

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 10517 / July 10, 2018

SECURITIES EXCHANGE ACT OF 1934
Release No. 83612 / July 10, 2018

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3949 / July 10, 2018

ADMINISTRATIVE PROCEEDING
File No. 3-18582

In the Matter of

**ADVANCED DRAINAGE SYSTEMS,
INC. and MARK B. STURGEON,
CPA,**

Respondents.

**ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS PURSUANT TO
SECTION 8A OF THE SECURITIES ACT
OF 1933, SECTIONS 4C AND 21C OF
THE SECURITIES EXCHANGE ACT OF
1934, AND RULE 102(e) OF THE
COMMISSION'S RULES OF PRACTICE,
MAKING FINDINGS AND IMPOSING
REMEDIAL SANCTIONS AND A CEASE-
AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”) and Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Advanced Drainage Systems, Inc. and Mark B. Sturgeon (collectively, “Respondents”); and that public administrative proceedings be, and hereby are, instituted against Sturgeon pursuant to Exchange Act Section 4C¹ and Rule 102(e)(1)(iii)² of the

¹ Section 4C provides, in relevant part, that:

The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

² Rule 102(e)(1)(iii) provides, in pertinent part, that:

II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers"), which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondents consent to the entry of this Order, as set forth below.

III.

On the basis of this Order and Respondents' Offers, the Commission finds³ that:

SUMMARY

1. Advanced Drainage Systems, Inc. ("ADS" or the "Company") is an Ohio-based manufacturer of corrugated plastic pipe and drainage systems. In July 2014, following an initial public offering ("IPO") of its shares pursuant to a registration statement filed with the Commission, ADS became a public reporting company. In its registration statement and in quarterly and other reports filed with the Commission, ADS materially misstated its financial results for fiscal years 2013, 2014, and 2015, and its quarterly financial results for fiscal years 2014 and 2015. For example, ADS overstated its income before taxes in fiscal years 2013, 2014, and 2015 by \$7.8 million (20%), \$1.8 million (5%), and \$22 million (90%), respectively.

2. As described below, these misstatements resulted from improper accounting, including unsupported journal entries directed or approved by the Company's Chief Financial Officer ("CFO"), Mark Sturgeon, and insufficient internal accounting controls. The CFO directed or approved unsupported journal entries to inventory, cost of goods sold, and other accounts that resulted in overstated Company earnings. ADS did not have sufficient internal accounting controls in place to provide reasonable assurance that, among other things, transactions were recorded as necessary to permit preparation of financial statements in conformity with generally accepting accounting principles ("GAAP").

3. On March 29, 2016, ADS restated and revised its financial results for fiscal years 2013, 2014 and 2015, and its quarterly financial results for fiscal years 2014 and 2015, in a series

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³ The findings herein are made pursuant to Respondents' Offers of Settlement and are not binding on any other person or entity in this or any other proceeding.

of filings that included its first annual report on Form 10-K (the “Restatement”).⁴

4. As a result of the conduct described herein, ADS violated the antifraud provisions of Securities Act Sections 17(a)(2) and 17(a)(3), the reporting provisions of Exchange Act Section 13(a) and Rules 12b-20, 13a-11, and 13a-13 thereunder, the books and records provisions of Exchange Act Section 13(b)(2)(A), and the internal accounting control provisions of Exchange Act Section 13(b)(2)(B); and Sturgeon violated Securities Act Sections 17(a)(2) and 17(a)(3), Exchange Act Section 13(b)(5) and Rule 13b2-1, and caused ADS to violate Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and Rules 12b-20, 13a-11 and 13a-13 thereunder. Sturgeon also violated Section 304(a) of the Sarbanes-Oxley Act of 2002 by failing to reimburse the Company for \$173,970 in profits realized from his sale of ADS securities following the Company’s filing of its 2015 quarterly reports on Form 10-Q, which required restatement.

RESPONDENTS

5. Advanced Drainage Systems, Inc. is a Delaware corporation with its principal place of business in Hilliard, Ohio. ADS is a manufacturer of corrugated plastic pipe and drainage systems. ADS’s common stock is registered with the Commission under Section 12(b) of the Exchange Act and trades on the New York Stock Exchange under the ticker symbol “WMS.”

6. Mark B. Sturgeon, 63, is a resident of Columbus, Ohio. Sturgeon worked at ADS from 1981 until 2016 and was the Chief Financial Officer and Executive Vice President of ADS from 1994 until November 9, 2015. Sturgeon retired from ADS in March 2016. Sturgeon is a Certified Public Accountant and maintained an active license in Ohio from 1980 to 2011.

FACTS

7. ADS is an Ohio-based manufacturer of corrugated plastic pipe and drainage systems that operates primarily in North and South America and Europe. In July 2014, the Company had an IPO of its shares pursuant to a registration statement on Form S-1 filed on April 2, 2014, and subsequently amended, which became effective on July 24, 2014. ADS’s final registration statement included audited financial statements for fiscal years 2013 and 2014 that were materially misstated.

8. Following the IPO, ADS became a public reporting company. ADS filed with the Commission quarterly reports on Form 10-Q for the first, second, and third fiscal quarters of 2015 on September 5, 2014, November 10, 2014 and February 9, 2015, respectively.⁵ ADS announced year-end and fourth quarter fiscal year 2015 financial results in an earnings release the Company filed on Form 8-K on May 12, 2015. The Company’s quarterly financial

⁴ In addition to the annual report, that same day ADS filed amended quarterly reports for the first three quarters of fiscal year 2015. The next day, March 30, 2016, ADS filed a Form 8-K that contained additional information about the Restatement.

⁵ ADS’s fiscal year-end is March 31.

statements, and its announced year-end and fourth quarter financial results for fiscal year 2015, were materially misstated.

9. ADS was required to file its first annual report on Form 10-K in June 2015. In early June, three ADS finance employees reported to the Company's auditor that during fiscal year 2015 they had been asked by their superiors to make improper journal entries. These entries had the effect of capitalizing certain costs into inventory, thereby reducing current period expenses. On June 30, 2015, the Company filed a Form 12b-25 seeking a 15-day extension to file its annual report. The Company attributed the delay to "(i) the finalization of the inventory costing analysis and, (ii) the review of journal entry control processes." On July 15, 2015, the Company issued a Form 8-K announcing an additional delay, and that it was now evaluating its accounting treatment of transportation and equipment leases. On August 17, 2015, the Company issued a Form 8-K announcing that its previously issued financial statements and financial data, including its May 12, 2015 earnings release, should not be relied upon. The Company announced additional delays in filing its annual report on December 11, 2015, February 2, 2016, and February 23, 2016.

10. On March 29, 2016, ADS filed its annual report on Form 10-K for fiscal year 2015, and amended quarterly reports on Form 10-Q for the first, second, and third fiscal quarters of 2015. These filings restated the Company's previously reported or announced financial results for fiscal years 2013, 2014 and 2015, and previously reported or announced quarterly financial results for fiscal years 2014 and 2015.

11. The material misstatement of ADS's financial results for fiscal years 2013, 2014 and 2015 resulted from improper accounting for leases, inventory, and other costs, including unsupported journal entries directed or approved by the CFO, and insufficient internal accounting controls. ADS, and Sturgeon as CFO, failed to devise and maintain a sufficient system of internal accounting controls at the Company, including controls related to journal entries and lease accounting. Sturgeon also circumvented existing internal accounting controls by directing or approving unsupported accounting entries.

Improper Accounting for Inventory and Related Costs

12. In aggregate, ADS's improper accounting for inventory and related cost accounts overstated the Company's income before taxes in 2013, 2014 and 2015 by \$3.1 million, \$1.5 million and \$16.8 million, respectively. Some of these errors resulted from entries directed or approved by CFO Sturgeon without proper support. In general, these improper accounting entries had the effect of overstating earnings by improperly capitalizing costs in inventory and decreasing cost of goods sold ("COGS") or other expenses. ADS failed to follow the Company's accounting policies and properly support accounting adjustments, which did not comply with GAAP. [ASC Topic 330]. The following are examples of the improper accounting entries to inventory and related cost accounts:

Pension Costs

13. ADS accrued monthly for estimated non-cash pension costs associated with the annual allocation of Company shares to participants in ADS's employee stock ownership plan.

The Company's accounting policy was to capitalize in inventory pension costs associated with manufacturing, which became part of COGS, and to expense as part of selling, general and administrative ("SG&A") pension costs associated with non-manufacturing operations.

14. In around February 2015, Sturgeon received information that the pension cost accrual should be increased by approximately \$2.9 million. Pursuant to the Company's accounting policy, the \$2.9 million adjustment should have been apportioned between manufacturing and non-manufacturing operations – with a portion capitalized into inventory costs and a portion immediately expensed as SG&A. Sturgeon, however, improperly directed that the entire \$2.9 million adjustment be capitalized into inventory. This improper accounting overstated the Company's fiscal fourth quarter 2015 income before taxes by approximately \$1.1 million.

Medical Costs

15. ADS also accrued monthly for estimated medical costs for its employees, and made adjustments to the accrual throughout the year as actual cost information became available. As with pension costs, the Company's accounting policy was to capitalize in inventory medical costs associated with manufacturing, which became part of COGS, and to expense as part of SG&A medical costs associated with non-manufacturing operations.

16. In March 2015, ADS personnel determined that actual medical costs for February exceeded the Company's accrual by \$552,000. Pursuant to the Company's accounting policy, this \$552,000 variance should have been apportioned between manufacturing and non-manufacturing. Sturgeon, however, improperly directed that the entire amount be allocated to manufacturing costs, which were capitalized into inventory. This improper accounting overstated the Company's earnings by failing to account for a portion of the adjustment as an SG&A expense.

17. The following month, ADS personnel determined that actual medical costs for March were approximately \$592,000 less than the Company's accrual. With this variance, Sturgeon improperly directed that the entire amount be *credited* to SG&A accounts. This improper accounting also overstated the Company's earnings by understating SG&A expenses. Together, these two improper accounting entries overstated the Company's fiscal fourth quarter 2015 income before taxes by approximately \$401,000.

Capitalized Freight Costs

18. ADS ships inventory between plants as part of managing inventory levels. ADS's policy was to capitalize in inventory freight costs associated with intra-company transfers of inventory. In fiscal year 2015, ADS booked two unsupported adjustments to capitalized freight that resulted in overstating the Company's earnings. In September 2014, Sturgeon directed a journal entry that increased the capitalized freight account, and correspondingly decreased COGS, by \$500,000. This accounting entry lacked adequate support. In addition, at year-end, accounting personnel booked a journal entry that increased the capital freight account, and correspondingly decreased COGS, by approximately \$296,000. This adjustment also lacked

adequate support. These two accounting adjustments overstated the Company's 2015 income before taxes by approximately \$796,000.

Inventory Cost Standards

19. ADS used estimated standard costs to account for raw materials and production costs in inventory and COGS. At year end, ADS updated its standard costs based on updated raw material and production costs. ADS's accounting practice was to make an accounting adjustment to inventory, and corresponding adjustment to COGS, to reflect any changes to the inventory balance resulting from the updated standard costs. ADS also maintained an inventory reserve account to reflect changes between standard and actual costs. From at least 2013, Sturgeon directed or approved frequent adjustments to the reserve account without adequate corroboration or documentation, which resulted in inaccuracies in certain financial statements.

20. At the end of fiscal year 2015, as part of the Company's annual update of standard costs, Sturgeon updated many of the Company's standard costs, resulting in a material increase in inventory and corresponding reduction in COGS. Many of Sturgeon's cost adjustments lacked support and in some instances were inconsistent with available cost information. In aggregate, these improper cost adjustments, and other deficiencies in the Company's raw material costing methodology, overstated the Company's fiscal year 2015 income before taxes by \$5.9 million.

Other Improper Accounting

Lease Accounting

21. As part of its operations, ADS leases significant amounts of equipment. Since at least 2010, the Company had improperly accounted for many of its equipment leases as operating leases, and not capital leases, based largely on the minimum payment terms for the initial twelve-month non-cancellable period of the leases. However, ADS did not consider other relevant lease terms and conditions in its operating or capital classification determination. ADS subsequently determined that the Company's lease accounting did not comply with GAAP [ASC 840]. Under GAAP, most of the Company's equipment leases should have been accounted for as capital leases. This accounting error had the effect of understating the Company's net property, plant and equipment in 2013, 2014, and 2015 by \$58 million, \$64 million, and \$73 million, respectively, understating its financing obligations by \$38 million, \$46 million, and \$61 million, respectively, and overstating its income before taxes by \$3.1 million, \$2.4 million, and \$5.1 million, respectively.

Volume Rebate Liability

22. ADS offered rebates to many of its high-volume customers. The Company accrued monthly for its estimated rebate liabilities. Following the end of fiscal year 2015, a member of the ADS accounting group, using a newly developed methodology, estimated that ADS's rebate liability was under accrued by approximately \$1.4 million. A subsequently prepared reconciliation schedule indicated it should be adjusted upwards by approximately \$845,000. The Company did not use either of these calculations to adjust the rebate liability account at year-end, and instead, without support, recorded only a partial adjustment of

\$400,000. The Company later determined, in connection with the Restatement, that the volume rebate account was under accrued by \$3.5 million at the end of fiscal year 2015.

Tone at the Top and Other Accounting Control Deficiencies

23. The material misstatements and improper accounting described above were due in part to insufficient internal accounting controls. As ADS acknowledged in its Restatement, the poor “tone at the top” set by senior management contributed to the Company’s ineffective internal accounting controls. Senior management also created a high pressure environment for accounting personnel, and there was an inappropriate emphasis on aggressive and arbitrary timelines. Sturgeon and others in the finance department managed ADS’s accounting in a top-down manner, overriding accounting policies and calculations by accounting personnel and directing or approving entries without adequate documentation. All of these factors led to an environment where many employees felt there was no meaningful way to challenge accounting instructions and entries with which they disagreed.

24. ADS also lacked accounting personnel with appropriate experience and training. The Company also had insufficient internal accounting controls over: inventory and lease accounting; segregation of accounting entry and approval duties; and documentation requirements for journal entries. These deficiencies, and others, contributed to the improper accounting and material misstatements of the Company’s financial results described above.

The Offer and Sale of Securities

25. ADS offered and sold securities pursuant to an Amended Form S-1 the Company filed on July 14, 2014, that went effective on July 24, 2014. This registration statement contained inaccurate financial statements for fiscal years 2013 and 2014, which the Company later corrected. ADS also offered and sold securities pursuant to a Form S-8 the Company filed on July 30, 2014, as a result of employee exercises of stock options during fiscal year 2015. The Form S-8 incorporated by reference ADS’s subsequent periodic filings under the Exchange Act, including the quarterly filings during fiscal year 2015, which the Company later restated. In May 2015, Sturgeon sold a total of 50,000 shares of ADS common stock on the open market.

ADS’S REMEDIAL EFFORTS

26. In determining to accept ADS’s offer, the Commission considered remedial acts promptly undertaken by ADS and cooperation afforded the Commission staff.

VIOLATIONS

27. Securities Act Section 17(a)(2) prohibits any person from obtaining money or property in the offer or sale of securities by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

28. Securities Act Section 17(a)(3) prohibits any person from engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities.

29. Exchange Act Section 13(a) and Rules 13a-11, and 13a-13 thereunder require that every issuer of a security registered pursuant to Exchange Act Section 12 file with the Commission, among other things, quarterly, and current reports as the Commission may require.

30. Rule 12b-20 under the Exchange Act requires that, in addition to the information expressly required to be included in a statement or report filed with the Commission, there shall be added such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading.

31. Exchange Act Section 13(b)(2)(A) requires issuers with a security registered pursuant to Section 12 to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect transactions and dispositions of their assets.

32. Exchange Act Section 13(b)(2)(B) requires issuers with a security registered pursuant to Section 12 to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to, among other things, permit preparation of financial statements in accordance with GAAP.

33. Exchange Act Section 13(b)(5) prohibits any person from knowingly circumventing or knowingly failing to implement a system of internal accounting controls or knowingly falsifying any book, record, or account described in Section 13(b)(2).

34. Rule 13b2-1 under the Exchange Act prohibits any person from, directly or indirectly, falsifying or causing to be falsified, any book, record, or account subject to Exchange Act Section 13(b)(2)(A).

35. Section 304 of the Sarbanes-Oxley Act of 2002 requires the chief executive officer or chief financial officer of any issuer required to prepare an accounting restatement due to material noncompliance with the securities laws as a result of misconduct to reimburse the issuer for: (i) any bonus or incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the false filings; and (ii) any profits realized from the sale of securities of the issuer during that 12-month period.

36. Based on the foregoing, the Commission finds that ADS violated Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) and Rules 12b-20, 13a-11 and 13a-13 thereunder.

37. Based on the foregoing, the Commission finds that Sturgeon (a) willfully⁶ violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, Section 13(b)(5) of the Exchange Act and Rule 13b2-1, and Section 304(a) of the Sarbanes-Oxley Act; and (b) caused ADS's violations of Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B) and Rules 12b-20, 13a-11 and 13a-13 thereunder.

⁶ A willful violation of the securities laws means merely “that the person charged with the duty knows what he is doing.” *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor “also be aware that he is violating one of the Rules or Acts.” *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED, effective immediately, that:

- A. Respondent ADS cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act, and Rules 12b-20, 13a-11, and 13a-13 thereunder.
- B. Respondent Sturgeon cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, Sections 13(a), 13(b)(2)(A), 13(b)(2)(B) and 13(b)(5) of the Exchange Act, and Rules 12b-20, 13a-11, 13a-13, and 13b2-1 thereunder; and
- C. Sturgeon is denied the privilege of appearing or practicing before the Commission as an accountant.
- D. Sturgeon shall, within 14 days of the entry of this Order, reimburse ADS for a total of \$173,970, representing profits from the sale of ADS stock pursuant to Section 304(a) of the Sarbanes-Oxley Act. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717.
- E. Within 14 days of the entry of this Order, ADS shall pay a civil money penalty of \$1,000,000 and Sturgeon shall pay a civil money penalty of \$100,000, to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717.
- F. Penalty payments must be made in one of the following ways:
 - (1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
 - (2) Respondents may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
 - (3) Respondents may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341

6500 South MacArthur Boulevard
Oklahoma City, OK 73169

- G. Payments by check or money order must be accompanied by a cover letter identifying the Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Brian O. Quinn, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.
- H. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against either of both Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent Sturgeon, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by these Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by these Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary