

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934

Release No. 73751 / December 5, 2014

ACCOUNTING AND AUDITING ENFORCEMENT

Release No. 3601 / December 5, 2014

ADMINISTRATIVE PROCEEDING

File No. 3-16297

In the Matter of

NEAL A. PETROVICH, CPA,

Respondent.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS
PURSUANT TO SECTION 21C OF THE
SECURITIES EXCHANGE ACT OF 1934,
MAKING FINDINGS, AND IMPOSING A
CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”) against Neal A. Petrovich, CPA (“Petrovich” or “Respondent”).

II.

In anticipation of the institution of these proceedings, Petrovich has submitted an Offer of Settlement (the “Offer”) 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 Petrovich and the subject matter of these proceedings, which are admitted, Petrovich consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Petrovich's Offer, the Commission finds¹ that:

Summary

This matter involves the accounting treatment by Hampton Roads Bankshares, Inc. ("HRBS" or the "Company") in connection with the recording of its deferred tax asset ("DTA") in 2009 and 2010. Petrovich was the Chief Financial Officer of HRBS from February 2009 through May 2010. During 2009 and the first quarter of 2010, HRBS recorded a large DTA without taking a significant valuation allowance against it.² HRBS, relying on an analysis performed under Petrovich's direction, concluded that based on anticipated future earnings, the Company was "more likely than not" to realize its DTA within the applicable carry-forward period. This conclusion was unreasonable because the financial projections underlying HRBS's projections of future earnings were not supportable based on the Company's financial condition, including in particular the ongoing deterioration of its loan portfolio.

HRBS's financial condition was deteriorating by early 2010, and the Company was discussing remedial measures to address its problems. HRBS was facing possible adverse regulatory consequences. In August 2010, HRBS amended its 2009 Form 10-K and first quarter 2010 Form 10-Q to include restated financial statements, reflecting a valuation allowance against the DTA, reducing the reported DTA for 2009 from over \$56 million to less than \$400,000, and to \$0 thereafter. In its restated Form 10-K for 2009, HRBS reported that it was "undercapitalized" as of December 31, 2009, as opposed to "adequately capitalized," as originally reported. Similarly, in its restated Form 10-Q for the first quarter of 2010, HRBS reported that it was "significantly undercapitalized," rather than "undercapitalized" as originally reported.

Accordingly, Petrovich was a cause of HRBS's violations of the reporting, books and records and internal controls provisions of the Exchange Act.

Respondent

1. Neal Petrovich, 52, is a resident of Chesapeake, Virginia, and was HRBS's Executive Vice President and CFO from February 2009 through May 2010. On May 13, 2010, Petrovich informed HRBS of his intention to end his employment with HRBS effective June 4, 2010, and he left the company on that date. Petrovich is currently employed as Senior Vice President – Finance with a publicly traded financial services company in the area. He is a licensed CPA in Virginia.

¹ The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

² HRBS did establish a \$1 million valuation allowance in 2009 related to capital losses realized, against the \$2.8 million in capital loss carryforwards. However, HRBS recorded a net DTA of \$56.38 million in its 2009 Form 10-K, the vast majority of which related to its loan losses.

Other Relevant Entity

2. Hampton Roads Bankshares, Inc., a Virginia corporation with its principal place of business in Virginia Beach, Virginia, is a bank holding company for Bank of Hampton Roads (“BOHR”) and Shore Bank (“Shore”), its primary subsidiaries. At all relevant times, HRBS’s common stock was registered with the Commission under Section 12(b) of the Securities Exchange Act of 1934 (the “Exchange Act”) and was listed on the NASDAQ Global Select Market (“NASDAQ”). HRBS was subject to periodic examinations by the Virginia State Corporation Commission’s Bureau of Financial Institutions (the “SCC”) and the Federal Reserve Bank of Richmond (the “FRB”) in 2009 and 2010.

Facts

HRBS History: 2008-09 Mergers and Subsequent Loan Losses

3. HRBS’s two primary subsidiaries, BOHR and Shore, provide community and commercial banking services to individuals and small-to-medium-sized businesses in the Hampton Roads region of southeastern Virginia; Richmond, Virginia; the Northeastern and Research Triangle regions of North Carolina; and the Eastern Shore of Virginia and Maryland. HRBS acquired Shore on June 1, 2008. On December 31, 2008, HRBS acquired all outstanding shares of Gateway Financial Holdings, Inc. (“Gateway”). At the time of the acquisition, Gateway’s subsidiaries, including Gateway Bank & Trust Co. (“Gateway Bank”), became wholly owned subsidiaries of HRBS. On May 8, 2009, Gateway Bank merged into BOHR, with BOHR being the surviving entity. The acquisition of Gateway increased HRBS’s assets from slightly under \$1 billion to approximately \$3.1 billion.

4. The performance of HRBS’s loan portfolio deteriorated during 2009, leading to losses. The Company disclosed in its 2009 Form 10-K that “our problem loans increased significantly in 2009; loans acquired from [Gateway] have been the primary source of that increase. Deteriorating economic conditions, difficulties in loan administration, and insufficient loan collection resources contributed to the credit quality problems.” Prior to restating its financials in August 2010, HRBS reported a net loss of \$60.7 million for fiscal year 2009, excluding the write down of goodwill of \$84.8 million. The company’s restated financials reflected a net loss of \$116.65 million, excluding the goodwill write-downs.

5. On August 10, 2010, HRBS announced that its financial statements for fiscal year ended December 31, 2009, as included in its 2009 Form 10-K, and the financial statements for the fiscal quarter ended March 31, 2010, as included in its first quarter 2010 Form 10-Q, should no longer be relied upon because HRBS had determined that restatements were necessary to provide for an increase in the valuation allowance against the Company’s deferred tax asset. On August 13, 2010, HRBS filed restated annual financial statements for 2009 in an amended Form 10-K for 2009, and restated quarterly financial statements for the quarter ended March 31, 2010, in an amended Form 10-Q. The restated financial statements included a valuation allowance of approximately \$56 million for the year ended December 31, 2009, and of an additional \$14.3 million for the first quarter of 2010. These valuation allowances reduced HRBS’s reported DTA as of year-end 2009 from \$56.4 million to \$397,000, and as of March 31, 2010 from \$70.3 million to \$0.

Deferred Tax Assets: Description and Accounting Guidance

6. Accounting Standard Codification (ASC) 740 (formerly FASB statement 109) establishes standards for companies to account for and report the effects of income taxes. A deferred tax asset is an asset on a company's balance sheet that represents the right to offset a future tax expense or obligation with a future tax benefit or refund. These assets arise as a result of timing differences that occur between reporting the effect of taxes accounted for under U.S. GAAP and calculating tax benefits and liabilities under the enacted tax law. For example, due to differences between tax laws and accounting standards for financial statement purposes, some events are recognized for financial reporting purposes and for tax purposes in different years. This can give rise to differences between the tax bases of assets or liabilities and their reported amounts in financial statements. These differences are temporary because the event will become taxable or deductible in the future. A deferred tax asset, or DTA, exists when temporary timing differences are more likely than not to result in deductible amounts in future years. Deferred tax assets can arise in connection with a company's allowance for loan and lease losses (ALLL), which was the case for the vast majority of HRBS's DTA.

7. A DTA is recorded on the balance sheet when it is more likely than not that the DTA will be realized in a future period. However, ASC 740-10-30 requires a company to "[r]educe deferred tax assets by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized. The valuation allowance shall be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized." The company must weigh all positive and negative evidence in determining whether a valuation allowance is necessary.

8. When considering the weighing of positive and negative evidence, the accounting guidance under ASC 740-10-30-21 and -23 states: "[f]orming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years," and "[a] cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome." ASC 740-10-30-21 provides other examples of negative evidence, including "losses expected in early future years (by a presently profitable entity)" and "unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years." The realizability of DTAs must be evaluated in each reporting period.

HRBS's Loan Losses and Increasing DTA

9. Prior to 2008, HRBS did not record a significant DTA. As of the end of 2007, the Company recorded a net DTA of \$2.66 million, and that number decreased through the first three quarters of 2008. Gateway, however, had seen an increase in its DTA during 2008 due to a deteriorating loan portfolio and a corresponding increase in loan losses. As of the end of 2008 – following the merger with Gateway – HRBS recorded a DTA of \$32.6 million.

10. As HRBS disclosed in its Form 10-K for 2009, "our problem loans increased significantly in 2009; loans acquired from [Gateway] have been the primary source of that

increase. Deteriorating economic conditions, difficulties in loan administration, and insufficient loan collection resources contributed to the credit quality problems.” Prior to its restatement, HRBS reported \$60.7 million in losses for 2009 (exclusive of its goodwill write-downs), and recorded provisions for loan losses of \$33.71 million, \$33.66 million, \$65.67 million, and \$45.61 million for the second, third and fourth quarters of 2009 and the first quarter of 2010, respectively.

11. Consequently, after a slight dip in the first quarter of 2009 from \$32.62 million to \$31.28 million, HRBS’S DTA increased through the end of the first quarter of 2010 along with the company’s loan losses. HRBS recorded a DTA of \$44.22 million for the second quarter of 2009, \$37.00 million for the third quarter of 2009, \$56.38 million for the fourth quarter and year-end of 2009, and \$70.32 million in the first quarter of 2010.

12. The vast majority of the DTA recorded by HRBS for 2009 and the first quarter of 2010 related to the Company’s loan losses. Prior to its restatement in August 2010, HRBS did not establish a valuation against its DTA relating to its loan losses. The only valuation allowance HRBS established against its DTA in this period was a \$1 million allowance relating to capital losses realized, against the Company’s \$2.8 million in capital loss carryforwards.

HRBS’s DTA Analysis

13. In November 2009, HRBS, under Petrovich’s direction, conducted an analysis of “whether [HRBS] can continue to justify carrying [the deferred tax assets] at the amount they are recorded in the general ledger.” The resulting memorandum concluded no valuation allowance was required. The memorandum was based in part on capital projections forecasting loan performance through the end of 2010, prepared by Petrovich and others under his direction, which assumed the Company would work through existing non-performing loans (“NPLs”) in 24-36 months and would earn a consistent \$8.4 million in quarterly pre-tax, pre-provision income (\$33.6 million annually). Petrovich knew or should have known that these conclusions were not reasonable. The projections underlying the analysis assumed that the provision for loan losses would drop from over \$33 million in third quarter 2009 to \$2.35 million by the end of 2010. However, at the same time, internal company reports that were circulated to Petrovich reflected that as of November 2009, the company’s total delinquent and non-accruing loans had reached nearly \$350 million, or 13.4% of total loans, an increase over the quarter-end totals for each of the first through third quarters of 2009. Likewise, non-performing assets had increased 11% from September to October 2009, continuing a trend of increases in problem loans since late 2008. HRBS reported a provision for loan losses for the third quarter of 2009 of \$33.7 million, and for fourth quarter 2009 of \$65.7 million. Further, HRBS’s DTA analysis relied on “pre-tax, pre-provision” income, and did not address the fact that the existing loan loss provisions were the single greatest driver of the Company’s losses at the time, and that loan losses would be based on the trends noted above indicating that these losses would likely continue.

14. From December 2009 through July 2010, HRBS provided materials to the SEC’s Division of Corporation Finance (“Corp Fin”) and Office of the Chief Accountant (“OCA”) concerning its conclusions that a valuation allowance was not required on its DTA, and that the financial projections supporting its analysis were supportable, notwithstanding the fact that the

Company's loan losses in 2009 had exceeded the aggregate taxable income for the prior three years, and were continuing.

15. In March of 2010, Petrovich and others under his direction prepared an internal memorandum setting forth an analysis of the necessity of a valuation allowance against the DTA as of year-end 2009. HRBS retained an outside accounting consultant to provide limited assistance in directing the Company to the appropriate accounting guidance and memorializing the Company's conclusions.³ The March 2010 memorandum concluded that HRBS would more likely than not earn the necessary \$8 million future taxable income per year (\$150-160 million total) necessary to fully utilize the DTA over the applicable carry-forward period. The analysis relied, in part, on the Company's historical pre-Gateway earnings over the prior four years (\$5.5 million, \$6.0 million, \$6.8 million, and \$7.2 million for 2005-08, respectively), concluding that the Company would more likely than not earn the necessary \$8 million future taxable income per year. The memorandum recognized that excluding non-recurring write-offs of goodwill associated with Shore Bank and Gateway, HRBS had suffered \$64 million in pre-tax losses in 2009, which was "approximately double the income earned over the prior 5 years," but noted that HRBS "do[es] not expect losses to continue past 2011." Petrovich knew or should have known that the conclusions in the March 2010 memorandum were not reasonable. At the time this analysis was drafted, total loans past due had trended upward since the beginning of 2009, and total delinquent and nonaccrual loans, while slightly lower than in February 2010, remained at historically high levels.

16. On April 23, 2010, HRBS filed its Form 10-K for 2009, signed by Petrovich, which incorporated financial statements recording a DTA of \$56.38 million, including a valuation allowance of \$1.0 million established against the Company's \$2.8 million in capital loss carryforwards, but no valuation allowance relating to the remainder of the DTA, including the portion of the DTA attributable to loan losses. The March 2010 DTA memorandum reflecting HRBS's rationale for this accounting decision was substantially reproduced in the footnotes to the financial statements included in the Company's 2009 Form 10-K.

17. In May 2010, HRBS, under Petrovich's direction, updated the analysis of whether a valuation allowance was required on the DTA for purposes of HRBS's first quarter 2010 financial statements. The identification and weighing of positive and negative evidence remained substantively unchanged from the March 2010 memorandum, though the updated memorandum noted that the required annual taxable income to fully utilize the Company's DTA was now an average of \$9 million, rather than \$8 million. The May 2010 memorandum supported its conclusion that this level would likely be reached by, in part, noting that HRBS, Gateway and Shore Bank had earned a combined \$31 million in 2007, the last full year prior to the mergers. The memorandum predicted that HRBS would become profitable in 2011, and attached bank-level capital projections, also drafted by Petrovich and others under his direction, that forecasted a slight profit as of third quarter of 2011, notwithstanding the Company's internal consolidated projections less than two months prior that projected quarterly losses of at least \$7 million through 2011. Petrovich knew or should have known that the conclusions in the May 2010 memorandum were not reasonable. Internal Company reports as of late May 2010 reflected continuing deterioration of

³ The outside accounting consultant did not provide an opinion on the validity of the company's conclusions and relied on the projections and assumptions that HRBS used in performing the DTA analysis.

HRBS's loan portfolio through increasing levels of classified loans, past due loans, delinquent and nonaccrual loans, and nonperforming loans as a percentage of total loans.

18. On May 17, 2010, HRBS filed its Form 10-Q for the quarterly period ended March 31, 2010. The Form 10-Q incorporated financial statements recording a DTA of \$70.32 million, including the previously-established a valuation allowance of \$1.0 million against HRBS's \$2.8 million in capital loss carryforwards. The financial statements again established no valuation allowance relating to the remainder of the DTA, including the portion of the DTA attributable to loan losses.

19. On May 13, 2010, Petrovich informed HRBS's Board of Directors and senior management of his intention to end his employment with the Company, effective June 4, 2010. On June 4, 2010, Petrovich left HRBS.

20. On August 13, 2010, HRBS issued an amended Form 10-K/A for 2009 and an amended 10-Q/A for the first quarter of 2010, restating the financial results for those periods to reflect a valuation allowance against the entire DTA.

The Effects of HRBS's DTA On Its Reported Capitalization Levels

21. The valuation allowance against HRBS's DTA played a role in determining the Company's capitalization level, a measure that banks are required to report quarterly under bank regulations. A portion of a bank's DTA is included in its Tier 1 capital calculation. Prior to its restatement, HRBS reported that it was "adequately capitalized" as of December 31, 2009, and "undercapitalized" as of March 31, 2010. Following the restatement, HRBS changed this statement to report that it was "undercapitalized" as of December 31, 2009, and "significantly undercapitalized" as of March 31, 2010.

22. Changes in regulatory classification are material information to investors. A bank that falls below certain regulatory capital classifications can be subject to adverse regulatory actions by bank regulators that severely restrict its activities. Such activities can include the requirement that a bank that becomes "undercapitalized" submit and obtain approval of a "capital restoration plan," and may also include requiring the institution to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions by a controlling bank holding company, requiring new election of directors or dismissal of directors and officers, and requiring regulatory approval of proposed dividends or consent to consolidation or divestiture of the institution or its affiliates.

Violations

23. As a result of the conduct described above, Petrovich was a cause of HRBS's violation of Section 13(a) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-13 thereunder, which require every issuer of securities registered pursuant to Section 12 of the Exchange Act to file with the Commission accurate periodic reports, including annual reports on Form 10-K and quarterly reports on Form 10-Q, and mandate that the required reports must contain any further material information necessary to make the required statements made in the reports not misleading.

24. As a result of the conduct described above, Petrovich was a cause of HRBS's violation of Section 13(b)(2)(A) of the Exchange Act, which requires reporting companies to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect their transactions and dispositions of their assets.

25. As a result of the conduct described above, Petrovich was a cause of HRBS's violation of Section 13(b)(2)(B) of the Exchange Act, which requires issuers of securities registered pursuant to Section 12 of the Exchange Act to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles.

Undertaking

Petrovich has agreed to the following undertaking:

Petrovich shall, within 10 days of the entry of an Order, make a payment in the nature of a penalty in the amount of \$25,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Such payment shall be made in one of the following ways:

- (1) Petrovich may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) Petrovich 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) Petrovich 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

Payments by check or money order shall be accompanied by a cover letter identifying Neal A. Petrovich as a 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 Scott Friestad, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

In determining whether to accept Petrovich's Offer, the Commission has considered this undertaking. Petrovich agrees that if the Division of Enforcement believes that Petrovich has not

satisfied this undertaking, it may petition the Commission to reopen the matter to determine whether additional sanctions are appropriate.

IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Petrovich cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(b)(2)(A), and 13(b)(2)(B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 thereunder.

By the Commission.

Brent J. Fields
Secretary