financial statements designated as AAERs are reported and analyzed together with PCAOB enforcement matters in Section 4 of this study.

3.2 Enforcement Data and Trends

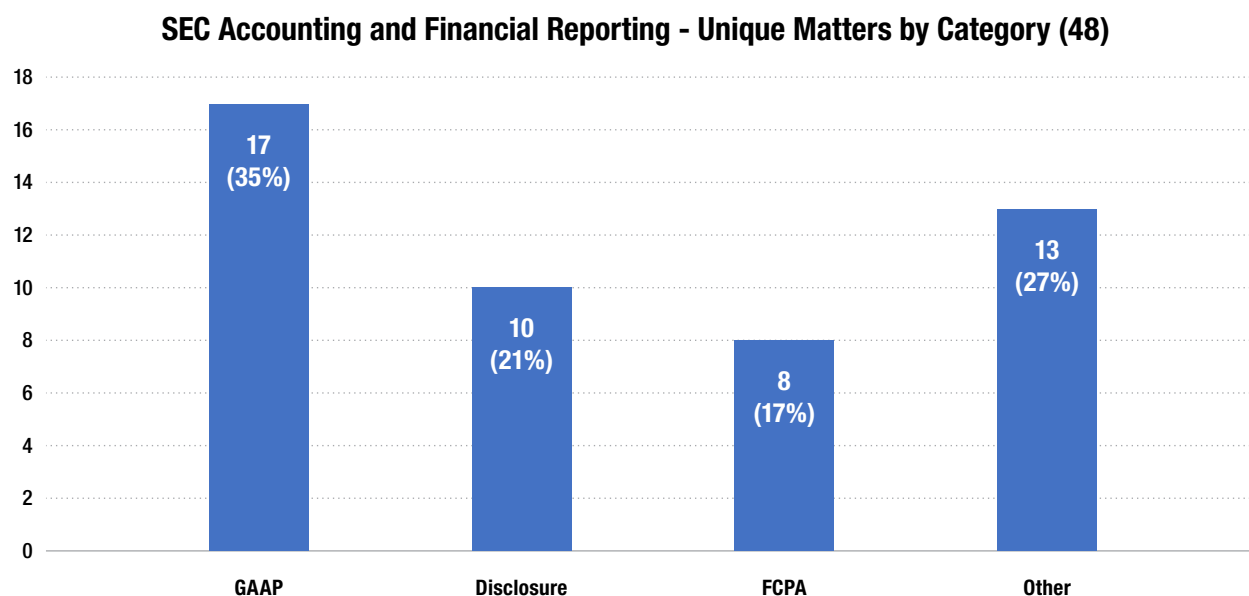
Number of Unique Respondents/Defendants and Unique Matters⁶



⁶ The matters presented here include parties named as Respondents in SEC Orders or as Defendants in litigation releases where there was a corresponding complaint filed by the SEC in Federal District Court during calendar year 2020. Reinstatements of accountants previously suspended pursuant to Rule 102(e) are not included in this presentation as they are not considered to be new matters. Unless otherwise specified, references to “respondents” encompass both respondents in administrative actions and defendants in Federal District Court proceedings.

As described earlier, based on our methodology the SEC brought accounting and financial reporting actions against 75 unique respondents/defendants in 48 unique matters during 2020. While the number of actions filed in a discrete period does not directly correlate to the “strength” or “aggressiveness” of the SEC’s enforcement program in this area, it is likely that the number of actions filed was somewhat lower than it would otherwise have been during 2020 due to the COVID-19 pandemic. However, despite the ongoing presence of the pandemic during the year, the SEC filed a wide range of matters covering a multitude of issues across the accounting and financial reporting spectrum.

Categories of SEC Accounting and Financial Reporting Matters Filed

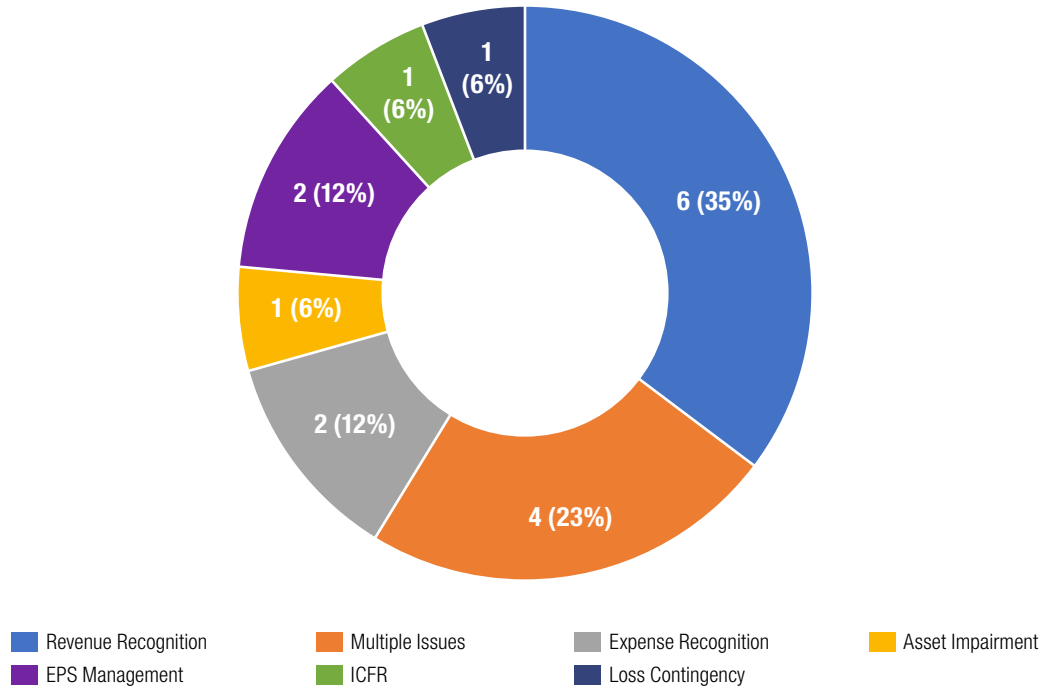


Our methodology included review of each unique matter to identify the primary type of accounting or financial reporting case being alleged by the SEC. Matters that alleged a violation of GAAP, typically resulting in a violation of Section 13(a) by the issuer, were the most common.⁷ While this is consistent with historical precedent, a significant number of disclosure cases were brought by the SEC during 2020 that did not allege a GAAP violation. A number of these disclosure-only cases are summarized in Appendix A and are worth noting since they may represent an indicator of the types of cases that may become more common under the new leadership’s enforcement program, particularly since disclosures related to environmental, social, and governance in addition to other areas (e.g. non-GAAP measures) have attracted attention in recent periods. The SEC also remained active in filing cases alleging violations of the Foreign Corrupt Practices Act (“FCPA”), as well as a variety of other matters involving offering frauds, market manipulation, and insider trading by accountants.

⁷ Cases that included both a GAAP violation and a disclosure violation outside the audited financial statements have been included in the GAAP matter type.

Primary GAAP Accounting Issue

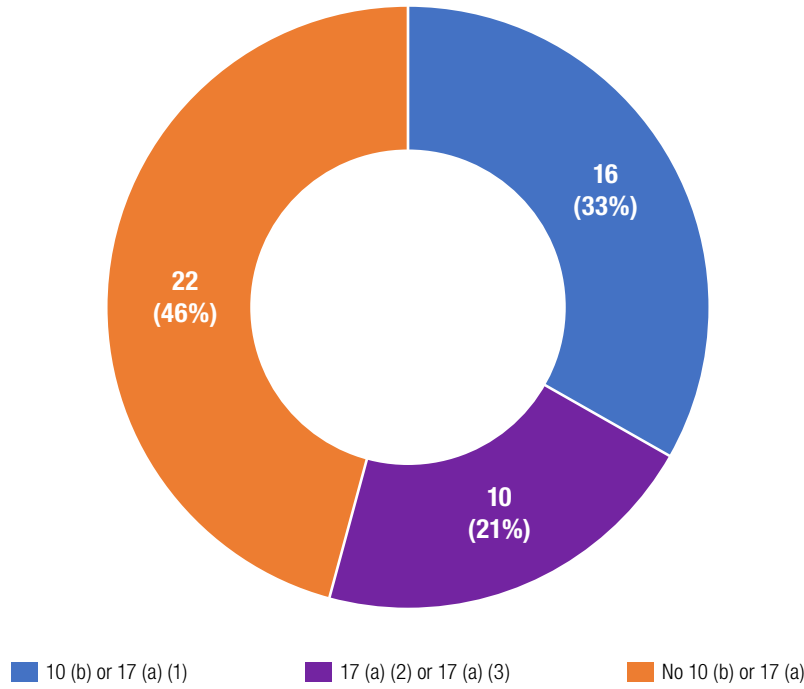
Primary GAAP Accounting Issue in SEC Unique Matters (17)



Consistent with past trends, revenue recognition continued to be the most cited primary GAAP violation in enforcement matters, followed by cases alleging the inappropriate recognition of expenses or EPS management. Other areas of GAAP highlighted in SEC matters included asset impairment, and ICFR violations, including a matter alleging that the issuer's insufficient internal control environment resulted in violations of GAAP. Given events in the market over the past several years, including the effects of the pandemic and continued merger and acquisition activity, it would not be surprising to see additional GAAP cases involving asset impairments, valuation, and accounting for business combinations, or other cases related to GAAP accounting issues stemming from the impacts of the pandemic.

Matters Alleging Fraud vs. Non-Fraud

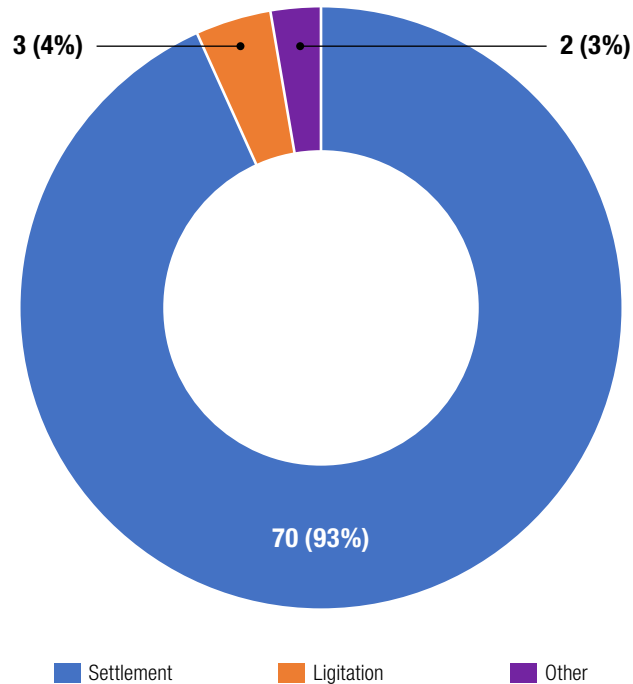
Matters Alleging Fraud in Unique SEC Matters (48)



Cases alleging violations of the anti-fraud statutes of the federal securities laws continued to make up more than half of the financial reporting matters brought by the SEC. One-third of the financial reporting cases brought by the SEC in 2020 included a violation that included scienter; and an additional ten matters (**21%**) included charges alleging violations of either Sections 17(a)(2) or 17(a)(3) for negligence-based fraud. While it is likely that the SEC will continue to aggressively pursue fraud charges in financial reporting matters, it is also notable that a not-insignificant share (**45%**) of the 2020 financial reporting cases did not allege fraud charges.

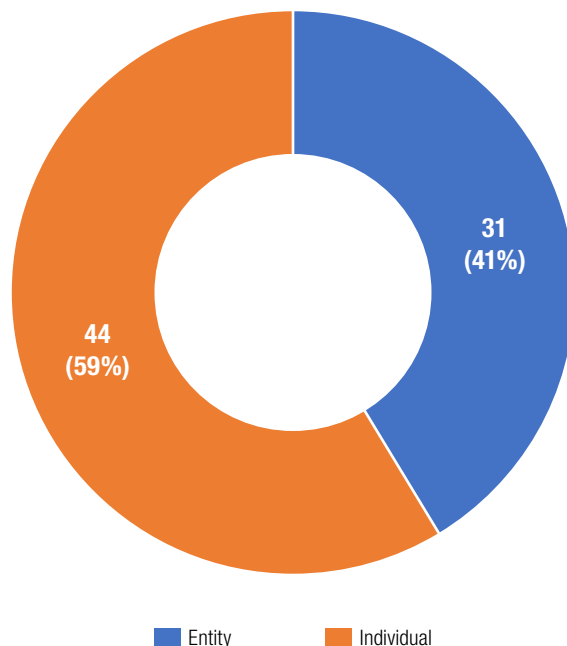
SEC Accounting and Financial Reporting Case Resolution – Settlement vs. Litigation

SEC Resolution Type - Settlement vs. Litigation (75 Respondents / Defendants)



Consistent with past precedent, the significant majority of cases brought by the SEC were settled in 2020 (more than **90%**), the overall trend of litigated cases being in the minority is generally consistent with past precedent.

SEC Accounting and Financial Reporting Cases - Individuals vs. Entities

**SEC Accounting and Financial Reporting - Individuals vs. Entities
(75 Respondents / Defendants)**

Of the 75 respondents/defendants in SEC accounting and financial reporting matters, 44 (59%) were individuals and 31 (41%) were corporate entities. This allocation is consistent with past precedent and with past public statements from the SEC that holding individuals responsible for accounting and financial reporting violations has an important deterrent effect for the overall enforcement program. At the same time, there were several notable cases brought in 2020 where no individuals were charged, including the settlements with BorgWarner, Inc., HP, Inc., and Andeavor LLC discussed in Appendix A.

3.3 Notable SEC Accounting and Financial Reporting Matters

Revenue Recognition and Related Disclosures Cases

As discussed earlier, revenue recognition, and more generally disclosures about sales and sales practices, continued to represent an area of focus for the enforcement staff in 2020. The following cases of note were brought during the year, as further detailed in Appendix A:

- **Super Micro Computer, Inc. (AAER 4161)** – This case alleged revenue recognition violations related to accelerating sales, failing to consider collectability, and not recognizing warranty revenue over the ratable period.
- **Belden, Inc. (AAER 4196)** – This case alleged revenue recognition violations related to sales that had not shipped.
- **Manitex International, Inc. (AAER 4177)** – This case alleged revenue recognition and other misstatements related to “bill and hold” sales.
- **Revolution Lighting Technologies, Inc. (AAER 4170)** – This case alleged revenue recognition violations related to “bill and hold” sales.
- **HP, Inc. (AAER 4183)** – This case alleged disclosure violations related to “pull in” sales and other practices that allegedly cannibalized sales.

Asset Impairment Cases

There was only one case involving a GAAP misstatement related to asset impairment testing in 2020. However, as discussed earlier, asset impairments could represent an important area to watch going forward given the current economic environment and the SEC’s interest in providing investors with sufficient information about the recorded values of assets on issuer balance sheets. Additional details are included in Appendix A.

- **Apex Global Brands (AAER 4199)** – This case alleged the misstated value of an asset as the result of the issuer’s failure to perform adequate impairment testing.

Earnings Management and EPS Cases

While somewhat less common in recent years when compared to revenue recognition matters, the SEC did bring cases in 2020 as the result of a risk-based initiative⁸ that focused on the manipulation of expense accounts and valuation allowances in order to meet earnings expectations. Like revenue cases, we expect these types of cases will continue to warrant the attention of the SEC enforcement staff. As more fully described in Appendix A, the following cases were brought as result of this initiative:

- **Fulton Financial Corporation (AAER 4174)** – This case alleged misstatement of a valuation allowance related to management’s effort to meet EPS projections.

⁸ See SEC Press Release, *SEC Charges Companies, Former Executives as Part of Risk-Based Initiative*, September 28, 2020, available at <https://www.sec.gov/news/press-release/2020-226>.

- **Interface, Inc.** (AAER 4175) – This case alleged the understatement of expenses to meet EPS estimates.

Internal Controls Cases

The SEC continued to focus on issuers' responsibility to maintain sufficient internal accounting controls, bringing several cases related to both an issuer's ability to prepare financial statements in accordance with GAAP, as well as the other areas covered by Section 13(b)(2)(B) of the Exchange Act. We note the following cases, as more fully described in Appendix A:

- **BorgWarner, Inc.** (AAER 4164) – This case alleged internal control violations that resulted in the misstatement of incurred but not reported liabilities.
- **Aeon Global Health Corporation** (AAER 4171) – This case alleged internal control violations related to recurring material weaknesses in ICFR that resulted in GAAP misstatements.
- **Andeavor LLC** (AAER 4190) – This case alleged a failure to devise and maintain internal controls sufficient to provide reasonable assurance that stock buyback transactions were executed in accordance with management's authorization.

Disclosure Cases

The SEC was active in enforcing issuer disclosure in 2020. There were multiple cases alleging failures to maintain DCP, including matters involving disclosure of non-GAAP financial measures, perquisites, and corporate governance, and material trends and uncertainties. These areas will likely continue to receive scrutiny going forward. Further, while some of these matters involve specific SEC rules, such as rules related to proxy filings, they contain similar or overlapping elements to DCP and ICFR related cases such that they warrant attention. The following cases of note were brought during the year, as further detailed in Appendix A:

- **Valeant** (AAER 4153) – This case alleged disclosure violations related to non-GAAP financial measures and other disclosures regarding the relationship between the company and one of its distributors.
- **Argo International** (AAER 4146) – This case alleged disclosure violations related to executive compensation and benefits.
- **Steven L. Jenkins, CPA** (AAER 4168) – This case alleged disclosure violations related to the personal bankruptcy of an executive in a corporate governance role.
- **Hilton Worldwide** (AAER 4182) – This case alleged disclosure violations related to executive travel-related perquisites and personal benefits paid to management.
- **General Electric Company** (AAER 4194) – This case alleged disclosure violations related to the nature of profit growth and cash collections in one business segment, and worsening trends in another business segment. Notably, GE settled to a penalty of \$200 million in this matter.

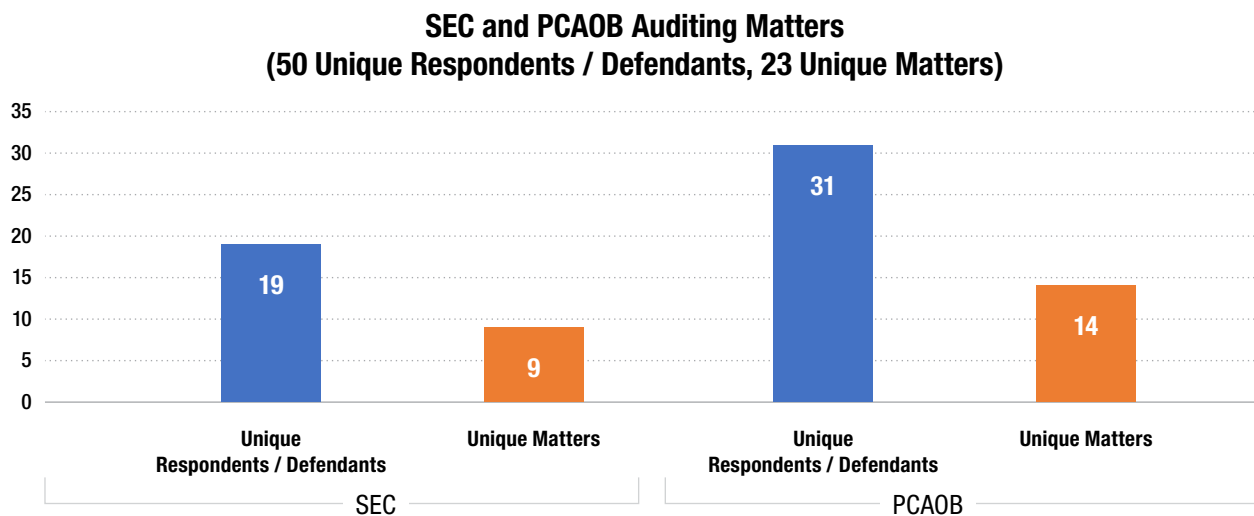
4 PCAOB and SEC Auditing Enforcement Matters - Data and Trends (Calendar Year 2020)

4.1 Introduction

This portion of the study presents and analyzes 2020 data and trends regarding PCAOB and SEC auditing cases as presented in PCAOB Disciplinary Orders (“PCAOB Orders”) and SEC AAERs.

4.2 Enforcement Data and Trends

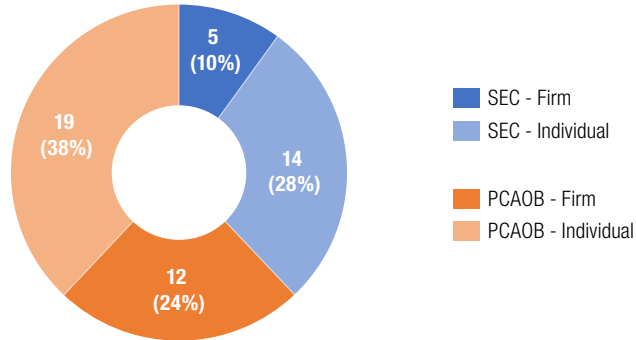
Number of Unique Respondents/Defendants and Unique Matters



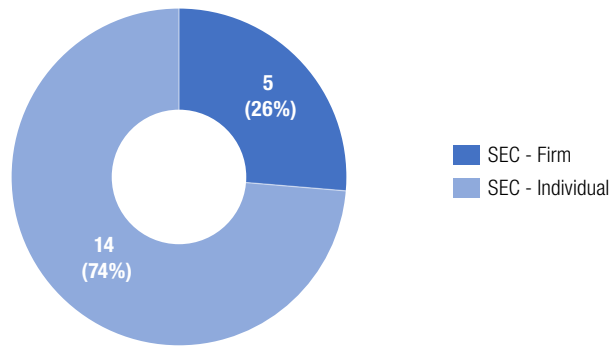
The PCAOB and the SEC enforcement programs related to auditors’ certification of financial statements continued in 2020, with actions filed against 50 unique respondents/defendants in 23 unique matters across both programs. Although the PCAOB brought more cases against auditors compared to the SEC, the distribution of cases reflects the coordination between the two regulators. While these numbers may represent a slight decrease in volume from previous years, we anticipate that the pace of actions against auditors will continue at a steady pace by both regulators. Further, the focus on auditors and gatekeepers by both regulators could increase or decrease depending on the priorities of new SEC leadership and the recently announced intention to name new board members to the PCAOB.

PCAOB and SEC Auditing Matters – Individuals vs. Firms

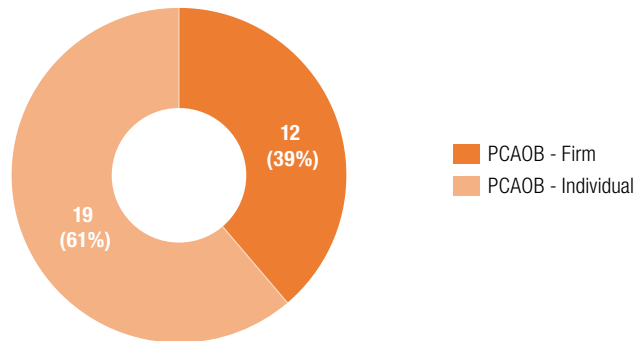
SEC and PCAOB Auditing Matters - Individuals vs. Firms



SEC Auditing Matters - Individuals vs. Firms



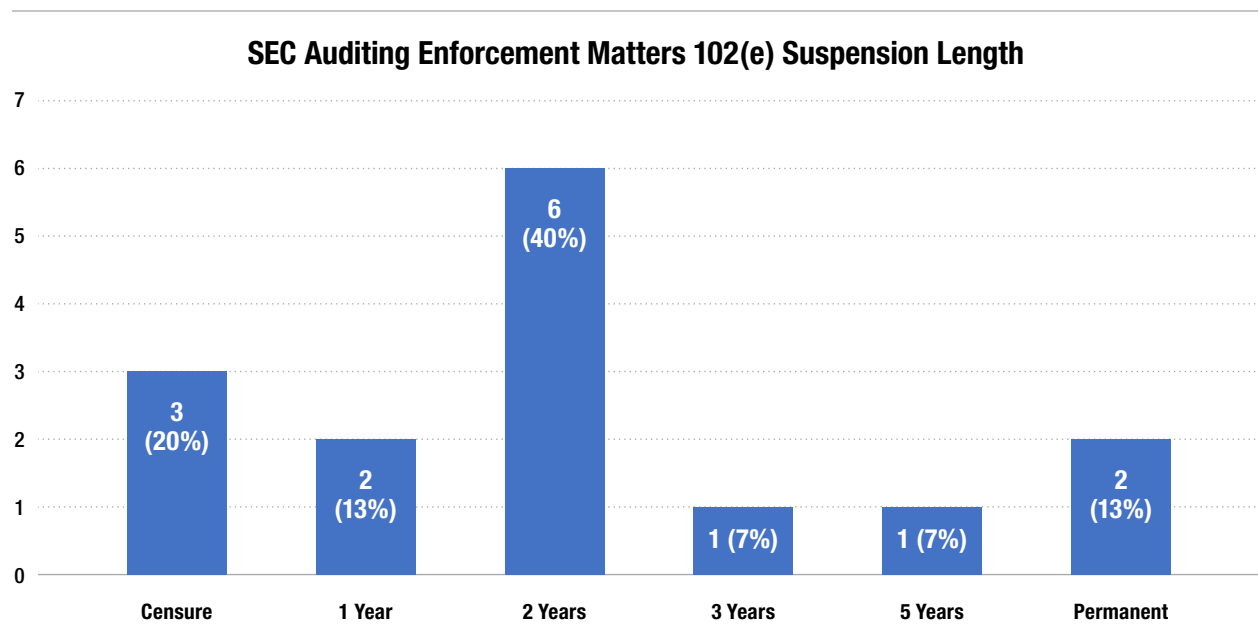
PCAOB Auditing Matters - Individuals vs. Firms



The 2020 data suggests that actions brought by the PCAOB generated more cases against firms relative to individuals (**39%** of PCAOB matters were against firms) when compared to the SEC (**26%** of SEC matters were against firms). While this may reflect a difference in priorities, it may also reflect the types of cases each regulator chooses to pursue.

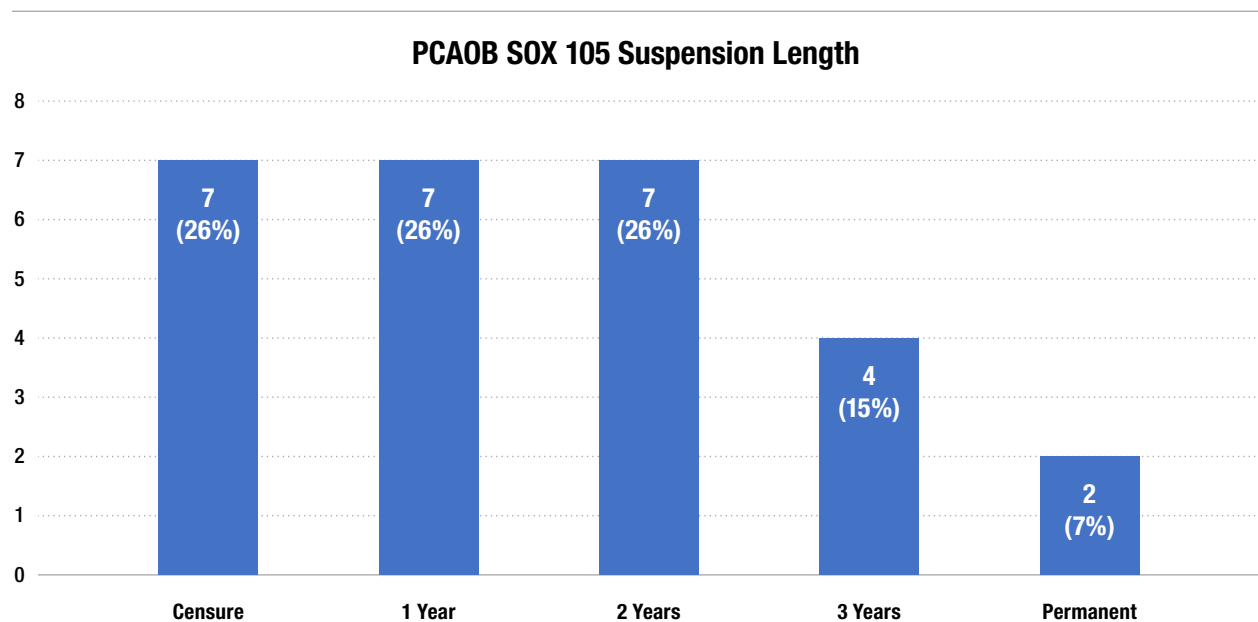
Length of Suspensions Imposed Against Accountants and Auditors

SEC 102(e) Suspension Length



The SEC's most common 102(e) suspension length during calendar year 2020 was two years. There were three censures (i.e., 102(e)'s that do not contain a suspension) during the year, all against firms, and there were two permanent suspensions that were "forthwith" suspensions resulting from criminal convictions.

PCAOB SOX 105 Suspension Length



With respect to PCAOB suspensions pursuant to Section 105 of the Sarbanes Oxley Act, censures, one-year, and two-year suspensions were the most common, followed by three years. There were also two permanent suspensions during the year.

Auditing Cases – PCAOB Professional Standards Alleged Violated

PCAOB Standards Charged (Frequency)	
AS 1015	Due Professional Care in Performance of Work (30)
AS 1105	Audit Evidence (22)
AS 1220	Engagement Quality Review (20)
AS 3101	The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (19)
AS 2110	Identifying and Assessing Risks of Material Misstatement (15)
AS 1215	Audit Documentation (14)
AS 2401	Consideration of Fraud in a Financial Statement Audit (12)
AS 2805	Management Representation (12)
AS 2301	Auditor's Responses to the Risks of Material Misstatement (11)
QC 20	System of Quality Control for a CPA Firm's Accounting and Auditing Practice (10)
AS 2410	Related Parties (9)
AS 2810	Evaluating Audit Results (8)
AS 2310	The Confirmation Process (7)
AS 2510	Auditing Inventories (7)
QC 30	Monitoring a CPA Firm's Accounting and Auditing Practice (7)
AS 1201	Supervision of the Audit Engagement (6)
AS 2101	Audit Planning (6)
AS 2501	Auditing Accounting Estimates (6)
AS 2305	Substantive Analytical Procedures (4)
AS 2905	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report (4)
AS 4105	Reviews of Interim Financial Information (4)
QC 40	The Personnel Management Element of a Firm's System of Quality Control-Competencies Required by a Practitioner-in-Charge of an Attest Engagement (4)
AS 1010	Training and Proficiency of the Independent Auditor (3)
AS 1301	Communications with Audit Committees (3)
AS 2815	The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" (3)
AS 2105	Consideration of Materiality in Planning and Performing an Audit (2)
AS 2201	An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements (2)
AS 2415	Consideration of an Entity's Ability to Continue as a Going Concern (2)
AS 2505	Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments (1)

Calendar year 2020 proved consistent with respect to the types of audit standards violations alleged in PCAOB and SEC auditing matters. Auditors were often charged with violating the general standard that requires due professional care in the performance of work undertaken (AS 1015). The requirement of an auditor to obtain sufficient appropriate audit evidence was also commonly cited (AS 1105). Other commonly alleged auditing standard violations included violations of the performance standards, notably including allegations related to certain risk assessment standards (AS 1201, AS 2301, AS 2101), consideration of fraud (AS 2401), and reliance on management representations (AS 2805). Notably, the PCAOB made common use of citing reporting standards in its enforcement cases, including violations of AS 3101 (related to the Auditor's Report). As discussed above and as further described in the notable cases section in Appendix B, both the PCAOB and SEC focused on audit firms' violations of the quality control requirements as contained in Quality Control Standards QC 20, 30, and 40.

4.3 Notable PCAOB and SEC Auditing Cases

Audit Failures

Both SEC and the PCAOB maintained active programs enforcing professional standards of auditors of issuers during 2020. The following matters are further described in Appendix B:

- **SEC Audit Firm Matter /Individual Auditor Matter (AAER 4116)** – This case alleged violations of the related party transactions standard and the requirements for obtaining an engagement quality review.
- **PCAOB Audit Firm/Individual Auditors Matter (Release No. 105-2020-019)** – This case alleged violations related to failure to understand risks presented by and failure to obtain sufficient appropriate evidence related to unrecorded liabilities.
- **PCAOB Audit Firm Matter/Individual Auditors Matter (Release No. 105-2020-010)** – This case alleged a lack of due care in evaluating significant unusual transactions with a distributor that was also an undisclosed related party.

Firms' System of Quality Controls

Both the SEC and PCAOB have focused on firms' systems of quality control in recent years (through both enforcement programs and the PCAOB's inspection program). As further described in Appendix B, the SEC brought the following matter related to a firm's system of quality control in performing audits for a private fund to comply with the Custody Rule:

- **SEC Audit Firm Matter (AAER 4117)** – This case alleged quality controls violations related to the audit of private funds pursuant to AICPA Standards.

Issues Related to Audits Performed in the People's Republic of China

Regardless of the new administration's stance on policies related to auditing issues in China, it should be expected that both the SEC and the PCAOB will continue to focus on firms' compliance with existing standards both domestically and abroad. The PCAOB brought notable matters related to a firm's failure to meet professional standards in audits that involved operations in China. In addition, the PCAOB brought a series of cases to enforce the reporting requirements of firms in China, noted below and further described in Appendix B:

- **PCAOB Audit Firm Matter** ([Release No. 105-2020-012](#)) – This case alleged an audit firm's failure to perform appropriate procedures regarding significant unusual transactions for an issuer with operations in mainland China.
- **PCAOB Matters** (Release Nos. [105-2020-015](#), [105-2020-16](#), [105-2020-017](#), [105-2020-018](#)) – These cases alleged failures by multiple firms to file reports related to items disclosable to the PCAOB on Form 3, specifically becoming a respondent in disciplinary proceedings and the conclusion of such proceedings.

5 Methodology Overview and Disclaimer

Sources - The primary source material for the data presented in this report is from SEC Accounting and Auditing Enforcement Releases (“AAERs”) and disciplinary Orders issued by the PCAOB (“PCAOB Orders”), sourced from the SEC and PCAOB websites. To the extent that an SEC matter related to financial reporting or auditing was not coded as an AAER by the SEC, for whatever reason, any such matter was not included in this analysis.

Assumptions – Assumptions were made in grouping certain data points for purposes of this analysis, including: (i) combining individual SEC AAERs or PCAOB Orders related to the same matter to determine the number of unique matters during the period; and (ii) selecting a “primary” accounting, disclosure, or auditing issue when multiple issues were alleged in a matter, based on our review of the relevant filings. It should be noted that this classification process did not necessarily consider every charge/violation alleged in the matter, only those required to make the classification noted.

Disclaimer – Commentary included in this analysis is based solely on Credibility’s review of the allegations and facts presented in the publicly-available SEC AAERs and PCAOB Orders and other publicly-available documents. Further, commentary included in this analysis does not represent conclusions or opinions on the veracity of the allegations or the facts described in the filings by any employee of Credibility International LLC.

6 Appendix A: Notable SEC Enforcement Cases – Accounting and Financial Reporting

Revenue Recognition Cases

Super Micro Computer, Inc. (AAER 4161)

In August 2020, the SEC settled a matter that alleged Super Micro Computer, Inc., a global producer of computer servers and equipment, prematurely recognized revenue and understated expenses in its fiscal years 2015, 2016, and 2017 financial statements. The SEC alleged that the company improperly recognized revenue in a manner inconsistent with GAAP and its stated policies in multiple ways, including accelerating sales ahead of specific delivery and approval terms, failing to consider collectability, and not recognizing warranty revenue over a ratable period.

The Order referenced Super Micro’s disclosed ICFR material weaknesses in its fiscal year 2017 Form 10-K. Although the SEC did not elaborate beyond stating that Super Micro “improved its internal controls and reorganized its management team,” the Order noted that the Commission considered the remedial acts taken in accepting Super Micro’s offer to settle to violations of non-scienter fraud, reporting, books and records and internal controls provisions, and to pay a \$17.5 million penalty.

This matter also included settled actions brought against Super Micro’s CEO (AAER 4163) and its CFO (AAER No. 4162). The action against the CEO was limited to reimbursing Super Micro for profits realized from sales of the company’s stock during the relevant time period pursuant to Section 304 of Sarbanes Oxley. The conduct against the issuer was imputed to the CFO, who was charged with violating Section 13(b)(5) of the Exchange Act in addition to causing the violation of the reporting, books and records, and internal accounting controls provisions.

Belden, Inc. (AAER 4196)

In December 2020, the SEC settled a matter alleging that Belden, Inc., a signal transmission company, improperly accelerated revenue, resulting in overstated revenue of \$29 million in the first three quarters of 2017. The Order alleged that Belden improperly recognized revenue on sales that had not been delivered to customers, including sales held at third-party warehouses, sales that did not leave its warehouse, and sales that lacked substance due to a former employee acting as a distributor. After the improper transactions were discovered by the internal audit department in Q4 2017, Belden corrected the errors before issuing its Form 10-K and disclosed a material weakness in its ICFR related to revenue recognition.

The settlement included violations of non-scienter fraud, reporting, books and records and internal accounting controls provisions and a penalty of \$650,000. Belden's Senior Vice President of Finance was also charged and denied the privileged of appearing and practicing before the Commission as an accountant pursuant to Rule 102(e) with the right to apply for reinstatement after three years.

Manitex International, Inc. (AAER 4177)

In September 2020, the SEC settled a matter that alleged Manitex, a crane manufacturer and distributor, materially misstated its financial statements from its fourth quarter 2014 through its second quarter 2017 as a result of two alleged fraudulent schemes. In the first, executives allegedly created fake inventory lists and shipping documents to cover an inventory shortfall of \$1.39 million, resulting in an overstatement of its 2014 operating income by approximately 11%. In the second, Manitex allegedly improperly recognized revenue and misled its auditor on "bill and hold" sales of cranes to a customer by providing the financing of the transactions through an undisclosed subsidiary. As a result, Manitex overstated its 2016 net revenues by over 6.9%.

Manitex was charged with violations of the anti-fraud, reporting, books and records and internal accounting control provisions, and ordered to pay a \$350,000 penalty. Although the Order noted Manitex's remedial efforts and cooperation, the Order contained significant undertakings, including a requirement that Manitex fully remediate deficiencies in its ICFR and to the extent not remediated by December 31, 2021, obtain an independent consultant to review and make recommendations on remediation. Such undertakings related specifically to ICFR are unique. Manitex's most recent Form 10-K contained extensive disclosures about its plan for remediation of its ICFR, and it is notable that Manitex's auditor specifically disclaimed any opinion on management's remediation plan in its opinion on ICFR for the period ended December 31, 2020.

The SEC charged three executives in connection with this matter in separate Orders: the former COO (AAER 4178), a former general manager (AAER 4179), and the former controller and CFO (AAER 4180), who were each ordered to cease and desist from committing violations of the anti-fraud provisions as well as causing Manitex's violations. Each executive was barred from serving as officers and directors. The former COO, formerly a member of the Institute of Chartered Accountants of England and Wales, was suspended from appearance and practice before the Commission as an accountant. The former controller and CFO, a CPA, was suspended with a right to apply for reinstatement after five years.

Revolution Lighting Technologies, Inc. (AAER 4170)

In September 2020, the SEC settled a matter that alleged Revolution Lighting Technologies, Inc. and four of its executives improperly recognized revenue from the fourth quarter of 2014 through the second quarter of 2018. The SEC alleged that counter to GAAP and its stated policy, Revolution's senior management pressured employees to accelerate future anticipated sales as "bill and hold" transactions, often at quarter-end, in order to meet revenue expectations. Certain Revolution executives were alleged to have concealed the nature of the transactions and to have provided false documentation to Revolution's auditor.

This settlement was obtained in Federal District Court. The company and its CFO were enjoined from violating the anti-fraud provisions in addition to reporting, books and records and internal accounting controls related violations. Three additional executives consented to injunctions from negligence-based fraud charges. Each of the defendants paid penalties, with Revolution paying a penalty \$1.25 million.

Follow-on 102(e) suspensions were issued for three of the executives: a Divisional CFO (AAER 4188) was suspended with a right to apply for reinstatement after five years, and Revolution's COO (AAER 4187) and CFO (AAER 4186) were suspended with the right to apply for reinstatement after three years.

HP, Inc. (AAER 4183)

In September 2020, the SEC settled a matter with HP related to its failure to disclose material information regarding its print supplies channel inventory management and sales practices from November 2015 through June 2016. While the SEC did not allege any violation of GAAP revenue recognition rules, this case related to disclosures regarding "pull forward" revenue recognition practices. During the period, HP regional managers were alleged to have used undisclosed sales practices, including a variety of incentives, to accelerate sales that they expected to occur in later quarters. In addition to the "pull forward" practice, management in one region sold printing supplies to distributors known to be in other regions, which cannibalized sales and eroded margins. The Order alleged that HP failed to sufficiently disclose the use of these practices to make its disclosures about its channel inventory not misleading.

In June 2016, HP announced it would change its sales model such that its channel inventory would be reduced. HP concurrently disclosed that it projected such changes would reduce future net revenue by \$450 million in its third and fourth quarters, causing HP's stock price to drop almost 6%.

HP settled to violations of non-scienter fraud and reporting charges, and paid a penalty of \$6 million. The Order included violations of Exchange Act Rule 13a-15 with respect to its requirement to maintain disclosure controls and procedures, citing HP's lack of company-wide controls over the use of discounts by regional management and ability to sufficiently obtain information about sales trends from operational personnel. No individuals were charged in this matter. It is also notable that this case did not allege violations of Item 303 of Regulation S-K regarding disclosure of material trends and uncertainties, which has been alleged in other SEC "pull forward" disclosure cases.

Asset Impairment Matters

Apex Global Brands (AAER 4199)

In December 2020, the SEC settled a matter against Apex Global Brands, Inc. (formerly known as Cherokee, Inc.), related to an alleged material misstatement of its trademarks due to inappropriate impairment testing over multiple periods. The SEC alleged that during the relevant period, although Apex performed impairment testing, the staff assigned had insufficient expertise and the company lacked written policies and procedures. Additionally, Apex ignored numerous indicators that should have triggered an impairment analysis, including the loss of contracts, declining financial performance, and third-party valuations. Apex incorrectly concluded that its trademarks were not impaired, leading to a \$35 million overstatement of assets and net income during the relevant period.

The settlement included findings that Apex violated the non-scienter fraud, reporting, and books and records and internal accounting control provisions of the federal securities laws. Apex did not pay a financial penalty as the order noted the company's current financial condition.

Earnings Management and EPS Cases

Fulton Financial Corporation (AAER 4174)

In September 2020, the SEC settled a matter against Fulton Financial Corporation, a financial holding company, regarding alleged material misrepresentations regarding the valuation allowance for its mortgage servicing rights (“MSR”). The SEC alleged that changing economic circumstances in 2016 supported the reversal of the full MSR valuation allowance. However, Fulton changed the method by which it accounted for the valuation allowance in that period, thus maintaining the allowance, in contravention of the accounting policies disclosed in its public filings. Fulton also requested that the third-party valuation firm hired to evaluate the allowance alter its estimate in support of maintaining the full allowance. In subsequent periods, Fulton reversed the remaining \$1.3 million MSR valuation allowance, without which the SEC alleged Fulton would have missed consensus EPS estimates.

As part of the settlement, Fulton was charged with violations of the reporting, books and records and internal control provisions, and ordered to pay a \$1.5 million penalty. Although it did not provide specifics, the Order noted that Fulton took prompt remedial action.

Interface Inc., (AAER 4175)

In September 2020, the SEC settled matters against Interface, Inc., its former controller, and its CFO. The SEC alleged that these executives collaborated to manipulate management bonus accruals, expenses related to a key independent consultant, and stock-based compensation to increase earnings per share and earnings growth in order to meet EPS estimates over the course of five quarters, directing entries that did not comport with GAAP. Interface’s lack of internal accounting controls, specifically related to its controls over journal entries, was noted in the Order.

Each of the respondents settled to violations (or causing violations) of non-scienter fraud, reporting, and internal accounting controls provisions. In addition, the Order found that the executives willfully violated Rule 13b2-1 for falsifying accounting records. Interface paid a \$5 million penalty, and the former Controller and former CFO paid penalties and were suspended from appearing and practicing before the Commission as accountants, with rights to apply for reinstatement after three and one years, respectively.

The Order did not include undertakings but did describe the remedial measures Interface had taken in light of this matter, specifying that Interface “has taken disciplinary action, enhanced review of the finance area, expanded and enhanced its corporate finance department, and instituted enhanced training, policies, and procedures to prevent and detect the type of misconduct described in the Order.”

Internal Control Related Matters

BorgWarner, Inc. (AAER 4164)

In August 2020, the SEC settled a matter against BorgWarner, Inc., for allegedly misstating its liabilities for asbestos-related claims from 2012 through 2016. BorgWarner’s practice included the accrual of claims when filed, but made no estimate for future claims it disclosed as probable but not reasonably estimable. Such claims, commonly referred to as “incurred but not reported” or “IBNR,” are common accounts at insurance entities and companies with legal claims (e.g. product liability). In this case, the SEC alleged that BorgWarner possessed the necessary historical and quantitative data to form an estimate of IBNR, but instead relied on untested qualitative assumptions not relevant to its IBNR asbestos liability.

The settlement included reporting, books and records and internal accounting control violations, and BorgWarner agreed to pay a \$950,000 penalty. No individuals were charged in this matter. While this case alleged a violation of GAAP, the Order detailed BorgWarner's process for estimating potential claims in the context of the total universe of information available, and described the evolution of BorgWarner's estimation methodology, including its effort to estimate the liability by hiring an outside actuarial firm.

It is also notable that BorgWarner issued a 4.02 8-K in early July 2018 when it announced its intention to restate its financial statements due to its IBNR claims accounting, noting that it had been in discussions with SEC staff since May 2017. The 8-K noted, “[f]ollowing extensive discussions and communications, the [SEC] Staff informed the Company of its belief that the Company did not adequately support its conclusions in 2015 and prior periods that it could not have made a reasonable estimate of IBNR Claims in those periods.” Subsequent filings indicated that the Division of Enforcement notified the company of its investigation weeks later.

Aeon Global Health Corp. (AAER 4171)

In September 2020, the SEC settled a matter against a healthcare services provider, Aeon Global Health Corp., which reported material weaknesses in its ICFR for four consecutive years and during which it restated its financial statements three times. The Order noted that certain reported material weaknesses persisted despite Aeon's other disclosures that it planned to remediate such material weaknesses.

This matter included reporting and books and records and internal accounting controls violations, as well as violations of Rule 13a-15, which requires issuers to “maintain” ICFR. The Order cited the company's financial condition in not imposing a civil penalty, and also included an undertaking for the issuer to obtain an independent consultant to review its ICFR and to adopt the consultant's recommendations. This case could further indicate that the SEC will investigate and take enforcement action against those issuers with longstanding ineffective ICFR.

Andeavor LLC (AAER 4190)

In October 2020, the SEC settled a matter against Andeavor, LLC, an oil refinery operation, related to share buybacks made in advance of its acquisition by Marathon Petroleum Corporation. The SEC alleged that in 2015 and 2016, Andeavor's Board of Directors authorized \$2 billion of share repurchases subject to a prohibition that repurchases could not occur while the company was in possession of material non-public information. Andeavor began negotiating a transaction with Marathon in 2017, and repurchased shares in a range of \$90 - \$103 per share two weeks before it agreed in principle to a deal to be acquired by Marathon at a valuation over \$150 per share. In the settlement, Andeavor agreed to cease and desist from violations of the internal accounting controls provisions of the Exchange Act and paid a penalty of \$20 million.

The Order stated that “Andeavor failed to design and maintain internal accounting controls sufficient to provide reasonable assurance that its 2018 buyback would be executed in accordance with its Board's authorization,” essentially alleging a violation under the “management authorization” prong of Section 13(b)(2)(B). The SEC's alleged internal control violation related to a share buyback program is novel.

Disclosure Related Matters

Disclosure of Non-GAAP Financial Measures

Valeant (AAER 4153)

In July 2020, the SEC settled a matter against Valeant Pharmaceuticals related to its alleged failure to disclose material information that affected both its GAAP financial statements as well as its purported non-GAAP financial measures. The matter alleged material misrepresentations regarding the company's relationship with Philidor, a specialty pharmacy that distributed Valeant branded drugs. According to the Order, neither the financial statements nor the disclosures adequately reflected Valeant's true relationship with Philidor, which included cash advances and other material support to the distributor of its products.

The settlement ordered Valeant to cease and desist from violation of the non-scienter fraud, reporting, and books and records provisions of the federal securities laws, including Rule 100(b) of Regulation G. Valeant also settled to a \$45 million penalty.

The Order described Valeant's internal accounting control failures as contributing to the reporting errors, and described the company's conclusion in its restatement that it failed to maintain effective internal control over financial reporting. The Order also noted Valeant's cooperation that included its replacement of management, review of accounting policies, revision and implementation of new controls, and efforts to train employees. This matter also resulted in separate orders charging the CEO (AAER 4154), CFO (AP No. 3-19901), and corporate controller (AAER 4155) with similar violations.

Perquisites and Corporate Governance

Argo International (AAER 4146)

In June 2020, the SEC settled a matter against Argo International Holdings, Ltd., a specialty insurance and reinsurance provider, and its CEO, (AAER 4195) related to its failure to disclose payments to its CEO of over \$5.3 million in a wide range of perquisites and personal benefits from 2014 through 2018, resulting in violations of the Commission's proxy and reporting rules. The benefits that were alleged to not be disclosed included expenses associated with personal use of corporate aircraft, rent and housing costs, helicopter trips, personal use of corporate automobiles, and tickets to sporting, fashion, and other entertainment events, among others.

Argo settled this matter by agreeing to cease and desist from violations of the Commission's proxy and reporting rules and to pay a penalty of \$900,000. The CEO agreed to cease and desist from causing the proxy and reporting rules and paid a penalty of \$450,000, in addition to the amounts he agreed to reimburse Argo. The Order also noted that this matter arose from a shareholder allegation and resulting proxy contest at the Argo annual shareholder meeting.

With respect to the remedies, the Order discussed Argo's cooperation with the investigation and its effort to remediate the underlying issues in this matter, including engagement of outside counsel and an independent forensic accounting firm to conduct an investigation. It further noted Argo's replacement of its CEO, efforts to obtain repayment, and the change to the composition of its board of directors.

Steven L. Jenkins, CPA (AAER 4168)

In September, the SEC settled a matter against Steven L. Jenkins for his failure to disclose two personal bankruptcy filings to RCI Hospitality Holdings, Inc., for whom Jenkins served as an independent director and on its audit committee. The SEC's allegations included that Jenkins did not disclose the legal proceedings despite specific questions in RCI's annual officer and director certifications ahead of RCI's proxy statement filing. When RCI learned of the bankruptcies it asked Jenkins to step down from its board. Jenkins was charged with willfully violating Section 14(a) and the related rules thereunder. The Order also included payment of a \$30,000 penalty and suspended Jenkins from appearance and practice before the Commission as an accountant with the right to apply for reinstatement after three years.

Hilton Worldwide (AAER 4182)

In September 2020, the SEC settled a matter against Hilton Worldwide Holdings, Inc., related to its alleged failure to disclose \$1.7 million of certain travel-related perquisites and personal benefits paid to or on behalf of its executives and board members from 2015 through 2018. The Order described that Hilton incorrectly viewed benefits to these executives as business expenses, including the use of corporate aircraft, expenses associated with hotel stays, and the payment of taxes related to such items. Hilton revised its reported perquisite disclosures in April 2020 after it internally reviewed its system for tracking and identifying perquisite disclosures.

Hilton agreed to cease and desist from violations of both the proxy disclosure rules and the reporting violations and to pay a \$600,000 penalty. It is notable that the Order quoted extensively from the Commission's 2006 adopting release for Item 402 of Regulations S-K with respect to the distinction between a perquisite or personal benefit and an expense integrally and directly related to an executive's job performance. Because Hilton's proxy statements were incorporated by reference into its annual reports, Hilton was also charged with reporting violations.

Material Known Trends and Uncertainties**General Electric Company (AAER 4194)**

In December 2020, the SEC settled a matter against General Electric for its failure to disclose material known trends and uncertainties related to two key segments of its business from 2015 through 2017. First, the SEC alleged that GE failed to disclose sufficient information about its reported profit growth and cash collections in its power segment, increasing its power segment profit margin by reducing costs and increasing its cash collections using an intercompany factoring arrangement. GE's disclosures in public filings and statements were alleged to not reflect these arrangements and resulted in a misleading view of the business. Second, the SEC alleged that GE failed to disclose worsening trends in its insurance business and the potential for substantial losses. Despite historical experience that its long-term care insurance policies were more expensive than initially expected, GE did not disclose that material insurance losses were reasonably likely in the future.

The Order noted that GE did not design and maintain sufficient internal accounting controls over loss recognition testing in its insurance segment, nor were there sufficient disclosure controls and procedures for communicating known trends and uncertainties to investors. The Order also noted that GE had performed remedial acts to replace insurance and power segment management and added internal accounting controls for insurance loss recognition and disclosure controls related to known trends and uncertainties.

GE settled to violations of non-scienter fraud, reporting, and books and records and internal control provisions. Notably, the settlement included charges of 13a-15 for GE's failure to maintain disclosure controls and procedures. GE was order to pay a civil penalty of \$200,000,000. No individuals were charged in this matter. The Order involved undertakings, including reporting the status of control implementation to the SEC and continued cooperation.

7 Appendix B: PCAOB and SEC Auditing Enforcement Cases

Audit Failure Matters

SEC Matter (Audit Firm and Individual Auditor) ([AAER 4116](#))

In February 2020, the SEC settled a matter that it had previously brought in a litigated action against a firm and engagement partner related to multiple audits of an issuer, Behavioral Recognition Systems, Inc. The Order alleged that the engagement partner failed to perform adequate procedures regarding the identification of related party transactions or design procedures sufficient to evaluate known related party transactions, and alleged that the engagement partner failed to properly assess the risk of the transactions, complete sufficient audit procedures, and relied exclusively on management representations. The Order further alleged that in proceeding audits, the engagement partner inappropriately served as an EQR in violation of AS 7 (now re-organized as AS 1220).

The Order suspended the firm and the engagement partner from appearing and practicing before the SEC with a right to apply for reinstatement after a period of two years. Consistent with past precedent, the reinstatement provision for a firm suspended from appearance and practice required the engagement of an independent consultant to review and identify any criticisms of or potential defects in the firm's quality control system related to supervision of engagement personnel. As this matter did not allege a securities law violation, the settlement did not include a civil penalty.

PCAOB Matter (Audit Firm and Individual Auditors) ([Release No. 105-2020-019](#))

In November 2020, the PCAOB settled an action against an audit firm and two partners serving as the engagement partner and EQR, respectively, of Erickson, Inc., an issuer that provided aviation services prior its bankruptcy in 2017. The nature of the audit deficiencies alleged in the Order related to liabilities for the servicing of leased aircraft. Contemporaneous with its declaration of bankruptcy, Erickson also announced that it had understated such return-to-service liabilities for its leased aircraft such that its previously issued financial statements could no longer be relied upon.

The PCAOB's Order cited the engagement team's failure to understand and adequately address the risks presented from the return-to-service liabilities and that the engagement team did not obtain sufficient appropriate audit evidence that would have identified the unrecorded liabilities. The Order also described the engagement team's failure to appropriately consider Erickson's ability to continue as a going concern, and described failures with respect to supervision by the engagement partner, violations of the Engagement Quality Review standard, and the firm's failures with respect to PCAOB quality control standards.

This Order resulted in the engagement partner being barred from association with a registered public accounting firm with right to petition the Board to re-associate after two years from the date of the Order, and further limited the partner's practice from serving as an engagement partner or EQR for a period of three years from the date of the Order. The EQR partner was not barred from association, but his practice was limited from serving as an engagement partner or EQR for two years from the date of the Order. The firm paid a \$750,000 penalty and the engagement partner paid a \$15,000 penalty.

PCAOB Matter (Audit Firm and Individual Auditors) ([Release No. 105-2020-010](#))

In August 2020, the PCAOB brought settled actions against an audit firm, its engagement partner, and the EQR related to multiple audits of an issuer operating a mobile electronic wallet service based in India. The Order alleged that purported sales to a distributor occurring near the end of the issuer's fiscal year were to an undisclosed related party, and alleged that the engagement team was made aware of the relationship between the issuer and the distributor when the issuer informed the engagement team that it planned to acquire the distributor.

The Order alleged that the engagement partner failed to obtain sufficient appropriate audit evidence related to the valuation or appropriate disclosure given the nature of the relationship between the purported related parties, and failed to exercise due professional care related to the acquisition, including failures to understand the business purpose of the transaction or perform an adequate review of the underlying transaction documents. The Order alleged that the EQR had been made aware of the significant risks associated with the issuer's accounts receivables and failed to respond appropriately or sufficiently document the procedures performed in accordance with AS 1220.

With respect to the firm, the Order alleged that the audit firm failed to have in place adequate policies and procedures to provide reasonable assurance that the work performed by its engagement personnel met the standards described in QC 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

The firm was censured and agreed to pay a penalty of \$20,000. The engagement partner was barred from association with a registered public accounting firm with a right to petition the Board to re-associate after a period of two years and paid a \$20,000 penalty. The settlement also contained a provision that limited the engagement partner's ability to participate in an audit as an engagement partner for audits of issuers or brokers and dealers for an additional year after re-association. The EQR was not suspended from association, but was restricted from participating in any audit as an engagement partner, EQR, or in any other capacity as a partner exercising supervisory authority related to audits of issuers or broker dealers.

Quality Controls

SEC Matter (Audit Firm) (AAER 4117)

In February 2020, the SEC settled a matter against an audit firm related to the sufficiency of its system of quality controls in performing audits of private funds pursuant to AICPA standards. The firm's private fund audit client, SBB Research, LLC, invested in structured notes linked to equity indices that were valued using a proprietary model. In December 2019, the Commission brought an action against SBB in which it alleged those investments did not reflect fair value in accordance with GAAP, i.e., the price a market participant would pay in an orderly transaction between market participants at the measurement date.⁹

The case against the auditor focused on the firm's contemporaneous quality controls, including its risk assessment policies and procedures and its staffing of the engagement, including the use of firm valuation specialists. The Order alleged that although the firm appropriately identified the subject investments as "significant risks" such that they required the use of a valuation specialist, the firm's quality controls were deficient because they did not assess the competence and experience of the assigned valuation specialist, who was unfamiliar with the particular financial instruments. As a result, the Order alleged that the firm failed to obtain an understanding of the inputs, methods, and assumptions underlying SBB's valuation model. In other periods, the Order focused on the valuation specialists' lack of understanding related to certain inputs in SBB's valuation methodology.

No individuals were charged in this matter, and the Order referenced specific remedial measures the firm undertook with respect to its quality controls since the time of the conduct. In light of the enhancements to the firm's quality controls, the remedies in this matter were limited to a censure of the firm and an undertaking to review and validate its policies related to this matter, specifically the assignment, supervision, and integration of valuation specialists with the engagement teams. It is also notable that this case appears to have originated from an examination by the SEC Office of Compliance and Examination (now the SEC Division of Compliance and Examinations) of SBB. The Order noted that the OCIE exam deficiency letter caused SBB and the firm to reevaluate the structured notes and the firm ultimately to recall its audit report and resign from the engagement.

Auditing Issues Related to China

(Release Nos. [105-2020-015](#), [105-2020-16](#), [105-2020-017](#), [105-2020-018](#))

The PCAOB continued its focus on enforcing compliance with its reporting requirements in 2020, taking action against four firms located in the People's Republic of China. This continued a series of cases in 2019 that enforced compliance with PCAOB Rule 2203, which requires registered accounting firms to provide Special Reports to the Board on Form 3. The firms each were alleged to have failed to make at least one report as the result of regulatory action or the filing of civil litigation against the firm.

⁹ The SEC previously sued SBB in district court. Litigation was ongoing as of February 2021. See <https://www.sec.gov/litigation/litreleases/2019/lr24680.htm>

While the Form 3 actions described above have not historically been limited to firms located and with significant operations in China, these enforcement actions are one piece of a broader enforcement program at both the SEC and the PCAOB, which itself is only a portion of the broader policy focus on China that accelerated through the last administration, culminating in the Holding Foreign Companies Accountable and the resulting interim final amendments issued by the Commission in 2021.¹⁰

PCAOB Matter (Audit Firm and Individual Auditors) (Release No. 105-2020-012)

In September 2020, the PCAOB brought settled actions in separate orders against a U.S. audit firm related to violations of its rules and standards during the audits of an issuer owned by a Hong Kong company with operations in mainland China. The PCAOB also separately charged the firm's engagement partner (Release No. 105-2020-13) and EQR (Release No. 105-2020-14). The PCAOB alleged that the firm engagement team failed to perform appropriate procedures regarding significant unusual transactions of the issuer, and noted that multiple fraud risks were associated with the transactions at issue.

In addition to citing the engagement team for its failure to appropriately respond to the fraud risks in understanding the business rationale for the unusual transactions, the Order also described firm failures related to the client acceptance process whereby the firm became aware of serious risks with respect to the engagement when it learned of the predecessor auditor's resignation. The Order also faulted the firm for its assignment of personnel who lacked the competence to adequately supervise the performance of the audit.

The settlement included a censure of the firm, a penalty of \$250,000, a self-directed review of the firm's quality controls related to client acceptance for certain issuers, and a prohibition from issuing audit reports for issuers with substantially all operations in the People's Republic of China for a period of three years from the date of the order.

The engagement partner was censured, barred from association with a registered public accounting firm with a right to petition the Board to re-association after two years, paid a penalty of \$25,000, and required forty hours of continuing professional education. In addition, the engagement partner's settlement included a prohibition against serving as an engagement partner or EQR on any issuer engagements for one year after re-association. The EQR was censured, barred from association with a registered public accounting firm with a right to re-associate after one year, paid a civil monetary penalty of \$15,000, and required to complete twenty hours of continuing professional education.

¹⁰ See Interim Final Rule and Request for Comment, Holding Foreign Companies Accountable Act Disclosure, effective May 5, 2021, available at <https://www.sec.gov/rules/interim/2021/34-91364.pdf>.