The SEC has settled charges against Texas-based oil company Magnum Hunter Resources Corporation (MHR) and several individuals. The list of individuals implicated in this proceeding includes MHR’s Chief Financial Officer, Chief Accounting Officer engagement partner responsible for providing its external auditing services, along with a consultant, whose firm was responsible for assisting MHR with certain accounting and reporting processes. The SEC allegations related to deficient evaluation of MHR’s internal controls over financial reporting as well as failures to maintain internal control over financial reporting between December 31, 2011 and September 30, 2013.¹

This proceeding was brought as a result of the efforts of the SEC Enforcement Division’s Financial Reporting and Audit Group (the FRAud Group).² Most readers will recall that the FRAud Group, officially announced by the SEC in 2013, concentrates on expanding and strengthening the SEC’s efforts to identify securities-law violations relating to the preparation of financial statements, issuer reporting and disclosure, and audit failures. The principal goal of the FRAud Group is fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures. The FRAud Group focuses on identifying and exploring areas susceptible to fraudulent financial reporting, including ongoing review of financial statement restatements and revisions, analysis of performance trends by industry, and use of technology-based tools.

As noted by the Director for the SEC’s Fort Worth regional office, this proceeding “emphasizes that all those involved in ICFR assessments – companies, management, external auditors and consultants – must take their responsibilities seriously and rigorously assess controls, including those over financial reporting.”

MHR is a Delaware corporation headquartered in Irving, Texas that operates as an independent company engaged in the exploration and production of oil and gas in the United States. It grew from $6 million in revenues in 2009 to $23 million in 2010, largely as the result of an $82 million acquisition in February 2010. Between December 2010 and April 2011, MHR acquired another $70 million in oil and gas properties and leasehold mineral interests. MHR also completed two other acquisitions in April and May 2011 for an aggregate purchase price of $565 million. In 2011, MHR booked over $100 million in revenues – largely as a result of these acquisitions. MHR filed a voluntary petition for bankruptcy in December 2015 and, on April 18, 2016, the bankruptcy court entered an order confirming the chapter 11 plan of reorganization, which became effective in May 2016.

What were the SEC’s allegations?

The SEC allegations related to deficient evaluation of MHR’s internal controls over financial reporting, and failures to maintain internal control over financial reporting between Dec. 31, 2011 and September 30, 2013. According to the SEC, MHR’s rapid growth strained its accounting resources. For example, the SEC staff observed that in connection with the issuance of the external auditor’s report on MHR’s 2010 year-end audit results, the engagement partner responsible for providing MHR’s external auditing services, informed the CFO, CAO and MHR’s Audit
Committee that MHR’s accounting department was experiencing “manpower issues” and lacked sufficient personnel to complete all required tasks on a timely basis.

Beginning in November 2011, MHR failed to complete its standard monthly close process and began formally closing its books on a quarterly basis with only sporadic monthly closes in 2012. The SEC noted that MHR’s outside consultant issued a report on MHR’s ICFR which identified problems in MHR’s accounting department and identified “(a) instances in which reconciliations were not prepared, reviewed or approved on a timely basis; (b) failures to document the completion of required monthly management reviews; and (c) significant delays in preparing financial statements and reports due to ‘inadequate and inappropriately aligned staffing.’” In fact, his report noted that “[T]he potential for error in such compressed work environment presents substantial risk.” Despite this recognition, the consultant concluded that MHR’s staffing problems represented only a significant deficiency, rather than a material weakness. MHR’s public accounting firm identified the same ICFR issues as the consultant, but failed to conclude that the deficiencies constituted a material weakness. MHR’s annual report on Form 10-K did not include any “material weaknesses” as part of its ICFR.

MHR amended and restated its second quarter 2012 Form 10-Q to correct numerous items and noted that its management had identified several material weaknesses. In its annual report on Form 10-K for 2012, MHR disclosed that its management had concluded that, as of December 31, 2012, its internal control over financial reporting were not effective due to the several material weaknesses.

Without admitting or denying the allegations made by the SEC, MHR agreed to pay a penalty, MHR’s CFO and consultant agreed to pay monetary penalties, and MHR’s CAO and the engagement partner responsible for providing its external auditing services agreed to be suspended from appearing and practicing before the SEC as an accountant.

Summary: a clear message from the SEC

The message from the SEC staff based on this proceeding and other recent speeches is clear: it is important to evaluate the severity of a control deficiency to determine whether it is a material weakness. As noted by the SEC in its 2007 interpretive guidance, “ICFR cannot provide absolute assurance due to its inherent limitations: it is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. ICFR also can be circumvented by collusion or improper management override.”

Action items

The SEC has indicated that as part of the evaluation of ICFR, management should consider whether each deficiency, individually or in combination, is a material weakness at of the end of the fiscal year and that the evaluation of the severity of a control deficiency should include both quantitative and qualitative factors. Some factors that should be considered include:

- Nature of the financial reporting elements involved (issues like related party transactions or suspense accounts may involve greater risk).
- Susceptibility of a related asset of liability to loss or fraud (greater susceptibility increases risk).
- Interaction of the deficiencies (multiple deficiencies may impact a single financial statement amount or disclosure).

Learn more about this development and its implications for your business by contacting Sanjay Shirodkar, David P. Lewis, Louis Lehot, Sarah E. Ritter, or your regular DLA Piper lawyer.

1 In the Matter of Magnum Hunter Resources Corporation, Release No. 77345, File No. 3-17166 (Mar. 10, 2016).

2 See this page.

AUTHORS

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